CORPORATE RESCUE LAW – AN ANGLO-AMERICAN PERSPECTIVE

Gerard McCormack

Corporations, Globalisation and the Law

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CORPORATIONS, GLOBALISATION AND THE LAW

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Preface

Britain and the United States are sometimes spoken of as two countries divided by a common language. One may find some truth to this paradox in the sphere of insolvency and corporate restructuring. Americans talk of corporate bankruptcy whereas in Britain the talk is of corporate insolvency with the language of bankruptcy in the main confined to the insolvency of individuals. Moreover, Americans speak of corporations and in the UK the talk is of companies. But certainly in the corporate rescue sphere the differences are more deep-rooted than mere matters of terminology. The differences are often presented in the form of a generalisation that US law is pro-debtor and UK law is pro-creditor. US law is based on a debtor-in-possession norm whereas in the UK the norm is that of management displacement. In addition there is superficially greater secured creditor control of the restructuring process in the UK. But part of my thesis is that the traditional generalisation is, at best, a potentially misleading over-simplification. Debtor-in-possession does not necessarily mean that the management team that was responsible for the company's financial misfortunes remain in control of the business. Creditors in the US can exercise decisive influence over the restructuring process through debtor-in-possession financing agreements.

The book also offers the conclusion that there is a degree of functional convergence in practice but, at the same time, acknowledges that corporate rescue, as distinct from business rescue, still plays a larger role in the US. The functional convergence has partly come through the UK Enterprise Act 2002 but the book suggests that the main move has been that of US law and practice in a UK direction with greater emphasis on business disposals and speedier cases than on corporate reorganisations, as traditionally understood. This mirrors practice in the UK where the emphasis has always been on the rescue of businesses through disposals of profitable or potentially profitable parts of a company's operations rather than carrying on business through the vehicle of the existing corporate entity. This outlook has not changed with the Insolvency Service Evaluation Report (January 2008) on the Enterprise Act revealing that the corporate rescue outcome is achieved in very few cases. The emphasis continues to be on maximising recoveries for creditors by means of business and asset sales. US law contains certain features such as a special funding mechanism for companies in financial difficulties that might usefully be transplanted across the Atlantic if corporate rescue is

going to play a larger role in the UK and the hopes of the architects of the Enterprise Act realised.

The focus throughout the book has been on providing a critical comparative evaluation of US and UK law, incorporating relevant empirical evidence where appropriate. Developments in other jurisdictions and on the international level have not been neglected however. Part of the interest in this book may lie in providing a possible way forward for other jurisdictions or at least in illuminating the path not to follow.

Gerard McCormack
Leeds, UK
April Fool's Day, 2008

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1. Introduction

This book compares and contrasts corporate rescue (reorganisation) procedures in the UK and the US. A dedicated corporate rescue procedure has existed in the UK since the 1980s in the form of administration, or at least administration coupled with a company voluntary arrangement (CVA). In the US, corporate rescue law is much older, with the law now contained in Chapter 11 of the US Bankruptcy Code 1978. In 2002, by means of the Enterprise Act, UK law was moved in the US direction. US law in this area has traditionally been seen as very 'pro-debtor' compared with the UK, which is seen as 'pro-creditor'.[1] Part of the theme of the book is that this generalisation is, at best, a potentially misleading over-simplification. The book will ask a number of questions including the following:

1. Firstly, what values and purposes are served by reorganisation procedures? Such procedures are generally premised on the assumption that the 'going-concern' value of a business is greater than the liquidation value. The question arises, however, whether the concern of the law should simply be about creditor wealth maximisation or whether a business should be kept alive for other reasons. Related to this is the issue of the destination of the 'surplus' value that is captured during the reorganisation process. In distributing this 'surplus' value, is the law simply interested in respecting pre-insolvency legal entitlements or should a different set of interests enter into the equation during the reorganisation process?
2. Why are the mechanisms for entering the procedures different in the UK and the US and, in particular, why does the secured creditor have such a central role in the procedure in the UK but apparently not in the US?
3. Why do solvency requirements before a company can enter the reorganisation process differ in the UK and the US? There is no insolvency

[1] See the paper by Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer and Robert W Vishny (1998) 'Law and Finance' 106 Journal of Political Economy 1113, where the US is given a score of 1 for creditors' rights whereas the UK is given the maximum score of 4.

prerequisite in Chapter 11 but a case can be dismissed early if filed in bad faith or without reasonable hope of success.

4. To what extent does the stay on creditor enforcement proceedings differ between the two countries and what are the conditions for getting the stay lifted? In the US, secured creditors may succeed in having the stay lifted unless the debtor has provided them with 'adequate protection' against a decline in the value of their property interests but the question arises about how this concept is interpreted in practice. In the UK, there is ostensibly more of a discretionary approach.
5. What are the reasons for allowing the incumbent management to remain in charge of company affairs during Chapter 11 whereas in the UK responsibility is entrusted to an outside insolvency practitioner? The difference has often been ascribed to a difference in entrepreneurial culture between the two countries, with many in Britain associating business failure with personal fault and stigma whereas in the US, business failure is often seen as one of the vicissitudes of fortune. But how convincing are these attributions?
6. Unlike in England, there is a specific provision in Chapter 11 to deal with financing of companies undergoing reorganisation – 'DIP' financing. Super-priority new financing is even permitted if the debtor can show such a loan is a condition of obtaining new financing and existing secured creditors are adequately protected against loss. The opportunity to introduce a similar procedure in the UK has however been rejected and the research will explore the reasons for this.
7. To what extent can a reorganisation plan be made binding on creditors (including secured creditors) against their wishes? In the US every impaired class of creditors must approve the plan though 'cramdown', which means confirmation of a plan despite creditor objections is possible. Generally, a secured class may be crammed down if it receives the value of its collateral, plus interest, over time, while an unsecured class may insist that shareholders receive nothing if a plan is to be approved over its objection. Objecting creditors are protected by the 'best interests' test under which each objecting creditor must receive at least as much under the plan as it would in liquidation and also by a 'feasibility test' which requires that the debtor should be reasonably likely to be able to perform the promises it made in the plan. In the UK there is no facility for 'cramdown'. I will endeavour to ascertain to what extent 'cramdown' is used in the US and ask whether the differences between the two countries in this respect are more subtly nuanced than would initially appear.

The first set of questions looks at the justifications for having corporate

rescue laws[2] and also at the philosophy behind such laws. Most people might say that corporate rescue is all about maintaining going-concern value, in that the value of a company's business operations is likely to be far greater than the scrap value of its assets.[3] They may be nonplussed, however, if asked to explain why going-concern value is likely to be greater than the liquidation value of assets. This chapter looks in more detail at the concept of going concern value. It then considers whether a company should be kept alive for reasons other than the preservation of going-concern value. In other words, are there wider purposes served by corporate rescue laws?

This leads into a discussion of the various academic theories offered up to justify the existence of corporate rescue laws and which are also used to critique such laws. Finally, the discussion returns to the legislative record in both the US and the UK and to a consideration of the factors that influenced both the enactment and content of Chapter 11 and the administration procedure in the UK.

GOING-CONCERN VALUE

In the UK, administration can be contrasted with liquidation. Liquidation of a company involves the cessation of its business, the realisation of its assets, the payment of its debts and liabilities, and the distribution of any remaining assets to the members of the company. At the end of the liquidation process, a company is wound up and ceases to exist. Administration, or administration coupled with a CVA, by contrast, is designed primarily as a rescue procedure aimed at facilitating the survival of the company's business either in whole or in part. The legislation states that an administrator must perform his/her functions with the objective of (a) rescuing the company as a going concern, or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors.[4] The statute sets out this hierarchy of objectives. An

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[2] One may define 'rescue' pragmatically as a major intervention necessary to avert corporate failure – see Alice Belcher *Corporate Rescue* (London, Sweet & Maxwell, 1997) at p 36. See also A Belcher 'The Economic Implications of Attempting to Rescue Companies' in H Rajak ed *Insolvency Law: Theory and Practice* (London, Sweet & Maxwell, 1991) at p 235.

[3] 'The premise of a business reorganisation is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap' – HR Rep No 595, 95th Congress, Ist Sess 220 (1977).

[4] Insolvency Act 1986 Schedule B1 para 3(1). An administrator must also perform his/her functions in the interests of the company's creditors as a whole.

administrator can only move from one objective to another if s/he thinks that it is not reasonably practicable to achieve a preceding objective. The administrator, however, is obliged to move from (a) to (b) if s/he thinks that (b) would achieve a better result for the company's creditors as a whole.[5]

The underlying principle behind restructuring or reorganisation proceedings is that a business may be worth a lot more if preserved, or even sold, as a going concern than if the parts are sold off piecemeal.[6] In other words, there is a surplus of going-concern value over liquidation value.[7] In the UK, the DTI review of company rescue and business reconstruction mechanisms[8] has spoken of:

> a growing sense that, in many cases, rescue or reconstruction, whether informal or moderated through formal insolvency procedures, probably benefits everyone involved with a company and its business more than a liquidation. The basis of this belief is that the 'fire sales' of assets that accompany such terminal procedures as liquidation inevitably reduce the values obtained whereas creditors will, over time, receive a better return where the company survives as a 'going concern'.

In the US, as one court put it, 'the purpose of [Chapter 11] is to provide a debtor with the legal protection necessary to give it the opportunity to reorganize, and thereby to provide creditors with going-concern value rather than the possibility of a more meagre satisfaction of outstanding debts through liquidation [under Chapter 7 of the Bankruptcy Code].'[9] Influential US commentators have reduced the liquidation versus reorganisation question to a quasi-mathematical formula. It has been suggested that whether a company should be kept together as a going-concern is answered by estimating the

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5 Ibid para 3(4).

6 For a somewhat sceptical perspective see Douglas G Baird and Robert K Rasmussen 'The End of Bankruptcy' (2002) 55 Stan L Rev 751 at 758: 'We have a going-concern surplus (the thing the law of corporate reorganizations exists to preserve) only to the extent that there are assets that are worth more if located within an existing firm. If all the assets can be used as well elsewhere, the firm has no value as a going-concern.' Richard V Butler and Scott M Gilpatric see 'going-concern surplus' more broadly in 'A Re-Examination of the Purposes and Goals of Bankruptcy' (1994) 2 American Bankruptcy Institute Law Review 269 at 282 – 'part of the going-concern surplus represents the value to the firm of the relationships which it has established with factor owners. The rest reflects the value to it of its relationships with customers, regulators, and other interested parties.'

7 Omer Tene 'Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganisations' (2003) 19 Bankruptcy Developments Journal 287.

8 London, DTI, 2000 at p 5.

9 *Canadian Pacific Forest Products Ltd v JD Irving Ltd* (1995) 66 F 3d 1436 at 1442.

income stream that the assets would generate if they were kept together, taking into account the risk of reorganisation failure, discounting that stream to present value, and comparing it to the amount that the assets would realise if they were sold off in separate pieces.[10]

Since going-concern value may be a lot more than the value of a business on a break-up basis, reorganisation proceedings are designed to keep the business alive so that this additional value can be captured.[11] This objective is itself controversial for there is a widely held view that if a company encounters economic difficulties the simplest and most effective solution is to put it out of its misery, so to speak, by terminating its existence. If a business is no longer viable then the most sensible solution may be to shut it down.[12] If a company is producing goods and services for which there is no ready market then why leave it in existence? For example, take the case of a dog food company that is producing food that the dogs do not like. There seems little gain in keeping such a company alive.[13] Moreover, preserving dying companies or putting them on a life support and resuscitation machine may do little to benefit the industry in which they operate. Instead, it may leave competitors

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[10] See DG Baird and TH Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment of adequate protection of secured creditors in bankruptcy' (1984) 51 U Chi Law Review 97 at 109. See also Thomas H Jackson *The Logic and Limits of Bankruptcy Law* (Cambridge MA, Harvard University Press, 1986) at p 184. For a European perspective see Horst Eidenmueller 'Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers' [2006] European Business Organization Law Review 239 at 241–242.

[11] But see Charles W Adams 'An Economic Justification for Corporate Reorganizations' (1991) 20 Hofstra L Rev 117 at 133 '[M]ost assets are probably not firm-specific, and so, most insolvent corporations will not have substantially greater going concern than liquidation values and, consequently, will not be good candidates for an effective reorganization.'

[12] For a different view of Chapter 11 see Lynn M LoPucki 'The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code?' (1983) 57 American Bankruptcy Law Journal 99 at 114: 'Congress has asserted that "the purpose of a reorganization . . . case is to formulate and have confirmed a plan of reorganization . . ." It is likely that only a few of the debtors studied came to Chapter 11 for this purpose. A large majority of them entered Chapter 11 with one or more of their creditors in hot pursuit, and filing was probably the only way they could remain in business or avoid liquidation. Their focus, quite naturally, was on short term survival, and only later, if at all, would a substantial number of them turn their attention to the long range prospects for their businesses.'

[13] See generally Michelle J White 'Does Chapter 11 Save Economically Inefficient Firms' (1994) 72 Wash U LQ 1319; 'The Corporate Bankruptcy Decision' (1989) 3 J Econ Persp 129; James J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139.

suffering by forcing them to compete with debt-reduced and reorganised, but ultimately inefficient, companies in crowded markets. In this regard, American commentators have highlighted the example of Eastern Airlines in the early 1990s where, in a desperate attempt to win back lost customers, Eastern offered a number of discount fares that priced its services below cost.

> Such a strategy made sense for the insolvent airline because getting passengers back was Eastern's only hope to emerge from bankruptcy as a viable entity. Unfortunately, these low fares induced other airlines to reduce their fares, thus generating losses at these other airlines as well. The slow death of Eastern thus compounded the losses of both Eastern's creditors and its competitors.[14]

After all, one of the principal characteristics of a market economy is that some companies fall by the wayside, and forcing investors to keep their assets locked up in what is, at best, a marginal enterprise may prevent these investors from making more productive use of their assets in a more efficient enterprise. It also may reduce their incentive to invest, rather than consume, those assets in the first place. Moreover, the effect of keeping open a business in a particular town may be to prevent a potentially more profitable business in a different town from opening.[15]

GOING-CONCERN VALUE AND THE MODERN SERVICE SECTOR-ORIENTED ECONOMY

It has been suggested that, with changes in the nature of advanced economies and the disappearance of heavy industry, corporate restructurings may have less of a role to play than previously, if any role at all.[16] This thesis has been advanced in the American context by Professors Baird and Rasmussen, who argue that because of economic changes and, in particular, technological advances, globalisation and the rise of the service sector, corporate reorganisations as traditionally understood are coming to an end.[17] In their view: 'To

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[14] See Robert K Rasmussen 'The Efficiency of Chapter 11' (1991) 8 Bankruptcy Developments Journal 319 at 320–321.

[15] See Baird and Jackson (1984) 51 U Chi L Rev 97 at 102.

[16] DG Baird and RK Rasmussen 'Chapter 11 at Twilight' (2003) 56 Stanford Law Review 673 and DG Baird and RK Rasmussen 'The End of Bankruptcy' (2002) 55 Stan L Rev 751.

[17] One study suggests that in 2002, in more than 80 per cent of all large Chapter 11s, the companies concerned used the process to sell off their assets rather than to reconstruct their debts in the traditional way – see Baird and Rasmussen 'Chapter 11 at Twilight' at 674.

the extent we understand the law of corporate reorganizations as providing a collective form in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, we may safely conclude that its era has come to an end.'

They point to the decline of heavy industry and make the point that successful companies today are not very much like the railways of the nineteenth century. In the case of a railroad company, the assets of the firm had very little value when sold off individually – nothing but a streak of rust iron in the prairie, to use a memorable phrase. In the case of a modern capital the most valuable resource may be human capital. The most valuable assets may walk out the door at five or six o'clock in the evening. The accoutrements of the modern office may have just as much value if sold off to another firm than if kept by the debtor: 'There is no special magic beyond transaction costs in accounting for any particular collection of assets assembled within a single firm.'

In the real world however, transaction costs cannot be ignored. Perhaps Baird and Rasmussen overstate their case.[18] Transaction costs are all around us. They exist in almost every move of daily life. Going-concern value resides principally in various relationships 'among people, among assets, and between peoples and assets'.[19] It is tough to start a business from scratch. Networks of relationships are at the heart of a modern business. Costs incurred in creating most of these necessary relationships will inevitably be lost if the business is scattered to the winds through a piecemeal sale of assets. Substantial additional costs will be incurred in the establishment of new relationships and the starting up of a business afresh. Moreover, centralised management, and other benefits from economies of scale, can be the source of going-concern value.[20]

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[18] Even Professor Baird himself seems to acknowledge this implicitly – see the discussion in *Elements of Bankruptcy* (New York, Foundation Press, 4th ed, 2006) at pp 229–235 and see the comment at p 235: 'The players in a large corporate reorganization, even those that most resemble the nineteenth-century railroad, no longer see a Hobson's choice between a sale in an illiquid market or a costly reorganization. Instead, they see the choice as one between selling the business to other investors in a developed, but not perfect, market or keeping it themselves in a proceeding that has become cheaper and easier to control over time.'

[19] L M LoPucki 'The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy' (2003) 56 Stan L Rev 645.

[20] See H Miller and S Waisman 'Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?' (2004) 78 Am Bankr LJ 153 at 192–193. 'Starting a business from scratch is expensive and time-consuming and entails a large degree of entrepreneurial risk.' Miller and Waisman also make the point that the flurry of recent mergers and acquisitions activity and the move towards consolidation across many industries suggests that there are benefits that cannot be obtained by simply contracting with the marketplace.

These points have been well made by the Legal Department of the International Monetary Fund (IMF), who go so far as suggesting that changes in the nature of the economy have meant that restructuring of ailing firms has become more important than ever before:

> [I]n the modern economy, the degree to which an enterprise's value can be maximized through liquidation of its assets has been significantly reduced. In circumstances where the value of a company is increasingly based on technical know-how and goodwill rather than on its physical assets, preservation of the enterprise's human resources and business relations may be critical for creditors wishing to maximize the value of their claims.

Simply stated, some companies are worth more as going-concerns run by existing managers and with existing shareholders than if sold to third parties and managed by new teams.[21] The going-concern surplus may result from the informational advantages of existing management or from the sunk costs of arranging assets in strategic blocks. The surplus has to be substantial, however, to justify the very substantial administrative, negotiating and legal costs of the reorganisation proceedings themselves.[22]

In the US context, on the other hand, the world of Chapter 11 has changed such that there is now a much greater emphasis on market sales rather than reorganisations in the traditional sense.[23] But, contrary to the position that might have appeared during the fall-out from the bursting of the bubble in technology-related shares in 2001/2002, traditional reorganisations have not completely disappeared. There is empirical evidence that reorganisation remains essential for dealing with distressed large public companies.[24] Commentators have compared the prices for which 30 large public companies were sold with the values of 30 similar companies that were reorganised in the 2000/2004 period. It was found that companies sold for a 35 per cent average of book value but reorganised for an average fresh value of 80 per cent of book value. Moreover, the average market capitalisation value as determined by post-reorganisation market trading was 91 per cent of book value. 'Even controlling for the differences in the prefiling earnings of the two sets of companies, sale yielded only half of reorganization value. These results

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[21] See D Baird and R Picker 'A Simple Noncooperative Bargaining Model of Corporate Reorganizations' (1991) 20 J Legal Studies 311 at 315.

[22] Robert Clark 'The Interdisciplinary Study of Legal Evolution' (1981) 90 Yale Law Journal 1238 at 1254.

[23] See Douglas G Baird 'The New Face of Chapter 11' (2004) 12 American Bankruptcy Institute Law Review 69 at 71.

[24] Lynn M LoPucki and Joseph W Doherty 'Bankruptcy Fire Sales' (2007) 106 Michigan Law Review 1 at pp 3–4.

suggest that creditors and shareholders can nearly double their recoveries by reorganizing large public companies instead of selling them.'

Other empirical evidence from the US suggests that Chapter 7 liquidations offer little advantage over Chapter 11 reorganisations. They take almost as long to resolve, require similar fees and 'in the end provide creditors with lower recovery rates – often zero – than a comparable Chapter 11 procedure.'[25]

ECONOMIC DISTRESS VERSUS FINANCIAL DISTRESS

In commenting on the value of corporate rescue laws it is common to draw a distinction between economic distress and financial distress. Economic distress implies that the business plan is not working. The economic model on which the company is grounded suffers from some flaws. Companies in economic distress are not good candidates for reorganisation unlike companies in financial distress. Financial distress implies liquidity problems of some sort and where a company cannot meet its current liabilities. This may have been caused by some short-term dislocations in market conditions. The bankruptcy of a customer may have affected the company's capacity to honour its commitments to its own suppliers. The company may have been trading across national frontiers and been badly caught out by currency fluctuations. Alternatively, debt-servicing costs may have risen sharply beyond the company's capacity to service them.[26] In the latter scenario an obvious solution (if difficult to achieve in practice) would be to convert some or all of the company's debt into equity. The necessary consent from creditors may not be forthcoming however and so recourse to formal procedures is necessary to concentrate minds sufficiently.

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[25] See Arturo Bris, Ivo Welch and Ning Zhu 'The Costs of Bankruptcy: Chapter 7 Liquidations vs Chapter 11 Reorganizations' (2006) 61 Journal of Finance 1253 at 1301. See also on Chapter 11 outcomes the bankruptcy research database compiled by Professor Lynn LoPucki available at http://lopucki.law.ucla.edu/.

[26] See Richard Posner *Economics Analysis of Law* (New York, Aspen, 6th ed, 2003) at p 421: '. . . the firm may find that its revenues do not cover its total costs, including fixed costs of debt. But they may exceed its variable costs, in which event it ought not be liquidated yet. And maybe in the long run the firm could continue in business indefinitely with a smaller plant. In that event it might not have to replace all of its debt when that debt was retired, its total costs would be lower, and its (lower) demand and (lower) supply curves might once again intersect. In short, the company may have a viable future, short or long, which it can get to if it can just wipe out its current debt. One way of doing this is to convert that debt into equity capital, at which point the debt will cease being a fixed cost and thus cease preventing the company form meeting its other expenses.'

While the distinction between economic distress and financial distress may be a useful analytical tool, it may also be a bit blunt at times. The two concepts seem to shade into one another. Although financially distressed businesses are not necessarily in economic distress, a business model that is not working can easily generate liquidity problems and the failure to meet debt-servicing obligations.[27]

FORMAL AND INFORMAL RESCUE

As is made clear throughout this book the emphasis in practice in the UK is on business rescue rather than corporate rescue. Corporate rescue may be achieved through administration coupled with a CVA but this is the outcome in only a small minority of administrations.[28] Chapter 11s are more likely to result in a confirmed plan of reorganisation.[29]

At least in the British context, there is the widespread view that the value of a company is best preserved through informal restructuring or reorganisation procedures.[30] The commencement of formal proceedings may cause a

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[27] See generally on the distinction and its usefulness Gregor Andrade and Steven N Kaplan 'How Costly is Financial (No Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed' (1998) 53 Journal of Finance 1443 and also Douglas G Baird 'Bankruptcy's Uncontested Axioms' (1998) 108 Yale LJ 573 at 580–583.

[28] See the empirical study 'Report on Insolvency Outcomes' – a paper presented to the Insolvency Service by Dr Sandra Frisby which is available on the Insolvency Service website – www.insolvency.gov.uk. This reports (at p 63) a 'general view that the only genuine rescue mechanism is the CVA within the protection of administration. Of those rescue outcomes recorded on the database all but two involved CVAs within administration, which would appear to support that view.'

[29] See generally Chapter 3 and in particular Professor Lynn LoPucki's bankruptcy research database – http://lopucki.law.ucla.edu. Professor LoPucki's book *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* (Ann Arbor, University of Michigan Press, 2005) in Chapter 4 'Failure' contains an extensive account of Chapter 11 plan confirmation rates and refilling rates – see, for example, the tables on pp 100, 101, 113 and 120. Professor Theodore Eisenberg in 'Business Insolvency Law: Creating an Effective Swedish Reconstruction Law' (Stockholm, Centre for Business Policy Studies, Occasional Paper No 75, 1995) reports that US Chapter 11 plan confirmation rates decrease with company size: the rate is 96 per cent for companies with assets greater than $100m, 36 per cent for companies with assets between $1m and $100m and 20 per cent for firms with less than $1m in assets.

[30] See A Tilley 'European Restructuring: Clarifying Trans-Atlantic Misconceptions' [2005] Journal of Private Equity 99 at 102: 'European restructuring is

loss of customer confidence and the disruption of business operations. The importance of achieving the survival of the company without recourse to formal procedures has also been linked to broader social and governmental trends about auditing performance more actively and adopting proactive risk management strategies. Corporate actors are encouraged to see corporate decline as a matter to be anticipated and prevented rather than responded to after the event.[31]

PRIVATE WORKOUTS IN THE US

Out-of-court workouts are common on both sides of the Atlantic, though the ease by which debtors can make use of Chapter 11, and the advantages that Chapter 11 brings, have probably reduced their importance in the US.[32] But even in the US it has been suggested that there are often clear advantages in preserving enterprise value by the parties seeking a consensus before a formal Chapter 11 filing. It is perhaps only in situations that are too complex for the stakeholders to reach a negotiated consensus or where the rejection of, what the Americans term, 'onerous legacy costs' is crucial that the formal process is used. These are the practicalities that drive the selection of the appropriate process in a particular case.[33] Empirical study suggests that

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still best achieved out of administration, and with the exception of the U.K. among the major economies, is still inflexible, bureaucratic, and value destructive. For this reason international practitioners favour the U.K. as a jurisdiction should a choice be available.' See also on the US/European contrast C Pochet 'Institutional Complementarities within Corporate Governance Systems: A Comparative Study of Bankruptcy Rules' (2002) 6 Journal of Management and Governance 343; M Brouwer 'Reorganization in US and European Bankruptcy Law' (2006) 22 European Journal of Law and Economics 5, and see generally Alice Belcher *Corporate Rescue* (London, Sweet & Maxwell, 1997) at pp 116–142.

[31] See V Finch 'The Recasting of Insolvency Law' (2005) 68 MLR 713, and see also V Finch 'Doctoring in the Shadows of Insolvency' [2005] JBL 690.

[32] See S Gilson 'Managing Default: Some Evidence on How Firms Choose between Workouts and Chapter 11' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) p 308.

[33] For an argument that the distinction between in-court, and out-of-court, restructuring has become meaningless from a governance perspective see Ethan S Bernstein 'All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress' (2006) 11 Stanford Journal of Law, Business and Finance 298. This paper suggests that in 2001 filing for bankruptcy did not change the role of CEO turnover when one controls for financial condition. The shadow of bankruptcy has lengthened making bankruptcy law a central tenet of governance policy regardless of whether a Chapter 11 petition is ever filed.

private restructuring is generally the preferred method of dealing with debtor default.[34]

Many, if not all, leading banks will have workout divisions. In the US, the machinations of workout bankers have been famously and scatalogically described in the Tom Wolfe novel *A Man in Full*,[35] though more neutrally they are also depicted thus:

> In marketing they're incentivized to think of charm and customer satisfaction as value-adding strategies, but not in the workout department. What we're dealing with now is a division of the bank that has a very narrow niche focus. . . . At the end of the day they know they're going to be judged by only one thing: how much money they recover for the bank. . . . Down in Texas after the oil crash and all the bankruptcies, the workout people the banks sent in were so niche-focused on that one thing, they started getting death threats.

The choice between a private workout and formal bankruptcy proceedings has an obvious parallel with the decision whether or not to litigate or to settle the matter privately out of court.[36] If settling privately is appreciably less expensive and/or less time consuming then the parties have an incentive to settle out of court. Nevertheless, if the parties are unable to agree on how to split the cost savings then they will end up in court even though the combined wealth of both parties will be less as a result.

The fact that frequent attempts are made to restructure debt privately indicates that workouts are less costly on average than Chapter 11 and this analysis accords with one's intuition. Lawyers and investment bankers tend to charge professional fees on an hourly basis and these fees will increase with the length of time that is spent on negotiations with creditors. Private workouts should be of shorter duration than Chapter 11 restructurings in part because a company need only deal with creditors whose claims are in default rather than with all creditors as is the case under Chapter 11. Moreover, Chapter 11 imposes procedural demands on company managers and this will normally serve to prolong proceedings.

A direct comparison on costs between Chapter 11 and private workouts is difficult however, because companies are not required to report the costs of the latter. In addition, calculating the costs of Chapter 11 proceedings has been

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34 For a now somewhat dated study see S Gilson, K John and L Lang 'Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default' (1990) 27 Journal of Financial Economics 315.

35 New York, Bantam Books, 1999 at p 71.

36 See S Gilson 'Managing Default: Some Evidence on How Firms Choose between Workouts and Chapter 11' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) p 308.

described as measurement sensitive, depending on whether one works on the basis of means or averages or whether one looks to pre-filing or post-filing estimates of corporate value.[37] Moreover, a significant number of Chapter 11s start off life as private workouts with companies attempting to reorganise informally. These end up in Chapter 11 when attempts to achieve consensus break down.

The available empirical evidence indicates that both shareholders and creditors are better off when debt is restructured privately than through Chapter 11.[38] Recovery rates for creditors are higher and, in addition, shareholders, typically, are allowed to retain a significantly higher percentage of the equity in workouts than in Chapter 11. In corporate bankruptcy, the so-called absolute priority principle mandates that all classes of creditors should be paid in full before shareholders receive anything. The fact that creditors are prepared to concede greater deviations from the absolute priority principle in private workouts indicates the greater benefits that come to them through avoiding Chapter 11. Creditors are willing to allow shareholders to have a bigger proportion of the cake and this suggests that the overall cake must be that much greater to compensate creditors for the share that they are giving up.

Another finding is that private restructurings are more likely to succeed when a higher proportion of the company's debt is owed to commercial banks and other 'sophisticated' investors such as insurance companies.[39] These 'sophisticated' creditors are more likely to recognise the potential benefits of private restructuring than trade creditors. The latter are generally less predisposed to settle their claims. Private workouts become easier when debt is concentrated rather than when a high volume of claims is held by trade creditors. Companies with a greater proportion of trade credit will tend to have recourse to Chapter 11. The rise of distressed-debt trading by vulture funds who buy up trade debt at steep discounts may, in fact, have facilitated debt restructurings.[40] Distressed-debt traders, while playing 'hard ball' on occasions, will also be anxious to reap a prompt return on the investment and see the advantages in private settlement rather than complicated court proceedings.[41]

Workouts function better when the creditors are fewer in number and the

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[37] See Arturo Bris, Ivo Welch and Ning Zhu 'The Costs of Bankruptcy: Chapter 7 Liquidations vs Chapter 11 Reorganizations' (2006) 61 Journal of Finance 1253.

[38] See J Franks and W Torous 'A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations' (1994) 35 Journal of Financial Economics 349.

[39] Ibid at 366.

[40] See B Betker 'The Administrative Costs of Debt Restructuring: Some Recent Evidence' (1997) 26 Financial Management 56.

[41] See generally Harvey R Miller and Shai Y Waisman 'Is Chapter 11 Bankrupt' (2005) 47 Boston College Law Review 129 at 152–154.

capital structure of the company is comparatively straightforward. An increase in the number of creditors adds to the likelihood that any one creditor will hold out and thus make disputes among creditors more likely. Complex capital structures also generate difficulties in terms of putting a value on claims and disagreements amongst creditors over whether they are being treated fairly, relative to other creditors or shareholders.

In certain circumstances, recourse to Chapter 11 may have certain advantages over private workouts. For instance, a successful workout is dependent on a high level of creditor consensus. If a high proportion of creditors agree to a restructuring plan then there may be enough spare cash or leverage to buy out the dissenters, but if the hold-outs are too great then this option ceases to be a practical possibility. If too many creditors engage in holdouts then the whole project is endangered by this strategic behaviour.[42] The Chapter 11 super-majority voting and cramdown rules can overcome holdouts.[43] Chapter 11 also contains a stay on creditor enforcement actions which stops a creditor from calling in its debt or enforcing security while restructuring negotiations are in progress.[44] The provisions in Chapter 11 for super-priority new finance may also alleviate some funding problems that an ailing company may face.[45] Moreover, Chapter 11 contains a mechanism for the rejection of collective bargaining agreements already negotiated by the company and for cuts to be made to retiree health care benefits.[46] In other words, a company can shed some of its employment costs in Chapter 11. In American jargon these are onerous legacy costs for rustbelt industries. Wage levels and health benefits must be forced downwards to cope with foreign competition and changes in the nature of the economy. These issues are addressed in more detail in Chapter 7. There is nothing directly equivalent in UK administration, but as one commentator remarks:[47] 'New pensions legislation could be seen to be encouraging a move into UK administration to deflect under-funding liabilities to a proposed Government-legislated but industry-funded contingency fund. Legacy issues are not just a preserve of US airlines, it seems.'

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42 See Horst Eidenmueller 'Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers' (2006) 7 European Business Organization Law Review 239 at 254–255 who suggests the imposition of cooperation duties on creditors.

43 S 1129 of the Bankruptcy Code.

44 S 362.

45 S 364.

46 Ss 1113 and 1114.

47 See A Tilley 'European Restructuring: Clarifying Trans-Atlantic Misconceptions' [2005] Journal of Private Equity 99 at 102.

PRE-PACKS

In the US, in the early 1990s there were some obstacles hindering out-of-court restructurings in the shape of an unfavourable judicial ruling and a change in the tax code that penalised out-of-court debt forgiveness. These hindrances were eventually overcome[48] but, in the meantime, 'pre-packs' developed as a response.[49] The rise and development of 'pre-packs' – both pre-packaged Chapter 11s and pre-packs in the context of administrations are discussed more fully in later chapters. Suffice it to say here that pre-packs aim to combine the speed, flexibility, and some of the cost advantages, of out-of-court restructuring with the facility for overcoming 'hold-outs' among minority creditors that Chapter 11 or administration offers. They are one solution to the hold-out problem. The pre-packaged Chapter 11 or administration is more or less a done deal before it formally begins with the main steps being choreographed in advance and then recourse is had to the formal procedure to carry them through. There are mixed views on pre-packs. According to one study:[50]

> On most measures considered, prepacks lie between out-of-court restructurings and traditional Chapter 11 reorganizations. Accordingly, it is tempting to conclude that a prepack is a more efficient mechanism for resolving financial distress than a traditional Chapter 11 reorganization, but less efficient than out-of-court restructuring. Unfortunately, because the firms in our sample have *chosen* to reorganize by means of a prepack (presumably because that represents the most efficient form of reorganization for the firm), that conclusion is unwarranted. Thus, our study, like those that precede it, is unable to resolve the question of whether one form of reorganization is more efficient than another.

Other assessments would suggest that possible efficiency gains are more than cancelled out by loss of valuable protections for minority creditors and shareholders

WORKOUTS IN THE UK

In the UK, an important empirical study preceding the Enterprise Act has

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[48] See B Betker 'An Empirical Examination of Prepackaged Bankruptcy' (1995) 24 Financial Management 4 and see also A Belcher *Corporate Rescue* at p 125.

[49] See J McConnell and H Servaes 'The Economics of Pre-packaged Bankruptcy' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) p 322.

[50] See generally E Tashjian, RC Lease and JJ McConnell 'Prepacks: An Empirical Analysis of Prepackaged Bankruptcies' (1996) 40 Journal of Financial Economics 135 at 137.

highlighted the existence of an elaborate rescue process outside formal procedures.[51] According to this study:

> About 75% of firms emerge from rescue and avoid formal insolvency procedures altogether (after 7.5 months, on average). Either they are turned-around or they repay their debt by finding alternative banking sources. . . . Turnarounds are often accompanied by management changes, asset sales, and new finance or directors' guarantees. There is evidence that these changes significantly influence the bank's response and the likelihood of a successful outcome.

Leading lenders may be able to use their leverage to force distressed companies to restructure, whether by means of downsizing, management replacement or otherwise. Moreover, the willingness of the company to restructure is significantly related to the size of debt repayments demanded by the bank. During the restructuring period however, the evidence also indicates that the exposure of the bank is substantially reduced whereas the debts due to trade and other creditors tend to expand. Trade creditors bear the major part of the risk associated with the restructuring process as they do not share the bank's knowledge of the company's financial position and their lending is unsecured.

In the 1980s, the Bank of England developed a set of principles – the 'London Approach' – for multi-lender corporate workouts and these guidelines became public by means of publications from Bank officials. The Bank of England's interest in corporate workouts stemmed from its core responsibilities relating to the maintenance of financial stability and the promotion of an effective and efficient financial system.[52] The 'London Approach' involved a willingness by the main creditors to consider a non-statutory resolution of a company's financial difficulties, the commissioning of an independent review of the company's long-term viability and the operation of an informal morato-

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[51] See J Franks and O Sussman 'The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies' (2000). This study was sponsored by the DTI/Treasury Working Group on Company Rescue and Business Reconstruction Mechanisms. See also Cook, Pandit and Milman 'Formal Rehabilitation Procedures and Insolvent Firms: Empirical Evidence on the British Company Voluntary Arrangement Procedure' (2001) 17 Small Business Economics. See also the policy document 'Banks and Businesses Working Together' from the British Bankers Association website – www.bba.org/.

[52] On the 'London Approach' see generally P Brierley and G Vlieghe 'Corporate Workouts, the London Approach and Financial Stability' [1999] Financial Stability Review 168; P Kent 'Corporate Workouts – A UK Perspective' (1997) 6 International Insolvency Review 165; J Flood, R Abbey, E Skordaki and P Aber *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach* (1995) ACCA Research Report No 45.

rium on creditor enforcement procedures during the review period. The main creditors try to arrive at a joint view about whether, and on what terms, the company is worth supporting on a long-term basis and a coordinating, or lead, bank may be designated to facilitate these discussions. Generally, the lead bank will be the bank with the largest exposure to the company and it is usually also the bank with whom the company has its main banking relationship.

Creditors form a steering committee and this constitutes a forum to which some decisions by lenders can be delegated. During the review period, the existing credit facilities are maintained in place by the lenders and, in addition, they may provide supplemental lending if there is a need for further liquidity support. This new finance may come from one or more of the existing lenders and normally assumes priority over existing exposures. If the company is deemed to be viable on a long-term basis by the financial review and there is support for this among creditors, then the creditors will consider longer-term arrangements such as extending loan repayment periods, providing additional financial support or converting debt into equity. Creditors may also be asked to consider a so-called 'haircut', i.e. an element of debt forgiveness. As a condition of gaining the cooperation and support of its creditors, the company will usually have to implement an agreed business plan and this may entail management changes, the sale of assets or divisions, or even the acceptance of a takeover bid.

The role of the Bank of England may have diminished in multi-creditor corporate workouts, if indeed it ever played a significant role at all apart from acting as a general 'honest broker'. The rise of hedge funds, debt trading and the general fragmentation of the financial markets has caused perceptions of the Bank's role to alter but nevertheless, all market participants are acquainted with the fact that a company with its business operations intact is much more valuable than a company whose customers have fled elsewhere on the commencement of formal proceedings.[53]

In the US there has been nothing equivalent to the semi-official status of the London Approach for multi-lender debtor workouts but a shared set of expectations among lenders towards debtor default undoubtedly exists based on a community of interests.

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[53] See generally J Armour and S Deakin 'Norms in Private Bankruptcy: the "London Approach" to the Resolution of Financial Distress' [2001] Journal of Corporate Law Studies 21.

PRIVATE WORKOUTS – AN INTERNATIONAL PERSPECTIVE

On the international level, INSOL, an international organisation of insolvency practitioners, has developed a statement of principles for multi-lender debtor workouts.[54] While not reproducing the exact detail and somewhat more limited in nature, the statement of principles reflects the broad thrust of the London Approach.

The IMF in its study of insolvency and debtor protection regimes has acknowledged the importance that informal restructuring mechanisms can play in a holistic approach towards corporate insolvency.[55] Nevertheless, it stressed that informal procedures were not, for a number of reasons, the exclusive answer to corporate distress. For a start, out-of-court procedures required the unanimous consent of creditors, which was not always available given the scope for prisoners' dilemma-type game playing. Secondly, it was important to encourage recourse to the restructuring option at an appropriately early stage – before it was too late – and formal procedures could be designed with this objective in mind. Thirdly, 'economic efficiency is not the only consideration when designing insolvency laws'. Formal procedures could provide the opportunity to investigate corporate misbehaviour, reverse questionable transactions and investigate the causes of the debtor's financial failure.

Informal 'rescues' are clearly not the perfect solution for every economic ill of a company.[56] There is the hold-out problem and moreover, private rescues may narrow the focus too much onto the immediate concerns of the company and its bank creditors. Other constituencies may deserve a say in the restructuring process. Formal procedures can bring these interests into play in a way that informal procedures do not.

WIDER PURPOSES SERVED BY CORPORATE RESCUE LAWS

In many jurisdictions, including the US and UK, discussion of the purposes served by corporate rescue laws has ranged beyond a narrow focus on the going-concern surplus over liquidation value of company assets.[57] This

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54 See the INSOL website – www.insol.org/.

55 *Orderly & Effective Insolvency Procedures: Key Issues* (Washington, IMF, 1999) at pp 13–15.

56 See Alice Belcher *Corporate Rescue* at p 127.

57 See, for example, Karen Gross *Failure and Forgiveness: Rebalancing the*

perspective emerges from a consideration of the US Congressional record on the Bankruptcy Code: 'The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors and provide a return for its stockholders.'[58]

Outside the congressional context, Chapter 11 has even been spoken of as bound up with the preservation of the American way of life. The argument is that Chapter 11 provides the opportunity for the small business debtor to survive economic upheaval and to remain in existence business-wise. If jobs in small business enterprises disappear, then competition and convenience may disappear with them.[59]

In the UK, the DTI review of company rescue and business reconstruction mechanisms[60] referred to the fact that:

> many countries have enacted changes to their insolvency law in an attempt to reduce the number of businesses and companies that are liquidated. Generally this has been done in order to ameliorate the consequences of the unfettered operation of the market (e.g. where the pursuit by creditors of their own individual interests would have led to the liquidation of businesses and companies.) And in particular (but not exclusively) where there are substantial implications for employment (i.e. to save jobs).

These themes have also been taken up by the IMF,[61] which has spoken of corporate rehabilitation procedures as serving a broader societal interest in that business debtors are given a second chance, thereby encouraging the growth of the private sector and an entrepreneurial class. More general, the IMF has acknowledged that:[62]

Bankruptcy System (New Haven, Yale University Press, 1997) and see also E Warren and JL Westbrook 'Contracting out of Bankruptcy: An Empirical Intervention' (2005) 118 Harvard Law Review 1197 at 1200–1201 who suggest that the current insolvency regimes limit 'the collection rights of each creditor individually in order to promote a somewhat more efficient liquidation or reorganization for the benefit of all concerned. This is accomplished by shrinking the collection rights of the most powerful creditors in order to achieve somewhat greater distribution among all those who have a stake in the debtor'.

58 HR Rep No 595, 95th Congress, Ist Sess 220 (1977).

59 James B Haines and Philip J Hendel 'The Future of Chapter 11: No Easy Answers: Small Business Bankruptcies after BAPCPA' (2005) 47 B.C.L. Rev 71 at 92 'We know this from common experience in the retail industry. When the small, local business disappears, consumers are left largely with the regional megastores. Less competition usually results in higher prices and poorer service.'

60 London, DTI, 2000 at p 5.

61 *Orderly & Effective Insolvency Procedures: Key Issues* (Washington, IMF, 1999).

62 Ibid at p 14. According to the IMF (at p 15): 'While it is generally recognized

> There are social and political factors that are served by the existence of formal rehabilitation provisions and, in particular, the protection of employees of a troubled enterprise. These considerations explain why the design of rehabilitation provisions varies from country to country. When countries evaluate and reform their insolvency laws, the key question will often be how to find the appropriate balance between a variety of social, political, and economic interests that will induce all actors in the economy to participate in the system.

Coming from the IMF, this admission is worthy of note.[63]

From the legislative record in both the US and UK, as well as in the opinion of international organisations like the IMF, there are considered to be important goals of corporate rescue law other than the preservation of a going-concern surplus. Apart from maximising returns to creditors, corporate rescue law is seen as also helping to preserve employment; encouraging the creation and development of an entrepreneurial class of business people and facilitating national strategic objectives such as maintaining choice for the consumer and keeping alive national champions that might otherwise fall victim to foreign competition. There is a degree of ambiguity, however, about whether the preservation of employment and the other identified objectives should be seen as independent goals of corporate rescue law or merely incidental benefits that come from rescue proceedings and the preservation of the going-concern surplus.

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that rehabilitation procedures are necessary, statistics show that, at least in a number of countries, up to 90 per cent of insolvency proceedings end up in liquidation. Yet, statistics may be misleading. They often fail to capture the fact that larger companies (which have a greater impact on the economy) are more likely to be rehabilitated. Moreover, the failure of rehabilitation in these circumstances may often be due to the inadequate design or application of the rehabilitation procedure, and the conversion of rehabilitation into liquidation may reflect the fact that an enterprise with no chance of rehabilitation has used the rehabilitation procedure solely as a means of forestalling liquidation.'

[63] For a searing criticism of the IMF see the international bestseller by Joseph Stiglitz *Globalization and Its Discontents* (New York, Penguin, 2002) and the comment at pp 12–13: 'Over the years since its inception, the IMF has changed markedly. Founded on the belief that markets often worked badly, it now champions market supremacy with ideological fervor. Founded on the belief that there is a need for international pressure on countries to have more expansionary economic policies – such as increasing expenditures, reducing taxes, or lowering interest rates to stimulate the economy – today the IMF typically provides funds only if countries engage in policies like cutting deficits, raising taxes, or raising interest rates that lead to a contraction of the economy.'

WIDER INTERESTS VERSUS THE CREDITORS' BARGAIN PERSPECTIVE ON CORPORATE RESCUE LAWS

There are many theorists and policy makers who hold to the view that the preservation of employment, etc. should be an independent goal of corporate rescue law. In the main, these commentators argue that the law should seek to protect employment and general community interests as well as providing equity among creditors. On this analysis, a 'rehabilitated' company provides benefits to a variety of external constituencies including the government in the form of more taxes. Existing and future employees also benefit, either in the form of continued or new employment and/or higher salary levels. Local communities too may benefit, in that the wealth in the locality is increased due to the presence of the reorganised and now profitable company. From this perspective, and bearing in mind the wider public benefits, it is not unreasonable to expect that secured creditors should bear some of the costs of reorganisation. In other words, secured creditors should not necessarily be compensated for any delay in enforcing their security interest attendant on the rescue proceedings. Moreover, secured creditors might be forced to accept a reorganisation plan against their wishes.

On the other hand, this 'wider perspectives' view of bankruptcy and corporate reorganisation law has been rejected forcibly in the US by many scholars, particularly those from the 'law and economics' camp. For example, Professors Jackson, Baird and Scott have advanced the creditors' bargain theory,[64] under which the costs of reorganisation should not be imposed on secured creditors who do not benefit from reorganisation but, instead, be imposed on the company itself and on unsecured creditors who may benefit. Creditors' bargain theorists see insolvency law as being designed to solve collective action problems,[65] or to express the point differently, a race among

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[64] See Thomas H Jackson *The Logic and Limits of Bankruptcy Law* (Cambridge, MA, Harvard University Press, 1986); 'Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain' (1982) 91 Yale LJ 857; DG Baird and TH Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi Law Review 97; Thomas H Jackson and Robert E Scott 'An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 Va L Rev 155.

[65] See Jackson *Logic and Limits of Bankruptcy Law* at p 10: 'The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors as a group when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse.'

creditors to collect available assets from an ailing company may lead to the premature dismemberment of the company and the destruction of value. Under the race and grab model, actions by individual creditors would harm the creditors as a group. Insolvency law, on the other hand, can ensure a larger average return for creditors by preserving a company's going-concern value. Mixing metaphors, insolvency law is seen essentially as a response to a common pool problem in that creditors fishing individually in a common pool may deplete or exhaust the stock of fish to the detriment of the group as a whole.[66]

In a company where there are diverse interests, and individual creditors have different packages of rights, these creditors have an incentive to take actions that will increase their own share of the assets even if, in so doing, they reduce the aggregate value of the company.[67] In the creditors' bargain scheme of things, insolvency law, at its core, is designed to prevent individual creditor actions against assets from interfering with the use of those assets that is in the best interests of creditors as a group. Insolvency law requires persons to act collectively rather than taking individual actions that may harm the group of creditors.[68] The cornerstone of the creditors' bargain theory is the normative claim that pre-insolvency entitlements should not be impaired in insolvency except where this is necessary to maximise net asset distributions to the creditors as a group. Pre-insolvency entitlements should never be impaired to accomplish purely distributional goals.[69] Insolvency law exists solely for the benefit of creditors and shareholders and the interests of employees, suppliers, customers and communities should be taken into account only to the extent that particular members of those constituencies are creditors with enforceable legal rights against company assets under general law. 'To take any other interest of those constituencies into account would constitute prima facie theft.'[70] Basically, concerns that arise outside the insolvency sphere should not be addressed by changing insolvency policy.[71]

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66 See Jackson, ibid at p 12: 'What is required is some rule that will make all hundred fishermen act as a sole owner would. That is where bankruptcy law enters the picture in a world not of fish but of credit.'

67 DG Baird and TH Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on adequate protection of secured creditors in bankruptcy' (1984) 51 U Chi Law Review 97 at 105.

68 Ibid.

69 Thomas H Jackson and Robert E Scott 'An Essay on Bankruptcy Sharing and the Creditors' Bargain' at 159.

70 See Charles W Mooney 'A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure' (2004) 61 Washington and Lee Law Review 931 at 964.

71 See the comment in Jackson *Logic and Limits of Bankruptcy Law* at p 25:

According to the creditors' bargain theory, if one protects the rights that a secured creditor enjoys outside insolvency this reinforces the insolvency law objectives about putting a company's assets to their best use.[72] The costs of corporate rescue procedures are placed on those who stand to benefit from such procedures. Otherwise, they will be encouraged to invoke and prolong such procedures. Insolvency rules that enable shareholders and junior creditors to gain from company rescue, while avoiding the full costs of making the rescue attempt, are seen as creating inappropriate incentives. There is the risk that the company will fail and if the choice between liquidation and reorganisation is not to be skewed, the argument is that those who benefit from a possible upswing of company fortunes should bear the risk of failure.[73] A rule which provides secured creditors with the full value of their existing proprietary rights is not seen as preventing desirable reorganisations but, instead, it encourages junior creditors and shareholders to pay for rescue opportunities that benefit them.

The creditors' bargain view of the world contains a central contractarian core based on the normative premise that insolvency law should generally reflect the hypothetical agreement that creditors would reach if they were to bargain amongst themselves before extending credit to the company.[74] The terms of the hypothetical bargain are regarded as efficient because those terms represent the product of unfettered bargaining among property owners. Once derived in this way, the terms of the hypothetical bargain stand as a critique of the corresponding provisions of insolvency law. The analysis assumes that the parties bargained solely on the basis of entitlements that are created by the general law applying outside the insolvency framework and did not bargain from any entitlements created under insolvency law.[75] In its role as a collective

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'Incorporating such a policy in a bankruptcy statute, however, would be to mix apples and oranges, if one accepts the view (as everyone seems to) that bankruptcy law also exists as a response to a common pool problem.'

[72] DG Baird and TH Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests', at 103.

[73] DG Baird and TH Jackson, ibid at 108–109.

[74] Jackson in *Logic and Limits of Bankruptcy Law* at p 17 fn 22 suggests that this is an application of the famous Rawlsian notion of bargaining in the 'original position behind a veil of ignorance' – see John Rawls *A Theory of Justice* (New Haven, Yale University Press, 1971) at pp 136–142. But for claims that Jackson got Rawls wrong see Donald R Korobkin 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71 Texas Law Review 541; RJ Mokal *Corporate Insolvency Law: Theory and Application* (Oxford, Oxford University Press, 2005) at pp 61–62.

[75] See the comments of the US Supreme Court in *Butner v US* (1979) 440 US 48 at 54–55: 'Property interests ae created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analysed differently simply because an interested party is involved in a bankruptcy

debt-collection device, insolvency law should not create rights but instead act to ensure that pre-existing rights are vindicated to the greatest extent possible.[76]

Critics, however, have complained that it is hard to see how the idea of a notional bargain among creditors could form the basis of a rational system of insolvency law.[77] Professor Sir Roy Goode, for one, speculates that

> if one could imagine a situation in which all creditors, secured and unsecured, were to come together to decide what was to happen in the event of disaster, would it not be likely that unsecured trade suppliers, on having brought home to them as a group the relative vulnerability of their position, would insist on a slice of the corporate cake as a condition of their co-operation?[78]

The creditors' bargain theory is ultimately based on some conception of what parties will do in practice in the real world. Nevertheless, the parties are only figments of a theoretician's imagination with all the imaginary attributes ascribed to them by their creator. The creator is conceiving certain characteristics and then investing the characters with these qualities. Such fictional features may not have any necessary relationship with the qualities of actual creditors.[79] The academic papers developing the creditors' bargain model were original and thoughtful but 'there was an eerie sort of abstraction about them. I always felt about Baird and Jackson on bankruptcy a little like I feel about Henry James on love: remarkable stuff, but can you trust an author who doesn't seem to know how babies are made?'[80] In the real world, creditors do not act collectively in taking decisions and consequently, we have no true idea of how they would proceed or the sorts of factors that they would bring to bear on the decision-making process. Where there is no actual agreement among creditors, an individual creditor cannot be sure what other creditors will do.[81]

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proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy.'

[76] See Jackson *Logic and Limits of Bankruptcy Law* at p 22

[77] See also Andrew Keay 'Insolvency Law: A Matter of Public Interest?' (2000) 51 NILQ 509 at 527: 'It is glib to say, as those outside the discipline may and some insolvency law commentators such as Professor Jackson do, that insolvency law only deals with economics and is only concerned with the plight of persons who have not been paid what they are owed.'

[78] See Roy Goode *Principles of Corporate Insolvency Law* (London, Thomson, 3rd ed, 2005) at p 47.

[79] See Goode, ibid at p 46.

[80] See John D Ayer (2004) 12 American Bankruptcy Institute Law Review 101.

[81] But see however, D Webb 'An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain' (1991) 43 Oxford Economic Papers 139.

THE PROCEDURAL THEORY OF INSOLVENCY AND CORPORATE RESCUE LAW

The creditors' bargain theory undoubtedly has its critics but, nevertheless, the underlying idea of respecting pre-insolvency entitlements has gained renewed vigour in the form of procedure theory. Procedural theorists assert as a cardinal principle that insolvency law should maximise recoveries and benefits for those with rights against a company's assets, but subject to the constraints that are consistent with the rationale for having an insolvency law.[82] The theory draws its normative force from substantive law that applies outside the insolvency sphere. It assumes that insolvency law, as part of the law of civil procedure, should not undermine these substantive rules of law based on conflicting policy views. Unless special treatment in insolvency can be justified on a basis or context peculiar to insolvency, general legal policies necessarily are undermined if persons other than 'rights-holders' are given special treatment in insolvency to the detriment of 'rights-holders'. The same is true if the interests of 'rights-holders' are diminished or enhanced for the benefit of, or at the expense of, other 'rights-holders' in a manner that is inconsistent with the general legal framework.[83] Procedure theory is generally dismissive of an insolvency system that would create a special reordering of the interests of 'rights-holders' in the insolvency context. Procedural law, including insolvency law, should advance, enhance and vindicate policies that the general legal framework creates, and seeks to implement, but should not disrupt such policies.[84]

Advocates of procedure theory suggest that service to extraneous interests at the expense of, or in a way that involves risk to, 'rights-holders' is prima facie theft. A judicial proceeding that transfers wealth from those who are legally entitled to benefit from that value to those who hold no legal entitlement is wrong. Sympathetic as an extraneous cause employment, rehabilitation or community may appear, redistribution of wealth in bankruptcy away from those who hold legal entitlements to those who do not, whether to further a political agenda or a communitarian philosophy or otherwise, is a corruption of civil justice. Robin Hood was after all a crook.[85]

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[82] See generally Charles W Mooney 'A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure' at 931.

[83] Ibid at 943–944.

[84] See Steven L Harris and Charles W Mooney 'Revised Article 9 Meets the Bankruptcy Code: Policy and Impact' (2001) 9 American Bankruptcy Institute Law Review 85 at 87–89: 'The Bankruptcy Code offers a blank check to the makers of non-bankruptcy law to define and delineate property law principles that will prevail in Bankruptcy.'

[85] See Charles W Mooney 'A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure' at 964–965.

The procedural school also suggests that the secured creditor's property rights should not be sacrificed for the benefit of the unsecured creditors, and where secured creditors are prevented from enforcing their collateral during rescue proceedings without being provided with full compensation, the effect 'is not merely wrong, it is outrageous'.[86]

On the other hand, critics may think that it is over-simplistic to suggest that insolvency law is, or should be, merely about protecting pre-insolvency entitlements. Certain issues come to the fore during the insolvency process and it is only right that these should be addressed during that process. Directorial misconduct is one such issue and, under s 7(4) Company Directors Disqualification Act, the administrator is obliged to report to the DTI Director Disqualification Unit whether the director's conduct in relation to the company in administration renders him unfit to be concerned in company management in the future. One could devise a system under which a director's conduct could be examined at any point during the company's history with a view to ascertaining whether disqualification was an appropriate response. Implementation of such a system would necessitate a massive bureaucracy however, and confining the disqualification option to situations where a company enters a formal insolvency process seems a defensible pragmatic response.[87]

Professor Goode makes the point that certain problems confronting claimants outside the common pool creditors arise specifically because of the company's insolvency and for no other reason. '[T]o treat bankruptcy law as confined to creditors confronting the common pool problem is surely to prejudge the very question in issue. It is also wholly inconsistent with insolvency laws around the world, all of which include provisions for claimants outside the common pool creditors.'[88]

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[86] Ibid at 641. The point is also made by Jackson *Logic and Limits of Bankruptcy Law* at 189.

[87] For a less extreme proceduralist theory of bankruptcy law see E Brunstad and M Sigal 'Comparative Choice Theory and the Broader Implications of the Supreme Court's Analysis in Bank of America v 203 North LaSalle Street Partnership' (1999) 54 Business Lawyer 1475 text accompanying 234 'Bankruptcy law does not exist in a vacuum, nor does it operate in one. Rather, it operates against a backdrop of pre-existing legal structures. These structures are important because . . . they govern commercial relations generally, and care must be taken to avoid bankruptcy rules that alter commercial expectations in ways that generate more harm than good. This does not mean . . . that bankruptcy law should never modify commercial procedures. In many instances, modifications are necessary to promote the goals of the Chapter 11 regime. But it does not follow that all non-bankruptcy norms are, therefore, irrelevant, or should be ignored simply because a firm files for bankruptcy relief.'

[88] See Goode *Principles of Corporate Insolvency Law* at p 45. But see Jackson *Logic and Limits of Bankruptcy Law* at p 26: 'Bankruptcy law cannot both give new

Professor Goode also asks the rhetorical question that, since it is conceived to be beneficial to bring all creditors within a collective proceeding for the common benefit of creditors, 'why should it not be equally beneficial to require creditors as a class to co-operate as part of a wider class of beneficiaries that would include employees and shareholders as regards interests and expectations beyond their pre-bankruptcy entitlements?'[89]

Under UK law, certain preferential claims are accorded preferential status and in an administration, receivership or liquidation, are to be paid out of floating charge recoveries in priority to the floating charge holder where there are insufficient 'free' assets of the company to satisfy the claims in full.[90] Moreover, under a regime introduced by the Enterprise Act a proportion of floating charge recoveries are set aside for the benefit of unsecured creditors.[91] In defence of these provisions and their 'insolvency-specific' nature, one could argue that all creditors expect to be paid in full.[92] There is no point in enacting a law that would apply outside the insolvency context which confers preferential creditors with priority over floating charge holders because all debts should be satisfied in full by the company. The legislature created a specific set of insolvency entitlements with full knowledge of the existence and content of non-insolvency entitlements and with the intention of departing from the latter. Secured creditors can hardly complain because all that a court is doing is applying a pre-existing rule of law to a specific case. There is nothing that is being taken from the creditor because at the time that the security arrangement was made, the secured creditor knew or should have known that its rights were circumscribed by the legislation.[93] If property rights are defined by reference to existing law then no 'taking' has occurred. It can hardly be

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group rights and continue effectively to solve a common pool problem. Treating both as bankruptcy questions interferes with bankruptcy's historic function as a superior debt-collection system against insolvent debtors. Fashioning a distinct bankruptcy rule – such as one that gives workers rights they do not hold under nonbankruptcy law – creates incentives for the group advantaged by the distinct bankruptcy rule to use the bankruptcy process even though it is not in the interest of the owners of the group.'

89 Goode *Principles of Corporate Insolvency Law* at p 45.

90 Ss 40 and 175 Insolvency Act 1986.

91 S 176A Insolvency Act 1986.

92 For a different viewpoint see John Armour 'Should We Redistribute in Insolvency' in J Getzler and J Payne eds *Company Charges: Spectrum and Beyond* (Oxford, Oxford University Press, 2006).

93 See generally J Rogers 'The Impairment of Secured Creditors' Rights in Corporate Reorganisation: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause' (1983) 96 Harv L Rev 973 and for a different, more 'pro-property' perspective see DG Baird and TH Jackson 'Corporate Reorganisation and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 Uni of Chi L Rev 97.

suggested that there is a prohibition on even purely prospective restrictions on secured creditors. Otherwise, one would be making the assumption that the property rights held by secured creditors are in some sense anterior to positive law, and that is an extreme proposition.[94]

MORE INCLUSIVE 'BARGAIN' MODELS

There are, of course, bargain theories of insolvency law suggesting that regard should be had to non-creditor interests. For instance, Professor Korobkin has propounded a normative framework for insolvency law based on a hypothetical bargain as devised by the representatives of all interests that might by affected by a debtor's financial distress. On this model, the bargainers all know they may be affected by the insolvency, but no one knows if s/he will be a debtor, an unsecured creditor whether contractual or involuntary, a secured creditor, an ordinary employee, a member of the community that is otherwise unconnected to the debtor company or somebody in a different kind of relationship. Korobkin suggests that this inclusive hypothetical group would seek to protect those who are rendered most vulnerable by the insolvency and come up with something approximating to the major features of current US bankruptcy law.[95]

With more specific relevance to the UK, this inclusive hypothetical bargaining model has been developed by Dr Rizwaan Mokal into an 'authentic consent model (ACM)' which aims to analyse and justify the principles of insolvency law.[96] The authentic consent model also extends participation in

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[94] The European Convention on Human Rights (incorporated in domestic English law through the Human Rights Act 1998) provides in Article 1 of the First Protocol: 'Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.' Article 1 adds however, that the preceding prescriptions do not in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties. Article 1 was considered by the House of Lords in *Wilson v First Country Trust Ltd (No 2)* [2004] 1 AC 816 in the context of the Consumer Credit Act 1974; on which see generally J De Lacy 'Company Charge Avoidance and Human Rights' [2004] JBL 448.

[95] For the exposition of Professor Korobkin's theory see 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 Columbia Law Review 717; 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71 Texas Law Review 541; 'The Role of Normative Theory in Bankruptcy Debates' (1996) 82 Iowa Law Review 75.

[96] See RJ Mokal 'The Authentic Consent Model: Contractarianism, Creditors'

the imaginary negotiation process to parties other than creditors but, at the same time, focuses intensely on what makes insolvency law special.[97] The model is founded on an idea of 'dramatic ignorance'.

> To this end, it identifies peculiar insolvency issues and gathers together all the parties affected by these issues. It then imbues them with the constructive attributes it claims democratic society expects of its citizens as legislators . . . The ACM requires all insolvency principles to be agreed to by all the relevant parties. But this agreement must not be extracted under conditions of Natural Ignorance. It must be fair, entered into under appropriate circumstances. It must be based on the premise that parties are free and equal, and it must not allow some of them to dominate others because of strength, financial clout or superior bargaining skill.[98]

The model regards all parties to the imaginary negotiation process as being free and equal as well as being reasonable and rational.[99] Consequently, the principles chosen would be fair and just. In real-life negotiations however, the parties may not be blessed with these ideal qualities. Moreover, individual conceptions of fairness or justice may differ very considerably depending on one's political, philosophical or religious beliefs. It has been said quite powerfully that ex ante hypothetical bargain theories of insolvency law, however elegantly dressed up, are open to the objection that they amount to little more than an argument that thoughtful, interested, objective and neutral lawmakers would come to the proponent's conclusions about insolvency.[100] Such models tend to assume an original position in which the various players act in an economically rational manner according to a single set of criteria. Persons

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Bargain and Corporate Liquidation' (2001) 21 Legal Studies 400; *Corporate Insolvency Law: Theory and Application* (Oxford, Oxford University Press, 2005) chapters 2 and 3. Dr Mokal is however, rather critical of Korobkin, stating in *Corporate Insolvency Law* at p 64 that the latter's 'expansive benevolence is arbitrary and misguided. Korobkin's grand, imperialistic vision of insolvency law results from a rather simple error. Somewhere along the way, he stops asking himself: What makes insolvency law *special*?'

97 See *Corporate Insolvency Law* (2005) at p 70 fn 41 'Those invited to participate in the choice position here are all parties affected by corporate insolvency in a unique way. The interests to be protected are interests either threatened only in the debtor's insolvency, or threatened by it in a manner peculiar to insolvency. The categories of such interests are unlikely to be wide.'

98 See RJ Mokal 'The Authentic Consent Model' at 430.

99 *Corporate Insolvency Law: Theory and Application* (Oxford, Oxford University Press, 2005) at p 87. Dr. Mokal insists that what separates the creditors' bargain theory from the authentic consent model is not a narrow slit consisting of dissimilar types of uncertainty but a 'wide chasm of profound philosophical differences'.

100 See generally Charles W Mooney 'A Normative Theory of Bankruptcy Law' at 966, whose comments were framed with particular reference to Korobkin's theory.

however tend to make decisions on the basis of more than merely economic considerations. Furthermore, a series of presuppositions can hardly replicate the complex realities of business life or the many possible decision makers and the matrix of circumstances in which decisions have to be reached.[101]

TEAM PRODUCTION THEORY

One of the implicit assumptions of the creditors' bargain theory seems to be that there is a common pool of assets against which creditors have a pre-insolvency claim. But this not in fact the case. Rather, creditors expect to be paid from the anticipated stream of income produced by the ongoing enterprise.[102] Building on this insight, and also theories of corporate law more generally,[103] Professor Lynn LoPucki has recently developed a team production theory of corporate reorganisation law.[104] Under team production theory, corporate reorganization is viewed not as a regulation imposed by government but instead becomes an implicit agreement under which creditors and shareholders agree to subordinate their legal rights to the preservation of the company as a going-concern. Preservation of the company as a going-concern may require that the company honour team production obligations by giving these obligations priority over legal obligations. It is suggested that the theory is solidly grounded on actual contracts entered into by team members but is also normative in its assertion that actual contracts should be enforced because they are efficient. Under the team production theory as it applies to corporate law generally, the so-called 'teams' delegate to a company's board of directors ultimate authority over both the direction of the enterprise and distribution among team members of production rents and surpluses. The team comprises all those members who make company-specific investments, including those who are unable to protect those investments by direct contracting, personal trust or reputation.

Team production theory invokes the legislative history of the US Bankruptcy Code which suggests that the purpose of Chapter 11, unlike liquidation, is to restructure a company's business operations so that it may

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101 See Goode *Principles of Corporate Insolvency Law* at pp 46–48.

102 See Axel Flessner 'Philosophies of Business Bankruptcy Law: An International Overview' in Jacob Ziegel ed *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford, Clarendon Press, 1994) 19 at pp 25–26.

103 See generally Margaret Blair and Lynn Stout 'A Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 247.

104 LoPucki 'A Team Production Theory of Bankruptcy Reorganization' (2004) 557 Vand L Rev 741.

continue to operate, provide its employees with jobs, pay its creditors, and produce a return for shareholders.[105] It is better to reorganise than to liquidate because reorganisation preserves jobs and assets. The team production theory sees preservation of the corporate entity as an independent value that partially accounts for this choice of reorganisation over liquidation. The greater inclusiveness of the team production theory is also said to minimise the externalisation of company costs.[106] Many of the social costs incurred in the creation of a corporate entity have been borne by employees, communities, suppliers, customers and others. When a company fails, then prima facie those parties are left with the costs. The team production theory suggests that those costs which have been incurred by anyone in reasonable reliance on the team production arrangements should be internalised by the company.

The theory was formulated with reference to the United States insolvency system and it may be more congruent with that system than with its UK equivalent.[107] For example, the US Chapter 11 is based on the concept of debtor-in-possession with the board of directors remaining in control of the company's affairs during the reorganisation process. In carrying out their management functions, the board of directors continue to be governed by the 'business judgment' rule which gives directors wide latitude in all matters connected with the operation of the business. Moreover, influential judicial statements in the US emphasise that, in the vicinity of insolvency, the board of directors have an 'obligation to the community of interests that sustained the corporation to exercise judgment in an informed good faith effort so as to maximise the corporation's long-term wealth creating capacity'.[108] Debtor-in-possession is a feature of Chapter 11 that may be accounted for by team production theory but not so easily by the creditors' bargain theory. One might rhetorically ask

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[105] See the comments in the US House of Representatives HR Rep No 95–595, p 220 (1977) 'The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.'

[106] LoPucki 'A Team Production Theory of Bankruptcy Reorganization' at 770.

[107] On the other hand, employee rights are better protected in the UK through the general employment law framework and in the case of business transfers by the EC Acquired Rights Directive implemented in the UK by the Transfer of Undertakings (Protection of Employment) Regulations generally known as TUPE. These matters are discussed in more detail in Chapter 7. The effect of the legislation is to bring about a statutory novation of contracts of employment from an insolvent employer to a solvent transferee.

[108] *Credit Lyonnais Bank Nederland NV v Pathe Communications* No CIV.A. 12130, 1991 Del. Ch. LEXIS 215 at 108–109 referred to by LoPucki above, n 104 at 758.

that if the reorganisation procedure is to serve only the interests of creditor-owners, why should a board of directors elected by the shareholders remain in control of the company?[109] In the UK, by contrast, administration operates as a management displacement device with the administrator assuming the management tasks formerly entrusted to the board of directors.[110]

The two systems differ also with regard to reorganisation plans. In the US, a class of creditors, including secured creditors, can be forced by the court to accept a reorganisation plan through a mechanism known as 'cram down', even though creditors are theoretically protected by the so-called absolute priority rule and by the 'best interests of creditors' test.[111] The absolute priority rule means that the reorganisation plan must follow the scheme of priorities established by the law. The 'best interests of creditors' test applies in favour of each individual creditor and shareholder and requires that they should receive at least as much under the reorganisation plan as they would receive in a liquidation of the company under Chapter 7 of the US Bankruptcy Code.[112] While liquidation values do establish a floor, a reorganisation plan has considerable latitude with regard to the distribution of the going-concern surplus.[113] In the UK, on the other hand, there is less flexibility about propos-

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[109] See LoPucki 'A Team Production Theory of Bankruptcy Reorganization' at 768.

[110] On the relative merit of debtor-in-possession versus management displacement insolvency regimes see D Hahn 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 JCLS 117. See also V Finch 'Control and co-ordination in corporate rescue' [2005] Legal Studies 374; O Brupbacher 'Functional Analysis of Corporate Rescue Procedures: A Proposal from an Anglo-Swiss Perspective' (2005) 5 JCLS 105.

[111] On cram down see Jack Friedman 'What Courts do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 Cardozo Law Review 1496 who suggests at 1499 that 'the traditional mystique concerning cram down which instills fear among secured creditors is exaggerated. Cram down is applied in a remarkably homogenous and predictable manner regarding secured claims.'

[112] See generally s1129 of the US Bankruptcy Code.

[113] See the views expressed in the US Congress about entitlements to the 'surplus' value produced by a liquidation case – 'The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer . . . Instead, negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. The bill only sets the outer limits on the outcome: it must be somewhere between the going-concern value and the liquidation value' – HR Rep No 595, 95th Cong, 1st Sess 224 (1977). For a slightly different perspective see Omer Tene 'Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reoganizations' (2003) 19 Bankruptcy Developments Journal 287 at 326 'Chapter 11 is a forum for structured bargaining among classes of investors. Bankruptcy law should

als in an administration or in a company voluntary arrangement. Such proposals cannot affect adversely the rights of a secured creditor to enforce its security without its consent.[114]

Ultimately, under the team production theory, team members repose trust in the board of directors 'to do the right thing' with regard to the distribution of corporate goods. While the theory may have considerable explanatory force in the US context, this appeal is lacking in the UK given the management displacement nature of administration. Moreover, even advocates of the theory seem uncomfortable about some of its aspects since the theory is based on a wholesale grant of unfettered power to the board of directors.[115]

MULTIPLE VALUES OR ECLECTIC APPROACHES

It has been suggested that a single unifying theory of corporate rescue law, while intellectually and theoretically attractive, cannot adequately explain the phenomenon. Moreover, one should not judge corporate rescue law against a single criterion or theory. The point has been made in forceful terms by Professor Elisabeth Warren who states:[116]

> A simple economic analysis of bankruptcy is clear, straightforward and always promises to yield firm answers to hard questions. The fact that the economic analysis is utterly self-referential also spares the proponent from nasty hours searching out empirical evidence or trying to learn about what happens in real borrowing and lending decisions. And the assumptions themselves are garbed in neutral terms, lending an aura of fairness to the development of policy.

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not determine the claimants' substantive rights and entitlements, but rather preserve the respective values of the parties' rights at the commencement of a case. Instead of dividing the unallocated GCS among classes of claimants, bankruptcy should provide unbiased procedural rules allowing the parties to negotiate on level ground. The claimants will distribute among themselves the surplus created in reorganization, that is, the GCS. While secured creditors may receive a portion of the GCS as a result of these negotiations, they should not obtain such value by virtue of bankruptcy law itself.'

114 Insolvency Act 1986 Schedule B1 para 73.

115 See the comments by Lynn LoPucki 'A Team Production Theory of Bankruptcy Reorganization' at 778. 'Team Production is not a theory with which I feel comfortable. The theory is based on a wholesale grant of unfettered power to directors. My inclination is to think that will not work. Power corrupts and absolute power corrupts absolutely. The almost daily reports of director fraud, negligence, and indiscretion in the newspapers confirms my inclination. Only a fool would trust corporate directors.'

116 'Bankruptcy Policy' (1987) 54 U Chicago L Rev 775 at 812.

In her view, single theories run a great risk of providing answers that may be quite sensible within a confined, abstract scheme but that will not work in a complex reality.[117] Professor Warren puts forward what she terms a 'dirty, complex, elastic, interconnected view of bankruptcy from which outcomes cannot be predicted, nor all the factors relevant to a policy decision necessarily fully articulated.'[118] She sees insolvency law as an attempt to reckon with a company's multiple defaults and to distribute the consequences of such defaults among a number of different actors. The law encompasses a number of competing – and sometimes conflicting – values in this distribution process. Solving the collective action problems facing creditors should not be taken as the sole intellectual yardstick, with insolvency law being judged exclusively as good, or bad, depending on whether it promotes, or impairs, creditor collectivism.

Professor Warren has identified four principal goals of the insolvency system: to enhance the value of an ailing company; to distribute that value according to multiple normative principles; to internalise costs of business failure among parties dealing with the company and finally, to promote reliance on private monitoring arrangements.[119] In her view however, the insolvency regime only protects in an indirect fashion the interests of parties without formal legal rights. It does this largely through provisions that permit businesses to reorganise instead of being shut down by a few anxious creditors.[120] Moreover, the system encourages entrepreneurial endeavour and risk-taking in that if the opportunity for corporate reorganisation exists, companies that pursue high risk but potentially rewarding strategies can survive some short-term dislocations and have a greater chance of seeing their risk-taking strategies pay off.[121] The existence of a rescue regime also insulates the government to a degree from pressure to fund bailouts for individual business failures.[122]

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117 Ibid at 811.

118 Ibid at 775.

119 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 Michigan Law Review 336 at 344.

120 Ibid at 356.

121 Ibid at 358: 'If investors perceived that businesses in some financial trouble faced immediate liquidation, they would likely have two responses: they would not invest their money to start businesses, or they would direct their business investments toward less risky enterprises. To the extent that reorganisation alternatives exist, companies that pursue risky alternatives have the opportunity to survive some short-term dislocations and a greater chance to see their risk-taking strategies pay off. At the margins, any law permitting reorganisation of a business increases the likelihood of survival of companies through troubled times, which makes risk-taking more attractive.'

122 Ibid at 361.

The multiple values or eclectic approach towards evaluating insolvency law has in turn been criticised for vagueness, uncertainty and indeterminacy. The multiple values approach may be unable to provide concrete standards for judging concrete cases or proposals. For example, little assistance is offered to decision-makers on the management of tensions and contradictions between different values or on the way that trade-offs between various ends should be carried through. In addition, there are no core principles to determine trade-off or to establish weightings.[123]

A variant on the multiple values approach is to set out, explicitly, various values or benchmarks for evaluating insolvency and corporate rescue law. This approach is favoured by Professor Finch who suggests that the legitimacy of the processes and principles of insolvency law can be tested by reference to four benchmarks, namely: efficiency, expertise, accountability and fairness.[124] There has been criticism of this benchmarking approach however, largely because of a perceived failure to distinguish between substantive and procedural goals.[125] Substantive goals are those which justify the existence of this part of the law by showing it in its best light while procedural goals, on the other hand, are about how the law goes about attaining its substantive goals. Simply stated, a distinction should be drawn between the ultimate ends of the law, and the methods that the law adopts in attempting to achieve those ends: 'Once a set of substantive goals has been exogenously specified (e.g. using a theory of justice) [procedural goals] can be used to judge between various proposed schemes for implementing it.'

Applying this analysis, the benchmarks of efficiency, expertise and accountability are largely about means and not ends. Consequently, 'fairness' is left standing as the sole substantive goal and bears a heavy burden of analysis and explanation.[126] On the other hand, if one adds 'justice' to the mix and then proceeds to examine corporate rescue law from the perspective of justice as well as fairness, this may not lead us any closer in the direction of providing specific proposals or solutions for specific situations.[127] Perhaps, the best

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123 See Vanessa Finch 'The Measures of Insolvency Law' (1997) 17 OJLS 227 at 241.

124 See generally V Finch, ibid; Vanessa Finch *Corporate Insolvency Law: Perspectives and Principles* (Cambridge, Cambridge University Press, 2002).

125 See the review article by RJ Mokal 'On Fairness and Efficiency' (2003) 66 MLR 452 and see also RJ Mokal *Corporate Insolvency Law: Theory and Application* (Oxford, Oxford University Press, 2005) at p 67 fn 31.

126 Vanessa Finch in 'The Measures of Insolvency Law' (1997) 17 OJLS 227 at 252 acknowledges that trade-offs 'between different rationales do remain a problem but . . . the absence of easy answers has to be accepted when dealing with processes whose essence is the balancing of multiple objectives.'

127 RJ Mokal in *Corporate Insolvency Law: Theory and Application* develops an

approach in trying to resolve uncertainty is to establish a clear hierarchy of values or objectives.

THE OBJECTIVES OF CORPORATE RESCUE LAW AND THE LEGISLATIVE RECORD

Chapter 11 and UK administrations are similar, yet distinct, procedures in many ways. Moreover, with both procedures it is submitted that there is an element of obfuscation at their heart. If one examines the legislative history in both the UK and US it becomes apparent that there is some degree of ambiguity about the respective merits of reorganisation versus liquidation of ailing enterprises and about the interests that corporate reorganisation law should protect. It is difficult to escape the conclusion that, at times at least, this ambiguity is deliberate and serves to obscure or gloss over difficult choices between potentially competing goals. In the influential Cork committee report which led to the UK Insolvency Act 1986 there is at least a bow in the direction of goals other than creditor wealth maximisation. The committee suggested that the aims of a good modern insolvency law included recognising that 'the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public interests are recognized and safeguarded'.[128] The committee also talked about providing 'means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country . . .'.[129]

On the other hand, administration, as revamped by the Enterprise Act 2002, appears to have creditor wealth maximisation at its core, although this core is well disguised since corporate rescue is ostensibly placed at the top of the legislative tree. It is provided that an administrator's functions must be performed with the objective of (a) rescuing the company as a going concern, or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or

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'authentic consent' model to explain and justify insolvency law based on fairness and justice as recognised in conditions of dramatic ignorance.

[128] *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) at para 198(i).

[129] Ibid at para 198(j). On the other hand, the subsequent White Paper *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984) focused on the interests of creditors.

more secured or preferential creditors.[130] An administrator can only descend this statutory hierarchy of objectives if s/he thinks that it is not reasonably practicable to achieve any of the preceding objectives even though an administrator has to move from (a) to (b) if he thinks that (b) would achieve a better result for the company's creditors as a whole. While the administrator cannot act solely in the interests of a creditor who may have initiated the administration process, producing better returns for company creditors appears, at the end of the day, to be essentially what administration is about.[131]

The first objective stated in the legislation (though not necessarily the primary objective) is rescuing the company as a going-concern. The parliamentary debates make it clear that this objective is about preservation of the business of the company rather than preservation of the company as an empty corporate shell.[132] The government stressed: 'We would not want the administrator to rescue the company if it is to the detriment of creditor value.'[133]

In many cases an administrator may reach a rapid conclusion that a sale of assets achieves a better result for company creditors than preserving the business of the company as a going concern. There seems little scope for challenging an administrator's judgement on this matter although it is provided in Schedule B1 para 74 Insolvency Act that a creditor or member may complain to the court that the administrator is acting, or has acted, so as unfairly to harm the interests of the applicant and/or others, or is proposing to act in such a manner. Moreover, the administrator has a duty, in the statement setting out proposals for achieving the purpose of administration, to explain why the 'rescue' objective cannot be achieved, and this statement may provide some ammunition to form the basis of a court challenge.[134] The relevant test though, is what the administrator 'thinks' and not what s/he 'reasonably believes'.

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130 Insolvency Act 1986 Schedule B1 para 3(1). An administrator must also perform his/her functions in the interests of the company's creditors as a whole – para 3(4)(b).

131 See S Frisby 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 MLR 247 at 262 and more tentatively Vanessa Finch 'Control and Co-ordination in Corporate Rescue' [2005] Legal Studies 374 at 395–396: 'The terms of EA 2002 mean that it is arguable that an administrator is obliged to pursue a going-concern sale where he thinks this will serve creditors better than efforts made to rescue the company – even where it might be possible to rescue the company. Primacy is accordingly given to maximising overall returns to creditors, rather than to rescue per se.' See also D Prentice 'Bargaining in the Shadow of the Enterprise Act 2002' (2004) 5 European Business Organization Law Review 153 at 158.

132 See the comments by Lord Hunt of Wirral in the House of Lords – HL debates col 765, 29 July 2002.

133 See the comments by the relevant Minister, Lord McIntosh of Haringey, in HL Debates col 766, 29 July 2002.

134 Schedule B1 para 49(2)(b).

While the state of a person's mind may be as much a fact as the state of the person's digestive tract, the 'thinks' test leaves little scope for judicial review.[135] It is not generally the practice of the courts to second-guess the commercial judgements of administrators and other discretionary decision-makers. It was explained during the parliamentary debates:[136]

> The administrator is the person on the ground who is best placed to judge whether or not a particular objective is reasonably practicable, in the light of his experience and professional judgment. . . .[I]t will be for the administrator to reach a conclusion as to whether or not the objectives are reasonably practicable, taking into account all the circumstances of the particular case of which he or she is aware at the time.

The emphasis placed in the legislation on the administrator's opinion may make judicial intervention virtually impossible provided that the opinion has been formed in good faith.[137] One commentator suggests[138]

> the likely practical effect of the paramount regard to what is in the best interest of the company's creditors as a whole is that there will be a few instances where the administrator performs his functions with the objective of rescuing the company as a going concern. After all, the interests of creditors are more often than not to be paid as much as possible, and as quickly as possible. Those primarily interested in a rescue are likely to be employees, guarantors of any debts of the company and shareholders, interests to which the administrator is not expressly required to have regard.

The overarching general requirement that an administrator should not unnecessarily harm the interests of company creditors as a whole[139] may go some of the way towards allowing limited second-guessing of administrators' decisions in certain contexts. An example is where a company has two assets; one of which is essential to the carrying on of a company's business but the other is not essential. The administrator then decides to sell the key asset, perhaps because it is a bit more easily saleable, so as to make distributions to secured and preferential creditors even though the sale has a crippling effect

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135 For somewhat different perspectives see J Armour and R Mokal 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' [2005] LMCLQ 28; R Mokal and J Armour 'The New UK Rescue Procedure – The Administrator's Duty to Act Rationally' (2004) I International Corporate Rescue 136; M Simmons 'Enterprise Act and Plain English' [2004] Insolvency Intelligence 76.

136 *Hansard*, HL Deb, col 768, 29 July 2002.

137 See Finch 'Re-Invigorating Corporate Rescue' [2003] JBL 527 at 546.

138 See Lisa Linklater 'The Enterprise Act: Fulfilling Great Expectations' (2003) 24 Company Lawyer 225.

139 Schedule B1 para 3(4).

on the further viability of the company's business. In these circumstances, it would seem that the administrator has acted in a way that has unfairly and unnecessarily harmed the interests of company members and creditors. Therefore this action may be challenged under para 74, whereas it seems that if an administrative receiver had behaved in a similar fashion, this conduct could not be impeached.[140]

Underlying the revised administration procedure appears to be the principle that if there are 'alternative courses of action, one of which will benefit creditors only, and another which, with a little delay, will confer benefits on employees and shareholders without significant detriment to the creditors, then it is a legitimate function of insolvency law to have regard to those wider interests'.[141] The interests of employees and shareholders, and indeed wider community interests, may be subordinate to those of creditors, but they have their place in the overall scheme of things. This policy is reflected in UK law as it applies to solvent companies. The appointment of an administrator displaces the board of directors from their management functions but the directors are responsible for running the company until the administrator takes their place. The formulation of director's duties in the Companies Act 2006 provides that a director must act in the way s/he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.[142] In fulfilling the statutory duty it is specifically stated that a director must have regard to:

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[140] An administrative receiver can choose to exercise or not to exercise the power of sale over a particular asset. According to the Privy Council decision in *Downsview Nominees v First City Corp* [1993] AC 295 the only constraint on the administrative receiver's choices is the criterion of good faith. In the words of Professor Sir Roy Goode in *Principles of Corporate Insolvency Law* at pp 284–285) *Downsview* suggests that: 'The receiver . . . is entitled, if he so chooses, to decide not to continue the company's business, and to sell a part of the business which would be better kept. It would also seem that he can select a particular asset to realise for the benefit of his debenture holder even though the removal of that asset would damage the company's business and there are other assets to which he could resort and on which the business is less dependent.'

[141] See Roy Goode *Principles of Corporate Insolvency Law* at p 45.

[142] The Company Law Reform Steering Group in 'Modern Company Law for a Competitive Environment: The Strategic Framework' (March 1999) at pp 39–46 set forth two alternatives. One is that of maintaining what they consider to be the existing directorial duty of following enlightened shareholder interests. The second alternative is that of creating a 'pluralist' duty to all major stakeholders. See generally on what interests corporate law should serve, Henry Hansmann and Reinier Kraakman 'The End of History for Corporate Law' in Jeffrey Gordon and Mark Roe ed *Convergence and Persistence in Corporate Governance* (Cambridge, Cambridge University Press, 2004) p 33.

a. the likely consequences of any decision in the long term,
b. the interests of the company's employees,
c. the need to foster the company's business relationships with suppliers, customers and others,
d. the impact of the company's operations on the community and the environment,
e. the desirability of the company maintaining a reputation for high standards of business conduct, and
f. the need to act fairly as between members of the company.'[143]

In the US, when the Bankruptcy Code was promulgated in 1978, there was great emphasis placed on corporate reorganisation. This point has been noted in caustic terms by one commentator:[144]

> Few free market law and economics scholars were around to make the cruel argument that society would prosper if the free market were allowed to kill off weak and inefficient companies. That the dismissed workers of a dead company might be better off in the long run as a result of that death (or that a competitor's workers would be) was hardly considered. The incantation, 'reorganization, yes, liquidation, no' echoed through the . . . Halls of Congress. Firms should be given every chance to save their goodwill; no one seems to have thought much of the firms with badwill that could be liquidated for a greater sum than they would command as going concerns, nor did anyone seem to believe that a large percentage of firms that would use chapter 11 might possess badwill, not good. So even in 1978 . . . the right was a pale and moderate version of its later self, and many of the arguments one might hear from the law and economics crowd today were but whispers then.

In the Congressional debates on the Bankruptcy code, there are discussions

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143 S 172(1) Companies Act 2006. S 172(2) provides that where 'or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.' According to the Explanatory Notes accompanying the Company Law Reform Bill which became the Companies Act 2006 this provision enshrines in statute what is commonly referred to as the principle of enlightened shareholder value. The statutory list of factors is said to highlight 'areas of particular importance which reflect wider expectations of responsible business behaviour'. See generally on this area John Parkinson 'Inclusive Company Law' in John De Lacy ed *The Reform of UK Company Law* (London, Cavendish, 2002) at p 43 who suggests that the priority afforded to shareholders 'reflects not so much a belief that their interests are inherently more deserving of protection than those of other groups, as acceptance of the traditional economic analysis that argues that the greatest contribution to "wealth and welfare for all" is likely to be made by companies with a primary shareholder focus.'

144 See the comments in James J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139.

of policies to protect public investors, safeguard jobs and to help save troubled businesses. Concerns were raised about the community impact of bankruptcy and the wider public interest that extended beyond the narrow realm of the parties in conflict. The legislature, it appears, intended the Bankruptcy Code to address issues that were broader than the immediate problems of the debtor company and affected creditors.[145]

This sentiment was picked up by the US Supreme Court in *NLRB v Bildisco*[146] who said: 'The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.' Analysis of these observations however, reveals an ambiguity. It is unclear whether saving businesses is primarily about improving the position of creditors or maintaining the status of owner-managers or preserving employment. What if there is a conflict between these objectives? Should the objective of creditor wealth maximisation be accorded ascendancy even if it means the sacrifice of employment opportunities? Is employment preservation a separate and independent goal of corporate rescue law or rather something that in the ordinary course of events will come about if returns to creditors are improved? While a careful reading of the record may reveal that the latter alternative most closely reflects the views of the legislature, employment preservation was certainly highlighted as a desirable benefit of a well-crafted corporate rescue law.

In recent years however, the mood music has changed and the objective of maximising creditor recoveries has come to assume a greater prominence. Asset sales have begun to predominate rather than reorganisations in the traditional sense.

> Whereas the debtor and its manager seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast. Chapter 11 no longer functions like an anti-takeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with asset sales and faster cases.[147]

CONCLUSION

The US Supreme Court has described the objectives of Chapter 11 in the following terms:[148]

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145 See Karen Gross 'Finding Some Trees but Missing the Forest' (2004) 12 American Bankruptcy Institute Law Review 203 at fn 47.

146 (1983) 465 US 513 at 528.

147 See David A Skeel Jr 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917 at 918.

148 *US v Whiting Pools Inc* (1983) 462 US 198 at 203. See also HR Rep No 595,

> In proceedings under the reorganization provisions of the Bankruptcy Code, a troubled enterprise may be restructured to enable it to operate successfully in the future . . . By permitting reorganisation, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners . . . Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap'.

There are similar judicial and legislative statements in the UK.[149] Yet the statement does bring into the spotlight some uncertainties about the goals of corporate rescue law. Yes, the going-concern value of company assets may be greater than its liquidation value. But this is not necessarily or invariably the case. Moreover, the going-concern premium may be captured and realised in different ways. For example, there are a variety of exit routes from administration. One possibility is that the central profitable core of a company's business is sold off to a purchaser with the largely empty corporate shell going into voluntary liquidation. Another possible end-result may be a company voluntary arrangement or a scheme of arrangement (in US terms a plan of reorganisation) whereby some or all creditors agree to accept a 'haircut', i.e. to give up part of their claims against the company or alternatively, to swap their debt for equity. In the US Chapter 11, while corporate restructuring through a plan of reorganisation is the traditional way of bringing a case to a close, preserving and maximising value through asset sales is now a large part of the landscape.

Yes, preserving the essence of a company's business may bring about benefits other than maximising the overall value of company assets. But whether these benefits should be a central independent goal of corporate rescue law as distinct from incidental side effects that may be realised in a particular case is a highly contested question. There is much high-flown rhetoric in both the US and UK about corporate rescue law being concerned with preserving jobs and providing community benefits. Closer analysis, however, suggests that these sentiments, while not completely devoid of substance, also contain a great deal of spin. The reality on the ground is that maximising creditor recoveries is the dominant sentiment.

95th Congress, Ist Session 220 (1977). It is worth pointing out that insolvency law (or bankruptcy law as it is termed in the US) is federal law, not law, under Article 1, s8, clause 4 of the US constitution. On the other hand, property law (including secured property law) falls within the domain of the individual states.

[149] See eg *Powdrill v Watson* [1995] 2 AC 394 where Lord Browne-Wilkinson talked about the 'rescue culture'. See generally Alice Belcher *Corporate Rescue*; David Brown *Corporate Rescue: Insolvency Law in Practice* (Chichester, John Wiley, 1996).

2. Corporate restructuring law in the UK

INTRODUCTION

This chapter looks at the main features of corporate restructuring law in the UK, namely: receiverships, administrations and company voluntary arrangements (CVAs) plus schemes of arrangement under the Companies Act. Attention is principally directed at administration. First however, it is necessary to set the law in context.

CONTEXT

In the last decade corporate restructuring law in the UK has been radically reshaped – principally by means of the Enterprise Act. The Act must be seen against the backdrop of the stakeholder rhetoric of the 'New Labour' government elected in 1997.[1] One might argue that the Enterprise Act 2002 aimed at a paradigm shift – to make the UK the best place in the world to do business. The statute can be viewed in the context of the late 1990s economic boom that was fuelled by the technology and Internet sectors.[2] At the same time however, the government feared a return of the economic downturn and recession of the

[1] For a full theoretical discussion of these issues see Vanessa Finch *Corporate Insolvency Law: Perspectives and Principles* (Cambridge, Cambridge University Press, 2002) and in particular chapters 8 and 9 and see also Finch 'Re-Invigorating Corporate Rescue' [2003] JBL 527. The specialist insolvency journals *Insolvency Lawyer, Insolvency Intelligence and Insolvency Law and Practice* also contain a wealth of literature on the new administration procedure and practical problems thrown up by the same.

[2] See generally on the flavour of the times John Cassidy *dot.con* (New York, Harper Collins, 2002) and for his comments at pp 25–26: 'The Internet bubble fits the broad historic pattern, but it had its own idiosyncrasies. Technology provided the focus for the speculative mania, but it can't fully explain what happened . . . The end of the Cold War surely played a role . . . The key to American success was widely believed to be a combination of free markets and technical progress . . . When the Internet arrived, it was seen as the latest triumph of American enterprise . . . In Britain, for example, Tony Blair's New Labor government was consumed with trying to replicate the free-wheeling culture of Silicon Valley.'

early 1990s.[3] There was a feeling that suitable mechanisms should be in place to prevent or at least to mitigate the consequences of banks 'cutting up rough' in any future recession.[4] Traditionally the main remedy available to a secured creditor has been the appointment of a receiver over the assets of a company.[5] Although designated by statute as an agent of the company this is a very curious and unusual form of agency since the main function of a receiver is to realise the secured assets for the benefit of the secured creditor who made the appointment.

To the 'New Labour' government, receivership was seen as too heavily creditor-oriented.[6] Essentially the concern was that the economic recession of the early 1990s had been prolonged by banks exercising their power to appoint a receiver with a view to protecting their investment. Consequently, the effect of this was to drive too many companies unnecessarily into insolvency.[7] Receivership was not seen as sufficiently responsive to the concerns of other stakeholders involved in the corporate process. The Enterprise Act abolished the right to appoint a receiver over substantially the whole of a company's business, in the generality of cases.

In addition, the administration order procedure for insolvent companies, introduced by the Insolvency Act 1986, was strengthened and explicitly designed to promote corporate rescue.[8] Even the title of the legislation

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[3] See the discussion in Stephen Davies ed *Insolvency and the Enterprise Act 2002* (Bristol, Jordans, 2003) at pp 13–14.

[4] See the statement by the government minister in *Hansard*, Standing Committee B, Enterprise Bill, 15th Sitting, 9 May 2002 at col 602.

[5] The Cork Committee on *Insolvency Law and Practice* (1982), whose report led to the Insolvency Act 1986, was very bullish about the virtues of receivership – see para 495.

[6] The White Paper *Productivity and Enterprise: Insolvency a Second Chance* (Cm 5234, London, HMSO, 2001) at para 2.5 talked about making 'changes which will tip the balance in favour of collective insolvency proceedings – proceedings in which all creditors participate, under which a duty is owed to all creditors and in which all creditors may look to an office holder for an account of his dealings with a company's assets.'

[7] For a defence of receivership see J Armour and S Frisby 'Rethinking Receivership' (2001) 21 OJLS 73. But see S Frisby 'Interim Report to the Insolvency Service on Returns to Creditors from Pre- and Post-Enterprise Act Insolvency Procedures' (July 2007) available on the Insolvency Service website www.insolvency.gov.uk at p 34: 'it would appear that the policy makers were correct in their estimation that administration, as a procedure, is likely to produce better outcomes, in terms of returns, for all creditors'.

[8] D Prentice, F Oditah and N Segal 'Administration: The Insolvency Act 1986, Part 11' [1994] LMCLQ 487 consider further the reasons for the introduction of the administration procedure, its evolution and effect. See more generally B Carruthers and T Halliday *Rescuing Businesses: The Making of Corporate Bankruptcy Law in*

suggests a new social order. Whereas before we had insolvency legislation now we have enterprise law.[9] The legislation was designed to strengthen the foundations of an enterprise economy by establishing an insolvency regime that encouraged honest, but unsuccessful, entrepreneurs to persevere despite initial failure.[10] In other words, the aim was to promote a culture in which companies that could be rescued were, in fact, rescued.

The law was moved in the direction of the corporate reorganisation provisions in Chapter 11 of the US Bankruptcy Code but still with some significant differences. The objective was to borrow the best features of the US system but, at the same time, avoiding the pitfalls. The US Bankruptcy Code has traditionally been seen as very 'pro-debtor'[11] in that proceedings are almost always begun by a voluntary petition filed by the corporate debtor.[12] The filing brings about a moratorium on enforcement proceedings against the debtor or its property and the incumbent management normally remain in place during the early stages at least of the reorganisation proceedings.[13]

By way of contrast, the pre-Enterprise Act English law is seen as pro-creditor – a banker's Valhalla.[14] While the Enterprise Act has repaired the main perceived defects, nevertheless the new procedure falls considerably short of

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England and the United States (Oxford, Clarendon Press, 1998); Alice Belcher *Corporate Rescue* (London, Sweet & Maxwell, 1997); David Brown *Corporate Rescue: Insolvency Law in Practice* (Chichester, John Wiley, 1996).

[9] The legislation was preceded by a 2001 White Paper *Productivity and Enterprise: Insolvency – A Second Chance* Cm 5234.

[10] See generally M Hunter 'The Nature and Functions of a Rescue Culture' [1999] JBL 491.

[11] See generally D Milman 'Reforming Corporate Rescue Mechanisms' in J De Lacy ed *The Reform of United Kingdom Company Law* (London, Cavendish, 2002) at p 415.

[12] For a synopsis of Chapter 11 see R Broude 'How the Rescue Culture came to the United States and the Myths that Surround Chapter 11' (2000) 16 Insolvency Law and Practice 194.

[13] For a comparative evaluation of the 'pro-creditor' nature of the US insolvency regime see the joint HM Treasury/DTI report 'A Review of Company Rescue and Business Reconstruction Mechanisms' (May 2000) at pp 38–41. The Review Group however concluded at p 33 of its report that 'it would be wholly inappropriate to attempt to replicate Chapter 11 in the UK, where the business culture and economic environment are quite different'.

[14] See the comment in JL Westbrook 'A Comparison of Bankruptcy Reorganisation in the US with the Administration Procedure in the UK' (1990) 6 Insolvency Law and Practice 86 at 87 'if an American banker is very, very good, when he dies he will go to the United Kingdom. British banks have far more control than an American secured lender could ever hope to have. Receiverships on the British model are unknown and almost unthinkable in the US. A US banker could barely imagine a banker's Valhalla in which a bank could veto a reorganisation as a UK bank may effectively veto an administration by appointing an administrative receiver.'

the US regime.[15] Administration still involves handing control of the company over to an outsider and, moreover, there is no method by which secured creditors can be 'crammed' down, i.e. forced to accept a reorganisation plan against their wishes. The possibility for 'cram down' is a feature of the US system.[16] On the other hand,[17] the legislation has won plaudits and with one commentator remarking that:[18]

> The government deserves much praise for seeking out this middle ground between, on the one hand, the ancient regime in the UK, dominated by the banks through the instrumentality of receivership and, on the other, Chapter 11 with its increasingly criticised partisanship favouring the debtor. If, as is to be hoped, all interests – secured and unsecured creditors, management, investors, insolvency practitioners – give this reforming Act a fair wind, we may yet see the most dynamic insolvency regime in the world.

BUSINESS RESCUE IN THE UK – RECEIVERSHIP

Administration in the UK grew out of receivership, which is essentially a creditor-oriented procedure. Receivership originated in the Court of Chancery as a remedy to protect a person's interest in property or as a form of execution.

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15 See the comment by Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367 at 397: 'In summary, English rehabilitation law recently has been overhauled to promote reorganization and fuel a failing economy. Even in its new form however, this law is very different from American rehabilitation law. Existing management cannot stay in place, there is an insolvency requirement, and the process is entirely creditor controlled. This form of rescue culture may achieve its goals of saving some businesses from piece-meal liquidation by allowing them to be purchased while still operational. It also may save jobs and avoid harm to suppliers who deal with the troubled company. It is not, however, a reorganisation in the traditional American sense of the word.'

16 See generally on similarities and differences between the two systems John Armour; Brian R Cheffins and David A Skeel Jr 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 Vand L Rev 1699. On cram down see Jack Friedman 'What Courts do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 Cardozo Law Review 1496, who suggests at 1499 that 'the traditional mystique concerning cram down which instills fear among secured creditors is exaggerated. Cram down is applied in a remarkably homogenous and predictable manner regarding secured claims.'

17 See H. Rajak 'The Enterprise Act and Insolvency Law Reform' (2003) 24 Company Lawyer 3.

18 See H. Rajak 'The Enterprise Act and Insolvency Law Reform' (2003) 24 Company Lawyer 3. It is highly questionable whether this is an accurate depiction of Chapter 11 given especially the increasing use of DIP financing agreements as a creditor control and governance device.

Subsequently, creditors who took security over the debtor's property were allowed to stipulate in the contract of loan for the power to appoint a receiver, or a receiver and manager, for the purpose of enforcing their security. Privately appointed receivers have since outstripped Court-appointed receivers in practical importance. There is a clear distinction between a receiver, on the one hand, and a receiver and manager on the other. As Lord Jessel MR pointed out in *Re Manchester & Milford Rly Co:*[19]

> A receiver . . . [means] . . . a person who receives rents or other income paying ascertained outgoings, but who does not . . . manage the property in the sense of buying or selling or anything of that kind . . . If it was desired to continue the trade at all it was necessary to appoint a manager, or a receiver and manager as it was generally called. He could buy and sell and carry on the trade.

In practice, a debenture holder who holds a floating charge over the entire undertaking of the company would usually have the power to appoint a receiver and manager rather than a mere receiver, because of the all-encompassing nature of the security. The power to appoint a private receiver and manager is purely contractual and provision for such a power must be found in the debenture, failing which the debenture holder will not be able to make an appointment.[20]

Receivership has often been viewed through rose-tinted corporate rescue or, at least business rescue, spectacles. The Cork Committee on Insolvency Law and Practice, which reported in 1982, highlighted the power to appoint a receiver and manager of the whole property and undertaking of a company. The committee went on to say:[21]

> Such receivers and managers are normally given extensive powers to manage and carry on the business of the company. In some cases, they have been able to restore an ailing enterprise to profitability, and return it to the former owners. In others, they have been able to dispose of the whole or part of the business as a going concern. In either case, the preservation of the profitable parts of the enterprise has been of advantage to the employees, the commercial community, and the general public.

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19 (1880) 14 Ch D 645 at 653.

20 Per Kerr LJ in *Cryne v Barclays Bank plc* [1987] BCLC 548 at 554: 'The third submission by counsel . . . was that there was in any event an inherent right in the bank as debenture holders, without the need for implying any term in the facility letter, to appoint a receiver once their security was in jeopardy. In that connection counsel relied on a line of cases . . . These cases are no authority for the proposition that a debenture holder may appoint a receiver out of court . . . if there is no contractual right to do so . . . Counsel for the bank has accordingly not persuaded me that it is arguable, let alone correct, that the bank had any inherent right to appoint a receiver if it had no contractual right to do so under the terms of the facility letter.'

21 Cmnd at para 495.

It is arguable that the Committee's view represented a rather idealised conception of receivership.[22] One empirical study points to a recurring complaint by managers and unsecured creditors that receivers looked out for the interests of the bank that appointed them and not the interests of the business or the other creditors:[23]

> Cork and all always liked to say that when you put in receivers, it was a way of saving the business. But actually, the first thing the receiver does is to say, 'how am I going to get my appointor's, my debenture-holders's, money back?' A bank is owed 10 million, you put the receiver in, the receiver's job is to find 10 million, and it often did lead to liquidation.

Be that as it may, the Cork Committee noted out that a receivership appointment and the benefits attainable were only possible where a company had created a floating charge.[24] Where there was no security, then there was a gap and a receiver-type person could not be appointed. Administration was brought into being to fill this gap. It was envisaged that administration would be used primarily in cases where the company had not granted a debenture secured by a floating charge but the Committee did not wish that the procedure should be confined to such cases.

The Insolvency Act 1986 introduced the administration procedure into English law and also put a lot of the law relating to receivers on a statutory footing in ss 29–48 though it is still necessary to refer to common law and equitable principles. Moreover, the Insolvency Act introduced the office of administrative receiver, which is defined as a receiver of the whole or substantially the whole of a company's property appointed by the holder of a floating charge. The administrative receiver is given various implied powers stated in Schedule 1 of the Act including power to carry on and manage the business of the company. Section 44 Insolvency Act 1986 lays down that an administrative receiver is deemed to be the company's agent unless and until the company goes into liquidation.[25]

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[22] For somewhat more critical voices see J Zeigel 'The Privately Appointed Receiver and the Enforcement of Security Interests: Anomaly or Superior Solution' in J Zeigel ed. *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford, Clarendon Press, 1994) p 451 at 461 and D Milman 'A New Deal for Companies and Unsecured Creditors' (2000) 21 Company Lawyer 59–60.

[23] B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 286.

[24] For a defence of receivership see J Armour and S Frisby 'Rethinking Receivership' (2001) 21 OJLS 73.

[25] Section 109(2) Law of Property Act 1925 states that any receiver appointed pursuant to that statute is deemed to be the agent of the mortgagor who is solely responsible for the receiver's act or defaults unless the mortgage deed provides otherwise.

Nevertheless this agency appears extremely curious if one looks to substance over form. One judge has remarked extra-judicially that the 'so-called agency of the receiver is not a true agency, but merely a formula for making the company, rather than the debenture-holders, liable for his acts.'[26] Hoffmann J has also commented in *Gomba Holdings (UK) Ltd v Homan*[27] that while nominally the agent of the company, the receiver's primary duty is to realise the assets in the interests of the debenture holder and his powers of management are really ancillary to that duty.[28]

The law on receivership can be set out in a number of fundamental propositions. Firstly, receivership in general, including administrative receivership, is a creditor-centred rather than debtor-centred procedure, with the primary duties of a receiver being owed to the appointor rather than to the company over whose property the appointment has been made. This is so even though the receiver is expressly constituted an agent of the company. The high-water mark of this analysis came with the Privy Council decision in *Downsview Nominees Ltd v First City Corp Ltd.*[29] It was held that, provided that a receiver acted in good faith for the purpose of enabling the assets comprised in the debenture holder's security to be preserved and realised for the benefit of the debenture holder, his decisions whether to continue the business or to close it down and sell particular assets could not be impeached, even if these decisions

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[26] See the article by Peter Millett QC, as he then was, 'The Conveyancing Powers of Receivers After Liquidation' [1977] Conv 83 at 88.

[27] [1986] 3 All ER 94 at 97.

[28] The peculiar incidents of the agency were stressed by the Court of Appeal *Silven Properties Ltd v Royal Bank of Scotland* [2003] BPIR 1429 at para 27: 'In particular: (1) the agency is one where the principal, the mortgagor, has no say in the appointment or identity of the receiver and is not entitled to give any instructions to the receiver or to dismiss the receiver . . . (2) there is no contractual relationship or duty owed in tort by the receiver to the mortgagor: the relationship and duties owed by the receiver are equitable only . . . (3) the equitable duty is owed to the mortgagee as well as the mortgagor. The relationship created by the mortgage is tripartite involving the mortgagor, the mortgagee and the receiver; (4) the duty owed by the receiver (like the duty owed by a mortgagee) to the mortgagor is not owed to him individually but to him as one of the persons interested in the equity of redemption. The class character of the right is reflected in the class character of the relief to be granted in case of a breach of this duty. That relief is an order that the receiver account to the persons interested in the equity of redemption for what he would have held as receiver but for his default; (5) not merely does the receiver owe a duty of care to the mortgagee as well as the mortgagor, but his primary duty in exercising his powers of management is to try and bring about a situation in which the secured debt is repaid . . . (6) the receiver is not managing the mortgagor's property for the benefit of the mortgagor, but the security, the property of the mortgagee, for the benefit of the mortgagee . . .'.

[29] [1993] AC 295; [1993] 3 All ER 626.

were disadvantageous to the company or other security interest holders. A receiver was not subject to any more extensive liability.

Downsview reinforces 'the traditional idea of receivership as essentially a private remedy between a creditor and a debtor requiring only limited glances by the receiver at the other parties, such as other creditors and guarantors standing in the wings'.[30] This represents a form of tunnel vision which diminishes any conception of receivership as contributing to the rescue culture. To the extent that public interest concerns are neglected, then the decision runs counter to the thrust of the Cork Report.[31] This decision has been severely criticised with Lightman J in an extra-judicial capacity describing it as 'the most retrograde step in recent times creating a hole in the rescue culture'.[32] He expressed the hope that the courts 'will muster the courage to dismiss *Downsview* as an aberration'. While such hopes have not yet been entirely fulfilled, there have been judicial moves in that direction.[33]

Downsview may have contributed to the partial demise of receivership in the UK through the Enterprise Act 2002. It is also out of step with, or has been superseded by, developments in other common law jurisdictions. An example is the New Zealand Receiverships Act 1993[34] which, in s 18, imposes an obligation on the receiver to act with reasonable regard to the interests of unsecured creditors, guarantors and others claiming an interest in property through the debtor. Also worth noting is the Canadian Bankruptcy and Insolvency Act 1992, which requires the receiver to deal with the assets in a commercially reasonable manner,[35] and the Australian Corporate Law Reform Act 1992, which imposes on a receiver a duty to exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances.[36]

Downsview has however been defended on the basis that a receiver might otherwise be faced with an unacceptable conflict of interests; a primary duty

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30 See Brenda Hannigan *Company Law* (London, LexisNexis, 2003) at p 746.

31 (1982) Cmnd. 8558 at para 495. Furthermore, there appears to be an inconsistency at the heart of the *Downsview* case. This inconsistency was highlighted by Scott VC in *Medforth v Blake* [2000] Ch 86. According to the law as confirmed in *Downsview* a receiver who sells but fails to take reasonable care to obtain a proper price may incur liability notwithstanding the absence of fraud or bad faith. Why, said Scott VC, should the approach be any different if what is under review is not the conduct of a sale but conduct in carrying on a business?

32 [1996] JBL 113 at 119–120.

33 See *Medforth v Blake* [2000] Ch 86.

34 See generally RM Goode *Principles of Corporate Insolvency Law* (London, Thomson, 3rd ed 2005) at p 285.

35 S 247.

36 S 232(4).

to ensure the repayment of the secured creditor's loan plus interest, and a duty of care to the company that might import postponement of a sale where there is a strong indication that the value of the assets is likely to increase. On the other hand, conflicts of interest are part and parcel of the modern financial world and that has not stopped the imposition of apparently conflicting duties.[37]

The second aspect of receivership is that the appointor is under no direct liability for the acts of the receiver. The appointor only becomes liable for the receiver's action if he interferes with the conduct of the receivership by giving instructions to the receiver. As Mann J said in *American Express International Banking Corp v Hurley*:[38] 'The mortgagee is not responsible for what a receiver does while he is the mortgagor's agent unless the mortgagee directs or interferes with the receiver's activities . . . The mortgagee is responsible for what a receiver does whilst he is the mortgagee's agent and acting as such.'

Thirdly, the receiver owes some limited duties to the company debtor and to guarantors of the secured debt in relation to the realisation (sale) of secured assets but not, it appears, with respect to the timing of realisation.[39] In *Standard Chartered Bank Ltd v Walker*[40] a receiver sold mortgaged property for an amount that was insufficient to satisfy the secured debt and this impacted adversely on a guarantor of the secured debt who was required to make up the shortfall. The Court of Appeal held that the receiver had not used reasonable care to realise the assets to the best advantage and the guarantor should be given credit in equity for the amount which the sale should have realised if reasonable care had been used. Lord Denning said the receiver:[41]

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[37] See generally McCormack 'Conflicts of Interest, Chinese Walls and Investment Management' (1999) 1 International and Comparative Corporate Law Journal 5.

[38] [1985] 3 All ER 564 at 568.

[39] In determining whether a receiver has broken his duties, one point that is worth stressing is that a sale by auction does not necessarily acquit a receiver or mortgagee of a claim of negligence. This is made clear by the Privy Council in *Tse Kwong Lam v Wong Chit Sen* [1983] 1 WLR 1349. In that case mortgaged property was sold at an auction by the mortgagee to a company in which he had a major shareholding. Damages were awarded to the mortgagor. Speaking for the Privy Council, Lord Templeman rejected a submission that an auction must automatically produce the best price reasonably obtainable. He said the price obtained at any particular auction may be less than the price obtainable by private treaty and may depend on the steps taken to encourage bidders to attend. An auction which generated only one bid was not necessarily a pointer that the true market value had been procured.

[40] [1982] 1 WLR 1410. See also *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949.

[41] [1982] 1 WLR 1410 at 1415–1416.

> owes a duty to use reasonable care to obtain the best possible price which the circumstances of the case permit. He owes this duty not only to the company (of which he is the agent) to clear off as much of its indebtedness to the bank as possible, but he also owes a duty to the guarantor, because the guarantor is liable only to the same extent as the company. The more the overdraft is reduced, the better for the guarantor. It may be that the receiver can choose the time of sale within a considerable margin, but he should, I think, exercise a reasonable degree of care about it.

Fourthly, it appears that a receiver has no duty owed to exercise reasonable care about the timing of sale, *China and South Sea Bank Ltd v Tan.*[42] *Downsview* also seems to suggest that a debtor cannot complain about the timing of a sale, even though the debenture holder would lose nothing and the debtor would gain a lot if a sale were temporarily delayed. The distinctions drawn in the case law seem very difficult to defend however, particularly in the light of *Medforth v Blake*.[43]

Fifthly, a receiver is potentially liable to the debtor and to the guarantor for negligent conduct of business operations pending sale of assets, provided that the imposition of liability in this context would not conflict with the primary duty owed by the receiver to the appointor. There has, however, been an element of judicial disagreement with divergent views articulated by the Privy Council and by the English Court of Appeal. In *Downsview Nominees Ltd v First City Corp Ltd*[44] the Privy Council rejected the view that a receiver owed a duty to take reasonable care in the exercise of powers and in managing the debtor's assets. According to *Downsview*:[45]

> The receiver . . . is entitled, if he so chooses, to decide not to continue the company's business, and to sell a part of the business which would be better kept. It would also seem that he can select a particular asset to realise for the benefit of his debenture holder even though the removal of that asset would damage the company's business and there are other assets to which he could resort and on which the business is less dependent.

In *Medforth v Blake* this restrictive view was rejected. This is a case where receivers of a farming business were appointed after the borrower defaulted under a loan agreement. It was explicitly stated that the receivers should be the agents of the farmer who alone should be responsible for their acts and defaults. The receivers carried on the farming business but the borrower

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42 [1990] 1 AC 536.

43 [2000] Ch 86.

44 [1993] AC 295.

45 RM Goode *Principles of Corporate Insolvency Law* (London, Thomson, 3rd ed, 2005) at p 284.

argued that they had broken a duty of care by failing to obtain substantial discounts on animal feed from suppliers notwithstanding that this was standard commercial practice and animal feed was a major part of the business expenses. The receivers appeared to accept that a chargee in possession would be accountable in similar circumstances but nevertheless, the receiver had no liability in the absence of bad faith. The Court of Appeal, led by Scott VC, rejected this proposition as offending commercial sense. The court said that if the receiver does decide to carry on the business he should be expected to do so with reasonable competence.

Finally, and re-emphasising the fundamental element that receivership is a debtor-centred procedure, there is no requirement that the secured creditor should give the debtor prior notice of the intention to appoint a receiver.[46] Such a requirement might give the debtor some breathing space in locating alternative sources of funding. Canada, for example, introduced a notice requirement in 1992 in s 244 of the Bankruptcy and Insolvency Act which requires that a secured creditor who intends to enforce a security over all or substantially the whole of the debtor's property should send a prescribed notice to the debtor.[47] The security interest cannot be enforced until ten days after service of the notice. The grace period is designed to allow the debtor time to put in place alternative funding arrangements or else to invoke one of the debtor reorganisation mechanisms. In the UK, while similar ideas have not met with either legislative or judicial acceptance, one might suggest that it is rare for the appointment of a receiver to come completely out of the blue as far as a debtor is concerned.

THE DEMISE OF RECEIVERSHIP AND THE RISE OF ADMINISTRATION

In the 1990s receivership went out of fashion in the UK. In the recession of the early 1990s the feeling was that banks had pushed companies unnecessarily into insolvency by being unduly precipitate in the appointment of receivers.[48] Banks were alive to this perception by centralising the way in which they handled distress companies so as to avoid the uncoordinated dumping of bankrupt assets

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[46] See *Bank of Baroda v Panessar* [1987] Ch 335; *Bunbury Foods Pty Ltd v National Bank of Australasia Ltd* (1984) 51 ALR 509. The debtor is only allowed the short time necessary to put in motion the mechanics of payment.

[47] This follows judicial developments in Canada – see *Lister Ltd v Dunlop Canada Ltd* (1982) 135 DLR (3d) 1.

[48] See the statement by the government minister in *Hansard*, Standing Committee B, Enterprise Bill, 15th Sitting, 9 May 2002 at col 602.

on to the market with a consequent depression of asset prices and recovery rates.[49] The broader political and business dynamics also changed. Increasingly, the receivership model was seen as too creditor-centred and insufficiently responsive to the concerns of other stakeholders. The 'New' Labour Government elected in 1997 embarked on a review of Business Rescue and Company Reconstruction mechanisms.[50] This review identified the function of an insolvency code as being to reinforce the working of the market in bringing about the efficient allocation of resources.[51] This could be done through providing a framework within which companies and their businesses could be 'rescued' where rescue maximised total economic value and secondly, to achieve an orderly liquidation of assets where liquidation was appropriate.[52] The perceived stranglehold enjoyed by secured creditors over company rescue procedures was seen as potentially contributing to the non-realisation of these broad strategic objectives. The Government White Paper *Insolvency – a Second Chance*[53] (July 2001) took up the same theme, stating

> Administrative receivership which places effective control of the direction and outcome of the procedure in the hands of the secured creditor is now seen by many as outdated. There are many other important interests involved in the fate of such a company, including unsecured creditors, shareholders and employees. We propose to create a streamlined administration procedure which will ensure that all interest groups get a fair say and have an opportunity to influence the outcome.

The Enterprise Act 2002 followed on from this White Paper[54] and revamped the existing structures so as to enhance the value of ailing enterprises. The Act was designed to strengthen the foundations of the economy, with even the title of the legislation suggesting a new social order. In the majority of cases, the legislation abolished the right of an all-assets floating

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49 See generally J Franks and O Sussman 'Financial Distress and Bank Restructuring of Small to Medium Sized UK Companies' (2005) 9 Review of Finance 65 and see also S Davydenko and J Franks 'Do Bankruptcy Codes matter? A Study of Defaults in France, Germany and the UK' European Corporate Governance Institute Finance Working Paper No 89/2005. See also V Finch 'The Recasting of Insolvency Law' (2205) 68 MLR 713.

50 See DTI/HM Treasury report 'A Review of Company Rescue and Business Reconstruction Mechanisms' (London, DTI, 2000).

51 Ibid at p 4.

52 See ss 8 and 9 of the Insolvency Act. See also *Re Croftbell Ltd* [1990] BCLC 844 which permitted the practice of lenders, even if they are already sufficiently secured by a fixed charge, to take a floating charge thereby giving them a power of veto on the making of an administration order.

53 Cm 5234 at para 2.1.

54 *Productivity and Enterprise: Insolvency – A Second Chance* Cm 5234.

charge holder to appoint an administrative receiver. The statute also adopted the existing administration procedure, first introduced by the Insolvency Act 1986, and turned it into something that was more specifically geared to the purpose of corporate rescue. On the other hand, secured lenders did win some significant concessions from the government during the passage of the legislation. This has led some observers to suggest that administration under the Enterprise Act 2002 is best understood as 'receivership-plus'; in other words, receivership with a few add-ons such as somewhat wider duties. Another analysis approaches administration with the concept of transmutation in mind. On this view, the new legislative dispensation is best described as a 'transmutation' or 'merger' of the administrative receivership and administration procedures rather than as being the end of administrative receivership.[55]

There are still a significant number of residual cases where administrative receivers may still be appointed. These are set out in ss 72B–G Insolvency Act 1986 and, in the main, cover 'exotic' high-end financing transactions and sector-specific financing, particularly in the context of public–private partnerships. Section 72B refers to capital market investments where a party incurs or, when the agreement was entered into, was expected to incur, a debt of at least £50m under the arrangement; s 72C is about public–private partnerships with step-in rights; s 72D utilities; s 72DA urban regeneration projects; s 72E financed project companies including step-in rights; s 72F charges in connection with financial markets; s 72G registered social landlords; s 72GA protected railway companies. If an economic recession bites, financial institutions are likely to make full use of the potentialities offered by these provisions. Perhaps the greatest potential is offered by s 72B – the capital markets exception – and s 72E – the project finance exception, though reliance on the provision failed in *Feetum v Levy*, both before Lewison J at first instance[56] and in the Court of Appeal.[57]

Section 72E(2)(a) provides that a project is a 'financed project' if under an agreement relating to the project a project company incurred, or when the agreement was entered into expected to incur, a debt of at least £50m for the purposes of carrying out the project. In *Feetum v Levy* there was no expectation that the company would borrow at least £50m and therefore the exception did not apply. Moreover, it was held that there were no 'step-in rights' within the meaning of the provision. Under s 72E a project has step-in rights if a person who provided finance in connection with the project had a conditional entitlement under an agreement to (a) assume sole or principal responsibility

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55 See generally S Davies (ed) *Insolvency and the Enterprise Act 2002* (Bristol, Jordans, 2003) at pp 40–41.

56 [2005] BCC 484.

57 [2006] Ch 685.

under an agreement for carrying out all or part of the project, or (b) make arrangements for the carrying out of all, or part of, the project. In *Feetum v Levy* the debenture stated that any administrative receiver appointed was the agent of the company and not of the lender. Therefore, if the receiver decided to carry out the project, the borrower would be treated in law as carrying it out or as making the necessary arrangements to do so. The lender was not entitled to make the arrangements to carry out the project for it was dependent on the discretionary decision of the receiver. Consequently, the project was not one in which there were step-in rights. On the other hand, Lewison J did say that the project finance exception should not be limited to project finance provided by banks.

The Court of Appeal confirmed the general attempt thrust of the first instance decision though Jonathan Parker LJ eschewed any attempt at a comprehensive or exhaustive description of the kinds of rights which may constitute step-in rights for the purpose of the statute. He pointed out, however, that an agreement under which a financier has step-in rights need not be the same agreement as that under which an administrative receiver is appointed. Also, the agreement with step-in rights may be an agreement with a different project company other than the project company in respect of which the appointment of an administrative receiver is made. Thirdly, more than one financier may have relevant step-in rights over the same project. Nevertheless, the most important point to draw from the case is that the power to appoint an administrative receiver should not be equated with step-in rights. Otherwise, the inclusion of a requirement for step-in rights would become superfluous.[58]

DEFECTS IN THE ORIGINAL ADMINISTRATION PROCEDURE

Administration in its original guise has been described as a 'hybrid procedure combining the exceptional powers of floating charge receivership with an altered set of objectives, based on collectivity of approach and a rescue-oriented mission'.[59] The administration procedure was, however, characterised by a number of features which curtailed its effectiveness. Firstly the procedure was very heavily court-centred. Only the court could appoint an administrator on application made by the company or its creditors. Secondly, the holder of a general floating charge over company assets had an effective veto on the making of an appointment. Largely this was because administra-

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58 See Jonathan Parker LJ at para 93.

59 See Ian F Fletcher 'UK Corporate Rescue' [2004] European Business Organization Law Review 119 at 125.

tion was seen as an alternative to receivership. Thirdly, there were no overarching statutory objectives.

Section 8(3) Insolvency Act 1986 set out various purposes for whose achievement an administration order might be made, namely:

a. the survival of the company, and the whole or any part of its undertaking, as a going concern;
b. the approval of a voluntary arrangement;
c. the sanctioning of a compromise or arrangement between the company and its creditors; and
d. a more advantageous realisation of the company's assets than would be effected on a winding up.

An administration order could specify more than one purpose, but the legislation did not specify whether one purpose could take priority over another.

Fourthly, there were gaps in the statutory moratorium that was designed to give an ailing company a breathing space to negotiate its way out of difficulty. After the presentation of a petition for the appointment of an administrator, and during the currency of administration, there was an embargo on the enforcement of security rights and other claims against the company. Although extensive, this embargo did not cover situations where a landlord of premises occupied by a company forfeited the lease for breach of covenant and peacefully retook possession. After some uncertainty and vacillation, the courts held that a landlord's right to forfeit a lease for breach of covenant by peaceful re-entry did not fall within the definition of security. A right of re-entry was not security over a lease but simply a right to terminate the lease and restore the landlord to possession of its own property.

Fifthly, there were no time limits apart from a requirement to hold a meeting of creditors within three months of appointment and to lay a statement of the administrator's proposals before such a meeting. The period could be extended by the court. The administration did not come to an end automatically within a certain time-frame or when a particular event occurred. There was always the possibility that administration might drag on indefinitely, though an administrator was required to apply to the court for the order to be discharged if it appeared that the purpose, or each of the purposes, specified in the administration order had been achieved, or was no longer capable of achievement.

Finally, the exit routes from administration into liquidation were procedurally difficult and cumbersome to negotiate. For example, creditors' voluntary liquidation is a more cost-effective alternative than compulsory liquidation under the control of the court but there were considerable difficulties in going down the creditors' voluntary liquidation route.

REMODELLED ADMINISTRATIONS AND THE LEGISLATIVE REFORMS INTRODUCED BY THE ENTERPRISE ACT 2002

In the main, the perceived difficulties of administration have been addressed in the Enterprise Act 2002 or to a limited extent in the Insolvency Act 2000. Firstly, there are now three routes into administration. One route is through out-of-court appointment by a qualified floating charge.[60] The second is by the company itself making its own out-of-court appointment on giving prior notice to a qualified floating charge holder.[61] The notification requirement affords the floating charge holder the opportunity to make its own appointment. The third option involves going to court, but considering the alternatives this route is unlikely to be invoked very often. A possible scenario is where a company has no substantial secured borrowings but unsecured creditors are dissatisfied with existing management and wish to see corporate restructuring proceed under the helm of an outsider.

On the second difficulty, at the risk of over-simplification it may be fair that the Enterprise Act has replaced the floating charge holder's veto on administration with a veto on the identity of the proposed administrator. For example, there is provision that where an administration application is made by somebody other than the qualified floating charge holder the latter may intervene in the proceedings and suggest the appointment of a specified person as administrator. The court is mandated to accede to this application unless it thinks it right to refuse the application 'because of the particular circumstances of the case'.[62] Furthermore, under para 35 the court is required automatically to accede to administration applications made by qualified floating charge holders and there is no threshold insolvency test in the case of such applications. Floating charge holders might seek a court appointment in cases where an administrator may be called upon to take control of company property or perform other functions in a foreign jurisdiction. Schedule B1 para 5 provides that an administrator is an officer of the court (whether or not he is appointed by the court). Nevertheless, a foreign tribunal may not accord recognition to an administrator appointed out of court.

Thirdly, on statutory aims under the new regime, whatever the method of appointment, an administration has the overriding objective of rescuing the company as a going-concern. Where however, this is not reasonably practical and/or it is not in the interests of creditors (as a whole) for the company to be

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60 Schedule B1 Insolvency Act 1986 para 14.
61 Schedule B1 Insolvency Act 1986 paras 22 and 26.
62 Schedule B1 Insolvency Act 1986 para 36(2).

rescued as a going-concern, then the administrator's mission is to achieve a better result for the company's creditors (as a whole) than would be likely if the company were wound up. If neither of the above is reasonably practical, then the final objective is to make a distribution to one or more secured or preferential creditors. An administrator is subject to an overarching duty to exercise his/her functions in the interests of creditors as a whole and, in realising the property secured, not unnecessarily to harm the interests of creditors as a whole. The statutory language is clearly different and, superficially at least, the administrator has a different set of functions to perform than the old style administrative receiver. Nevertheless, one of the main functions of administration is still making distributions to secured and preferential creditors. If this is done and the person appointing the administrator is the floating charge holder, then the similarities between administration and old-style administrative receivership seem very strong. It has been suggested that the administration procedure protects the interests of secured creditors as well as, if not better than, administrative receiverships.[63] It offers a more effective set of tools overall for dealing with an insolvent company than does receivership.[64]

Fourthly, during administration a moratorium preventing creditors (including floating chargeholders) from enforcing their debts comes into effect: no enforcement of security, or legal proceedings, can be taken against the company without the consent of the administrator or the court. The gaps in the statutory moratorium were largely closed by the Insolvency Act 2000 which extended the moratorium to catch a landlord's right of forfeiture by peaceable re-entry.[65]

The Enterprise Act 2002 also imposes reasonably strict time limits for the completion of the administration process and facilitates the smooth transition from administration to liquidation and dissolution. Administration in the UK has traditionally not been a stand-alone procedure in the same way that Chapter 11 is in the US.[66] It is more a gateway to other procedures whether

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[63] See S Frisby 'Interim Report to the Insolvency Service on Returns to Creditors from Pre- and Post-Enterprise Act Insolvency Procedures' (July 2007) available on the Insolvency Service website www.insolvency.gov.uk at p 10.

[64] Ibid at p 18 who quotes an insolvency practitioner: 'Now, if you ever talk to a mechanic he'll tell you to get a bigger hammer. If you hit it hard enough it will fit, and administration is the biggest hammer I know, it does virtually everything.'

[65] See now Schedule B1 Insolvency Act 1986 para 43 (4).

[66] For an empirical study of the administration procedures in operation see the 'Report on Insolvency Outcomes' – a paper presented to the Insolvency Service by Dr Sandra Frisby – see www.insolvency.gov.uk and for a summary S Frisby 'Not Quite Warp Factor 2 Yet? The Enterprise Act and Corporate Insolvency' (2007) 22 Butterworths Journal of International Banking and Financial Law 327.

this is an agreement with creditors through a company voluntary arrangement or scheme of arrangement or the liquidation and dissolution of the company. The Enterprise Act however, offers the possibility that administrations may function on a stand-alone basis since it permits a company to proceed straight from administration to dissolution without going through the intermediate stage of liquidation if there are insufficient assets to make distributions to unsecured creditors. The administrator is given power to make distributions to secured and preferential creditors and also, with the leave of the court, to unsecured creditors.[67] The threshold for the exercise of such power is subjective – what the administrator thinks is likely to assist the achievement of the purpose of administration.[68] This implies that the administrator must use commercial judgment but early strategic planning is needed about the way in which the administration is intended to end. Information about exit options should be included in the administrator's proposals to creditors. The fast-track route from administration to dissolution requires the filing of a notice with the registrar of companies, with dissolution deemed to occur automatically three months after the filing though there is a mechanism whereby this period may be extended.[69]

It seems clear from the structure of the legislation however, that in the normal run of cases, administration should not be used as a procedure that substitutes for liquidation. Professor Keay asks:[70]

> Is it necessarily a bad thing if administration is sought to be used as a substitute for liquidation? The answer is not clear. It is probably 'no' and 'yes'. The answer is 'no' if, ultimately, the creditors get a better deal with greater dividends and a quicker pay-out. The answer is 'yes' if administrations are used to circumvent some of the investigative processes that are usually undertaken in liquidation, and conduct that is inconsistent with commercial morality is being perpetrated, and not being uncovered.

Administration is intended as a fast process with the administrator performing his functions as quickly and efficiently as is reasonably practicable[71] whereas liquidations may be more long-drawn-out affairs. The liquidator has certain powers that are denied to administrators. The conduct of the directors may warrant further scrutiny in which case the move to liquidation is appropriate,

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67 Schedule B1 Insolvency Act 1986 para 65.

68 Schedule B1 Insolvency Act 1986 para 66.

69 Schedule B1 Insolvency Act 1986 para 84.

70 See generally A Keay 'What Future for Liquidation in Lights of the Enterprise Act Reforms' [2004] JBL 153 at 158 and see also A Keay 'The New Era for Administrations: Pointers from Down Under' (2005) 18 Insolvency Intelligence 1.

71 Schedule B1 Insolvency Act 1986 para 4.

for only a liquidator, and not an administrator, may bring proceedings against directors in respect of fraudulent or wrongful trading by the company.[72] Moreover, under s 178 of the Insolvency Act, a liquidator but not an administrator may disclaim onerous property. For the purposes of the section, 'onerous property' means any unprofitable contract and any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous acts. It can include statutory exemptions or licences, such as a waste management licence.[73] In *Manning v AIG Europe*[74] the Court of Appeal considered the meaning of 'unprofitable contract' and decided that the critical feature was whether 'performance of the future obligations will prejudice the liquidator's obligation to realise the company's property and pay a dividend to creditors within a reasonable time'.[75] Under s 178(6), any person sustaining loss or damage in consequence of a disclaimer is deemed a creditor of a company to the extent of the loss or damage sustained and may prove for that loss or damage in the winding-up of the company.[76]

THE CONDUCT OF ADMINISTRATION

An administrator may do all the things necessary for managing the company's affairs while making investigations and inquiries so as to formulate proposals to achieve the statutory goals. Normally, the creditors should be afforded an opportunity to consider and review what the administrator proposes to do. The

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72 Ss 213 and 214 Insolvency Act 1986.

73 *Re Celtic Extraction Ltd* [2001] Ch 475.

74 [2006] Ch 610.

75 The court also approved the following statement of principle by Chesterman J in the Australian case *Transmetro Cop Ltd v Real Investments Pty Ltd* (1999) 17 ACLC 1314 at 1320: '[1] A contract is unprofitable . . . if it imposes on the company continuing financial obligations which may be regarded as detrimental to the creditors, which presumably means that the contract confers no sufficient reciprocal benefit. [2] Before a contract may be unprofitable for the purposes of the section it must give rise to prospective liabilities. [3] Contracts which will delay the winding up of the company's affairs because they are to be performed over a substantial period of time and will involve expenditure that may not be recovered are unprofitable. [4] No case has decided that a contract is unprofitable merely because it is financially disadvantageous. The cases focus upon the nature and cause of the disadvantage. [5] A contract is not unprofitable merely because the company could have made or could make a better bargain.'

76 *Re Park Air Services plc* [2000] 2 AC 172 – landlord entitled to prove for statutory compensation for loss of his right to future rent and compensation assessed in the same way as damages for breach of contract.

legislation makes the assumption that, in exchange for the moratorium, creditors are to have an important say in the conduct of the administration.

Creditors and members must be sent a copy of the administrator's proposals at the latest within eight weeks of the company entering into administration and under para 51 an initial creditors' meeting must be held within the following two weeks though this time limit can be extended by the court or by the creditors. The statement of proposals will necessarily be a detailed document setting out the history of the company, its present financial position and future plans during the administration as well as providing sufficient financial information to enable the creditors to decide whether or not they should approve the proposals. The time-scales are intended to reflect the day-to-day practicalities of administration. Unrealistically short periods would mean a significant number of court applications for extensions of time leading to more costs being incurred and greater inconvenience for insolvency practitioners and creditors. It should be noted however that the administrator must perform the statutory functions as quickly and efficiently as is reasonably practicable.[77]

An administrator has power to dispense with the requirement to hold an initial creditors' meeting if s/he believes either that the company is fully solvent, i.e. the company has sufficient property to enable each creditor to be paid in full,[78] or where the company has insufficient property to make a distribution to unsecured creditors other than by virtue of the statutory ring-fencing provision in s 176A Insolvency Act 1986.[79] The decision whether to hold a meeting is based upon the administrator's subjective assessment and, in the opinion of certain commentators, is 'ripe for abuse'.[80] On the other hand, an administrator can be forced to hold an initial creditors' meeting if so requested by creditors whose debts amount to at least 10 per cent of the company's total indebtedness.[81] The creditors' meeting may perform an important accountability function particularly where the administrator has been appointed out-of-court by a floating charge holder. It can play a part in ensuing that more than lip-service is paid to the administrator's obligation to perform his functions in the interests of company creditors as a whole.

During the parliamentary process however, the government successfully resisted an amendment that would have made an initial creditors' meeting

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77 Insolvency Act 1986 Schedule B1 para 4.

78 See generally Schedule B1 para 52(1).

79 What is now s 176A Insolvency Act 1986 which sets aside a proportion of floating charge recoveries for the benefit of unsecured creditors.

80 See Stephen Davies ed *Insolvency and the Enterprise Act 2002* (Bristol, Jordans, 2003) at p 152.

81 Schedule B1 para 52(2).

mandatory in all instances.[82] A government spokesperson suggested that the proposal would

> add unnecessarily to costs, burden the courts and reduce the returns for those creditors who did have a financial interest . . . [T]he virtues of creditors' meetings are grossly exaggerated. It costs a lost of money for the boss of a small company to attend a creditors' meeting, possibly more than he is owed.

Subsequent empirical evidence has borne out the supposition that unsecured creditors have little desire to play a central role in insolvency decision making. According to a study conducted on behalf of the Insolvency Service:[83] 'Interviewees unanimously reported that creditor meetings are always very poorly attended, and that they strongly suspected that when reports, proposals and progress reports were sent out these were dispatched without ceremony to a cylindrical filing cabinet under the desk which is emptied daily.'

It must be said also that the creditors' meeting has limited powers. It can accept the administrator's proposals in their totality but any modification suggested requires the administrator's consent.[84] Where administrator and creditors cannot reach agreement, the matter must be referred back to the court and the latter can make any order that it thinks fit including allowing the administration to proceed despite the creditors' opposition.[85] It may also make a winding up order on a winding-up petition that has been suspended while the company is in administration. The administrator's role after approval of the proposals is to manage the company in accordance with the proposals. There is provision for the administrator to summon further creditors' meetings if directed to do so by the court or so requested by creditors owed at least 10 per cent of the company's total debts.[86] Ordinarily, any proposed substantial revisions to the proposals must be put to a creditors' meeting but it has been held

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[82] HL Debates 29 July 2002 at col 783. It was said 'Creditors must be given a chance to voice their concern and they should not be denied that right, particularly where the administrator thinks the company has insufficient property to enable a distribution to be made to unsecured creditors. These creditors will recover nothing and they . . . must be satisfied that nothing can be done for them and to be able to test that at the meeting.'

[83] 'Report on Insolvency Outcomes' at p 54 – a paper presented to the Insolvency Service by Dr Sandra Frisby – see www.insolvency.gov.uk and for a synopsis 'Not Quite Warp Factor 2 Yet? The Enterprise Act and Corporate Insolvency' (2007) 22 Butterworths Journal of International Banking and Financial Law 327.

[84] Schedule B1 para 53(1).

[85] *Re Maxwell Communications Corp* [1992] BCLC 465 at 467; *Re Structures & Computers Ltd* [1998] BCC 348 at 353.

[86] Schedule B1 Insolvency Act 1986 para 56.

that the court has jurisdiction itself to authorise deviation from the original proposals in an exceptional case, e.g. where the delay involved in convening a meeting could be fatal to the chances of success of the revised proposal.[87] If revised proposals are not approved, the administrator can continue to follow the old proposals, or, if experience leads to the conclusion that the purpose of the administration is incapable of achievement, then an application can be made to the court for the administrator's appointment to cease to have effect.[88]

The basic model of creditor consultation and approval of proposals ignores, however, the possibility of circumstances arising where the administrator should act very quickly, perhaps even before there is an opportunity to convene a meeting of creditors. The administrator might be offered a favourable price for the business that is conditional upon a sale being concluded in accordance with a tight timetable. The legislation gives the administrator wide powers, even before approval of proposals by the creditors, and it has been judicially affirmed that these powers extend to selling off the company's business prior to the holding of the creditors' meeting. Lawrence Collins J addressed this issue in *Re Transbus International Ltd*.[89] He said:[90]

> I am satisfied that a better view would be that administrators are permitted to sell the assets of the company in advance of their proposals being approved by creditors. . . . Para 68(2) of the Schedule requires the administrators to act in accordance with directions of the court 'if the court gives [them]'. This appears to be a deliberate choice to adopt wording that mirrors the interpretation which Neuberger J had put upon the previous provisions [in *Re T & D Industries plc*[91]] . . . [T]he same policy arguments apply.

Lawrence Collins J said that the Enterprise Act reflected a conscious policy to reduce the involvement of the court in administrations. He also noted that in many cases the administrators are justified in not laying any proposals before a creditors' meeting, e.g. where unsecured creditors are going to receive no payment.

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87 *Re Smallman Construction Ltd* (1988) 4 BCC 784, [1989] BCLC 420.
88 Schedule B1 Insolvency Act 1986 para 79.
89 [2004] 2 All ER 911.
90 At paras 12–13 of the judgment.
91 [2000] 1 WLR 646.

OBTAINING CREDITOR APPROVAL AND VARYING CREDITOR RIGHTS

Creditor approval of proposals requires a simple majority of votes cast as measured by the amount of the outstanding indebtedness[92] although the proposals may not result in non-preferential entitlements being paid ahead of preferential entitlements or one preferential creditor of the company being paid a smaller proportion of his debt than another.[93] More generally, respect for proprietary rights is clearly demonstrated by para 73(1)(a), which provides that an administrator's statement of proposals may include any action which affects the right of a secured creditor of the company to enforce its security. Secured creditors' rights are inviolate in this respect. Moreover, changing the substantive rights of creditors of whatever kind cannot simply be done by means of approval of proposals in the administration context. Such proposals have no effect on creditors' rights and are not the equivalent of a Chapter 11 reorganisation plan.[94] Something more has to be done before creditors' rights can be discharged or varied without their consent.

One option for overcoming objections is a scheme of arrangement under the Companies Act; another possibility is a voluntary arrangement under the Insolvency legislation. A third possibility is a voluntary arrangement coupled with a moratorium also under the Insolvency legislation but this alternative is not likely to be part and parcel of an administration since it comes with its own moratorium on individual creditor enforcement actions. The latter procedure is restricted to small companies and is conditional on the directors producing sufficient evidence that the proposed CVA had a reasonable prospect of success and that the company is likely to have sufficient funds during the moratorium to enable it to carry on business.

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92 See Rule 2.43(1) of the Insolvency Rules which provide that 'at a creditors' meeting in administration proceedings, a resolution is passed when a majority (in value) of those present and voting, in person or by proxy, have voted in favour of it.' The resolution however is invalid if more than half of creditors not connected with the company voted against it. A secured creditor may note for the amount of his secured debt only where there is insufficient property to make a distribution to unsecured creditors apart from the prescribed part. Normally, at a creditors' meeting under Rule 2.40 a secured creditor is 'entitled to vote only in respect of the balance (if any) of his debt after deducting the value of his security as estimated by him'.

93 Schedule B1 para 73(1)(a) and (b).

94 The empirical study 'Report on Insolvency Outcomes' – a paper presented to the Insolvency Service by Dr Sandra Frisby – see www.insolvency.gov.uk reports (at p 63) a 'general view that the only genuine rescue mechanism is the CVA within the protection of administration. Of those rescue outcomes recorded on the database all but two involved CVAs within administration, which would appear to support that view.'

SCHEMES OF ARRANGEMENT UNDER THE COMPANIES ACT

The DTI/Treasury Report on Company rescue and Business Reconstruction Mechanisms has described schemes of arrangement under the Companies legislation as complex and difficult to organise, demanding of expensive legal resources and generally the preserve of larger companies.[95] If the scheme is carried through during administration however, then some of the difficulty and complexity is removed because of the statutory moratorium. Schemes of arrangement can be used to buy out minority shareholders compulsorily but it is also possible to facilitate corporate reorganisations through this route. A scheme requires court sanction and approval from a majority in number representing 75 per cent in value of the class of shareholders or creditors affected and, once these conditions are met, it becomes binding on abstainers or dissenters.[96]

The approval of a scheme of arrangement is a three-stage process.[97] Firstly, there must be an application to the court for an order that a meeting or meetings should be summoned. Secondly, the scheme proposals are put to the relevant meetings with a view to obtaining the appropriate level of approval. Thirdly, if approved, there must be a further application to the court for its sanction. At the first stage, the court tries to ensure that those affected have a proper opportunity of being present (in person or by proxy) at the meetings. The second stage ensures that the proposals are acceptable to the necessary majorities and, at the third stage, the court tries to ensure that the views and interests of scheme opponents receive impartial consideration.

In *Telewest (No 2)* it was held that in deciding whether to sanction a scheme, the court must be satisfied that it is a fair scheme – one that 'an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve'. The scheme proposed need not be the only fair scheme however, or even, in the court's view, the best scheme. There is room for reasonable differences of view on these issues and, on matters of finance, shareholders or creditors are superior judges of their own

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95 The relevant provision is now s 895 Companies 2006 (formerly s 425 Companies Act 1985). See generally on the process Andrew Wilkinson, Adrian Cohen and Rosemary Sutherland 'Creditors' Schemes of Arrangement and Company Voluntary Arrangements' in Harry Rajak ed *Insolvency Law: Theory and Practice* (London, Sweet & Maxwell, 1993) p 319.

96 Schemes of arrangement have been used by provisional liquidators of distressed insurance companies as a quasi-liquidation process – until recently insurance companies did not have access to an administration order procedure.

97 *Re Hawk Insurance Co Ltd* [2001] 2 BCLC 480.

interests than are the courts. Lewison J in *Re British Aviation Insurance Co Ltd*[98] pointed out that the test is not whether the opposing creditors have reasonable objections to the scheme. A creditor may be equally reasonable in voting for or against the scheme and, in these circumstances, creditor democracy should prevail.

COMPANY VOLUNTARY ARRANGEMENTS

Company voluntary arrangements under Part 1 Insolvency Act 1986 are based upon a proposal to the company and its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs. The proposal must provide for some person to act as trustee or otherwise to supervise its implementation. That person is referred to as the 'nominee' and must be a licensed insolvency practitioner.[99] While not required to do so, an administrator may be designated as the nominee and this is usually the case.[100] The nominee must then summon meetings of the creditors and shareholders[101] to decide whether to approve the proposal.[102] The meetings may modify the

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98 [2005] EWHC 1621 at para 75. The judge added: 'Where, as here, those who voted in favour of the scheme are large and sophisticated corporations, the rigid application of this test as the sole criterion would rarely, I think, enable the court to refuse to sanction the scheme. It is also not entirely clear to me how the rigid application of this test sits with statements that the court has an unfettered discretion.'

99 S 1(2). But see however s 389A Insolvency Act 1986 as introduced by s 4 Insolvency Act 2000 which allows the Secretary of State to authorise persons who are not qualified insolvency practitioners to act as nominees and supervisors of CVAs. This measure is designed to promote the rescue culture by opening up CVA work to so-called 'company doctors', i.e. specialists in corporate turnaround who are not necessarily insolvency practitioners.

100 S 1. Professor Goode in *Principles of Corporate Insolvency Law* (London, Thomson, 3rd ed, 2005) at p 406 points out that the Insolvency Practitioner will now be 'wearing two hats simultaneously and it is important to distinguish his two capacities. As administrator he is responsible for the management of the company, subject to any powers given to him in his capacity of supervisor, and as administrator he makes payments to and holds property for himself in the capacity of supervisor. It is at that point that a trust of the payments and property comes into being for the benefit of the CVA creditors unless this has been created earlier under the proposal or the CVA itself.'

101 S 3. Where the nominee is not the liquidator or administrator, the summoning of meetings is subject to directions from the court: s 3(1).

102 S 4. Failure to provide sufficient and accurate information to enable the creditor to consider the merits of the proposed arrangement with a view to determining if and how to cast her vote at the meeting is a material irregularity entitling the court to revoke approval of the arrangement under s 6(4) of the Insolvency Act – see *Re Trident Fashions* [2004] 2 BCLC 35. Lewison J added however at para 39: 'It seems to me that

proposal in certain respects, but the modifications must not be so extensive as to change the character of the proposal so that it is no longer a composition in satisfaction of the company's debts or a scheme of arrangement in respect of its affairs.[103] Also, the meetings are specifically prohibited from approving any proposal that would interfere with the rights of a secured creditor to enforce his security or with the priority of a preferential debt unless the secured or preferential creditor concurs.[104]

Before amendments made by the Insolvency Act 2000 both the creditors' and shareholders' meetings had to accord approval but this is no longer the case. The effect of s 4A is that where different decisions are taken at each of the two meetings the decision taken at the creditors' meeting shall prevail, subject to the right of a member to challenge this conclusion in court within 28 days of the creditors' meeting. On such an application, the court has wide discretionary powers including the power to make such order as it thinks fit.[105]

If the voluntary arrangement is approved by the requisite majorities,[106] it:

1. takes effect as if made by the company at the creditors' meeting; and
2. binds every person who, in accordance with the Insolvency Rules, had notice of, and was entitled to vote at, the meeting (whether or not the person was present or represented at the meeting) or would have been so entitled if the person had notice of it as if he were a party to the voluntary arrangement.[107]

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the court should only interfere if a judgment made by the administrator about the material to be placed before the creditors was a judgment to which no reasonable insolvency practitioner could come. The judgment should I think be made on the basis of the material available to the administrator at the time and not with the benefit of hindsight.'

103 S 4(2).

104 S 4(3) and (4). Some 'wriggle-room' is however introduced by the decision in *IRC v Wimbledon Football Club Ltd* [2005] 1 BCLC 66. The interpretation of the term 'security' can be problematic: cf *March Estates plc v Gunmark Ltd* [1996] BPIR 439 and *Razzaq v Pala* [1998] BCC 66.

105 S 4A(6) Insolvency Act 1986.

106 The detailed procedural aspects are governed by the Insolvency Rules 1986 (rules 1.13–1.21). Broadly, more than three-quarters in value of the creditors present in person or by proxy and voting on the resolution must support the arrangement for it to become effective (rule 1.19); at the meeting of members the equivalent requirement is that more than one-half in value (determined by reference to voting rights) of the members present in person or proxy and voting on the resolution must support the arrangement (rule 1.20). The insolvency rules are due to be revamped in a fresh consolidation towards the end of 2008 but this is not available at the time of going to press.

107 S 5(2) and see also *Inland Revenue Commissioners v Adam and Partners Ltd* [1999] 2 BCLC 730, applying *Johnson v Davies* [1999] Ch 117.The facility to bind unknown creditors is very valuable and was introduced by s 2 and Schedule 2 Insolvency Act 2000.

Creditors with unliquidated or unascertained debts are entitled to vote at the meeting provided the chairman agrees to put an estimated minimum value on these debts,[108] as well as creditors whose debts are liquidated and presently due. Once a voluntary arrangement has been approved, the nominee becomes its supervisor,[109] whose role it is to carry out the functions conferred by the arrangement.[110] The supervisor must notify all creditors and members who are bound by the arrangement when the arrangement is complete and also provide them with an account of receipts and payments.[111]

The decision to approve a voluntary arrangement may be challenged through a court application made not later than 28 days after the results of the meetings were reported to the court.[112] The challenge may be based on the substantive ground that the arrangement unfairly prejudices the interests of a creditor or shareholder of the company, or may relate to material irregularities at, or in relation to, either of the meetings. A procedural irregularity does not invalidate the approval given at a meeting unless it is the subject of a successful statutory challenge.[113] Where the court is satisfied that grounds for challenge are made out, it may revoke or suspend approvals given by the meetings and direct the summoning of further meetings, either to consider a new proposal from the original proposer or to reconsider the original proposal.[114] The court itself has no power to devise a new proposal for consideration. The supervisor has a general right to apply to the court for directions in relation to any particular matter arising and may also apply to the court for a winding-up order to be made.[115] Such an application may become necessary if the company fails to fulfil the terms of a CVA whether by failing to meet a payment due to creditors, or otherwise.

There has been substantial litigation concerning the effect of subsequent liquidation on the CVA and the status of funds collected by the CVA supervisor

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108 *Doorbar v Alltime Securities Ltd* [1995] BCC 1149 (CA).

109 S 7(2).

110 Ibid.

111 Rule 1.29(1) and (2).

112 S 6(3). An application under the equivalent provision in the personal insolvency regime (s 262) failed in *Doorbar v Alltime Securities Ltd* [1995] BCC 1149 (CA). See also *Re Sweatfield Ltd* [1997] BCC 744 (application under s 6 but no material irregularity held to have been established).

113 S 6(7).

114 S 6(4). If the original proposer fails to put forward a new proposal in accordance with the court's direction, the court must revoke the direction and revoke or suspend the earlier approvals: s 6(5). The court may also give supplemental directions: s 6(6).

115 S 7(4). An example of such an application is *Re FMS Financial Management Services Ltd* (1989) 5 BCC 191.

prior to liquidation.[116] It was held however, in *Re NT Gallagher & Son Ltd*[117] that so long as the terms of the arrangement were clear, funds collected by a supervisor were held on trust exclusively for the benefit of the CVA participants. Moreover, the fact that the CVA proposal did not use the terminology of 'trust' was not material. The fate of the CVA trust and its survival on liquidation depended on the terms of the arrangement. The court said that to treat a trust created by a CVA as continuing notwithstanding the liquidation of the company did not produce such unfairness to post-CVA creditors so as to warrant a termination default rule. Peter Gibson LJ observed:

> Further, as a matter of policy, in the absence of any provision in the CVA as to what should happen to trust assets on liquidation of the company, the court should prefer a default rule which furthers rather than hinders what might be taken to be the statutory purpose of Part 1 of the Act. Parliament plainly intended to encourage companies and creditors to enter into CVAs so as to provide creditors with a means of recovering what they are owed without recourse to the more expensive means provided by winding up or administration, thereby giving many companies the opportunity to continue to trade.

It should be noted that creditors whose debts have not been fully discharged by trust moneys brought into being through a CVA may prove for the balance in the liquidation.

CVAs VERSUS SCHEMES OF ARRANGEMENT

In general, it is more advantageous to make use of company voluntary arrangements under the insolvency legislation than schemes of arrangement under the Companies Act for the process is administratively simpler and less cumbersome. Creditors in a CVA are dealt with as a single collective group and not as members of separate classes. Moreover, there is no need for two separate applications to the court. Formerly, it was the case that unknown creditors could be bound by a scheme of arrangement but not by a CVA but the Insolvency Act 2000, however, makes the CVA binding on creditors who were not given notice of the meeting.

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116 See, for example, *Re Excalibur Airways Ltd* [1998] 1 BCLC 436; *Re Maple Environmental Services Ltd* [2000] BCC 93; *Welsby v. Brelec Installations* [2000] 2 BCLC 576; *Re Kudos Glass Ltd* [2000] 1 BCLC 390.

117 [2002] 1 WLR 2380.

PRE-PACKAGED ADMINISTRATIONS

UK Insolvency legislation does not make any reference to pre-packaged administrations[118] though, superficially at least, the pre-Enterprise Act decision in *T & D Industries*[119] as well as the post-Enterprise Act case *Transbus International* facilitates their use. In *T & D Industries* it was held that an administrator had power to sell the assets of a company prior to obtaining creditor approval. In *Transbus International*[120] it was confirmed that, notwithstanding the slight difference in statutory wording, administrators under the new regime retained the power to dispose of corporate assets before creditor approval. Nevertheless, it could be argued that there is a difference between the situations envisaged in these cases and a pre-packaged disposal. 'The crucial difference is that in a pre-pack the decision is made before the administrator is in office. He or she has not considered the possibility of rescuing the company qua administrator before making the decision to sell the business.'[121]

Although there is no specific legislative or judicial authority for pre-packaged administrations, recent years have seen their burgeoning popularity. The pre-pack has emerged with a bang as a new effective device on the UK insolvency scene:

> The pre-pack has grown in popularity in the United Kingdom in parallel with the growth in 'live side' or 'pre-insolvency' approaches to corporate troubles. Increasingly it has become practice to deal with corporate difficulties in advance of collapse – a trend that has been encouraged by such developments as the embedding of a rescue culture in the United Kingdom; the emergence of better financial forecasting systems; a shift of approach from debt collection to financial risk management; the increased willingness of major lenders to take steps to prevent corporate disaster; and the emergence of a new cadre of turnaround professionals. The pre-pack has come to serve an important role in contingency and recovery planning as 'the divide between informal and formal (insolvency) continues to blur'.[122]

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118 The pre-pack may be defined as a process in which a troubled company and its creditors conclude an agreement before an office holder – either an administrator or an administrative receiver – is appointed. This office holder will then execute the restructuring transactions on behalf of the company – see V. Finch 'Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains' [2006] JBL 568 at 568–569.

119 [2000] 1 BCLC 471.

120 [2004] EWHC 932.

121 See P Walton 'Pre-packaged Administrations: Trick or Treat?' (2006) 19 Insolvency Intelligence 113 at 115 and A Lockerbie and P Godfrey 'Pre-packaged Administration – the Legal Framework' (2006) Recovery (Summer) 21 at 22.

122 See V Finch 'Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains' [2006] JBL 568 at 569.

As part of this phenomenon debt trading during corporate restructurings has become more and more popular:

> Now, it's not uncommon to see banking syndicates and other stakeholder groups such as bonds and mezzanine transformed through the life of a restructuring as distressed debt investors take the place of the original par lenders. So many of the recent major changes we have seen in the restructuring world have originated from the US – following a 'wall' of US money that has been lent to and invested in the UK and continental European markets . . . And it is US market practices that have brought the rapid rise in distressed debt trading and investing.[123]

Moreover, there has also been a development of 'whole business solutions', where an investor such as the distressed investment department of an investment bank 'may seek to acquire *all* of the capital structure of a company at a discount rather than just a small piece.'[124]

Specifically on pre-packs, it appears that there has been a significant rise in their number since the Enterprise Act came into force. The Enterprise Act 2002 itself was neither intended to prompt a surge in the use of pre-packs nor was it meant to reduce their use. Nevertheless, the reforms introduced by the Act, including the streamlined system of out-of-court entry into administration and the simpler exit routes have made it easier for pre-packs to be undertaken in practice.[125]

If the heads of a deal for the sale of company assets have been thrashed out in advance of the appointment of an administrator, the administration procedures can then be carried through at maximum speed. Pre-packs may be a good option for service focused companies or those whose business is reputation-based or intellectual property based. In such companies, the value of the business can be diminished quickly by the hint of a formal insolvency.[126] In a pre-pack, the corporate assets may be sold off to the existing management team. The secured creditors are then paid off out of the proceeds of the sale but agree to maintain lending facilities in place with the new corporate entity that has taken over the assets of the company. Effectively to many outside observers, the old company is trading on, albeit under a slightly different guise, but having shed its unsecured debt.

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123 M Fuller 'The Distressed Debt Market – A Major Force that's Here to Stay' (2006) Recovery (Spring) at 15.

124 M Fuller ibid 15 at 16 'This investment may be made with a view to a turnaround or piecemeal sale of the capital structure. Either way, the acquirer's time horizon is likely to be short to medium rather than long term.'

125 Desmond Flynn 'Pre-pack Administrations – A Regulatory Perspective' (2006) Recovery (Summer) at 3.

126 Martin Ellis 'The Thin Line in the Sand – Pre-packs and Phoenixes' (2006) Recovery (Spring) at 3.

There is a high degree of certainty in a pre-pack and secured creditors also enjoy a high degree of control. For these reasons, secured creditors may consider it a more attractive alternative than a protracted formal insolvency process.[127] In the eyes of some commentators, therefore, pre-packs function as a means 'by which powerful players can bypass carefully constructed statutory protections'.[128] It is argued that in a pre-pack the market will rarely have been properly explored and consequently, the business may be sold at an undervalue.[129]

In certain circumstances it may be commercially justifiable to sell the business back to management or some other connected party particularly where the original management seem the only potential buyers in the market.[130] Nevertheless, the practice may have given pre-packs a bad name[131] since the suspicion is that corporate insiders are benefiting at the expense of outside unsecured creditors. It may be true that abuse has taken place in only a handful of cases and this has been occasioned by some 'professional bad apples'. But these exceptional cases have fuelled a feeling that the rise of pre-packs will generally enhance the interests of insiders, professional advisers and secured creditors at the expense of smaller unsecured creditors and outside shareholders.[132]

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127 P Walton 'Pre-packaged Administrations: Trick or Treat?' (2006) 19 Insolvency Intelligence 113 at 116.

128 See V Finch 'Pre-Packaged Administrations' at 568.

129 V Finch ibid at 570 and Stephen Davies QC 'Pre-pack – He Who pays the Piper Calls the Tune' Recovery (2006) (Summer) at 16.

130 See Sandra Frisby 'Report On Insolvency Outcomes' (2006), from http://www.insolvency.gov.uk at p 71: 'But often the management are prepared to pay a higher price because it's their job and their livelihood, and they'll pay a premium for that. And they know the business better, the risks in the business, and therefore they have, if you like, discounted the risks that others would say that they have to take into account.' For a synopsis of the report see 'Not Quite Warp Factor 2 Yet? The Enterprise Act and Corporate Insolvency' (2007) 22 Butterworths Journal of International Banking and Financial Law 327.

131 P Walton 'Pre-packaged Administrations: Trick or Treat?' (2006) 19 Insolvency Intelligence 113 at 114 and Sandra Frisby 'Report On Insolvency Outcomes' (2006), from http://www.insolvency.gov.uk at p 70.

132 See S Frisby 'Interim Report to the Insolvency Service on Returns to Creditors from Pre- and Post-Enterprise Act Insolvency Procedures' – see www.insolvency.gov.uk at pp 39–40: 'One very tentative contention is that whilst pre-packs save more jobs they probably realise less, purely because they save more jobs. The purchaser of a business who accepts its actual and contingent employee-related liabilities will be inclined to apply an appropriate discount on what he would have been prepared to offer for the business without its employees. This, therefore, results in less funds being available to the company's creditors, with its unsecured creditors inevitably bearing the brunt of the discount.'

The administrator plays an indispensable part in the pre-pack procedure. As an agent of the company, the administrator is in a fiduciary position and moreover, has a statutory duty to consider rescuing the company. If, prior to becoming administrator, the same individual is bound by a pre-pack agreement to sell the business to an existing management team, then he has fettered his discretion. His objectivity appears to be impaired by a potential or actual conflict of duties.[133] In order to avoid the allegation of abuse, an administrator who is considering a pre-pack must be satisfied that (1) in the circumstances, a rescue of the company is not reasonably feasible and the only option is to sell the business as soon as possible; (2) the pre-packaged plan will produce the best result for creditors as a whole.[134]

The relative absence of statutory provisions suggests that policy makers have not 'caught up with the mismatch between the market and the statutory scheme'[135] and it has been argued that effective control of pre-packs in the form of professional regulation or legislative reforms is needed. As one commentator remarks:[136]

> A system of professional regulation of pre-packs might be furthered by extending the coverage of professional monitoring regimes so as to take on board pre-pack negotiations. This could be achieved by the issuing of professional guidance on pre-packs and a professional requirement that when IPs construct a pre-pack and process it through an administration, they file a report on the negotiations that have been conducted . . . A system of monitoring by the IP's professional body might be combined with such a legislative change. Further legislative reforms might, if necessary, be introduced to place the IP's pre-pack auditing function on a statutory basis.

On the other hand, an extended system of control is not a panacea and extending statutory regulation into what is, at the moment, a pre-formal or informal area of rescue work would be likely to increase costs and procedural complexity as well as undermining the advantages of these procedures as a means of bringing about corporate turnarounds.[137] It has been argued that

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133 P Walton 'Pre-packaged Administrations: Trick or Treat?' (2006) 19 Insolvency Intelligence 113 at 116.

134 Relevant factors include whether the speedy appearance of a purchaser can ensure continuity of customer and supplier relationship as well as the retention of key employees; whether the value of the assets and business will be dissipated without a quick sale; and whether a drawn-out insolvency procedure might cause a regulator to withdraw essential licences from the business.

135 Stephen Davies QC 'Pre-pack – He Who pays the Piper Calls the Tune' at 17 and see also Andrew Lockerbie and Patricia Godfrey 'Pre-packaged Administration – the Legal Framework' (2006) Recovery (Summer) 21 and Mike Chapman 'The Insolvency Service's View of Regulation' (2005) Recovery (Winter) 24.

136 V Finch 'Pre-Packaged Administrations' at 585.

137 Ibid, at 587.

some of the perceived lack of controls may stem from the seamless way in which an administrator can get transformed into a liquidator under the Enterprise Act and that the appointment of an independent liquidator is needed to review the conduct of prior officeholders including administrators and directors. This reform alone, however, would not be sufficient since a company may move under the Enterprise Act from administration to dissolution without a liquidator ever having been appointed! Moving from administration to dissolution is possible without a company going through the intermediate stage of liquidation.

CONCLUSION

This chapter has looked at corporate rescue procedures (broadly understood) in the UK. Certain conclusions follow from this account. Firstly, the traditional adage that UK law in this area is pro-creditor whereas US law is pro-debtor may be something of an over-simplification but, like many generalisations, it may contain a grain of truth. Certainly, in the UK the emphasis in corporate insolvency procedures, if they are concerned with 'rescue' at all, has been about saving the business, rather than the company shell.[138] Administrative receivership exemplifies this par excellence in that it is basically an auction procedure, followed by a distribution of realisations by way of dividend to the secured creditor who appointed the receiver, after which the company usually goes into winding-up. Administrations are also often employed as a delayed break-up and liquidation of the business in practice.

Moreover, in administrations (and also in administrative receiverships) shareholder claims are not formally considered at all. There is no provision for meetings of shareholders and creditors alone are involved in the approval of proposals. The CVA is a bargaining procedure and may be used to negotiate a rehabilitation plan between creditors and shareholders, but most CVAs are concluded in association with an administration and, in practice, CVAs may not in fact involve reorganisation of the company, instead focusing on going-concern sales or disposal of particular assets.[139] The so-called rescue system in the UK is therefore quite market-oriented. The practice tends to centre on saving businesses rather than corporate shells.

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[138] See Roy Goode *Principles of Corporate Insolvency Law* (London, Thomson, 3rd ed, 2005) at p 330. See also Robert Stevens 'Security after the Enterprise Act' in J Getzler and J Payne eds *Company Charges: Spectrum and Beyond* (Oxford, Oxford University Press, 2006) 153 at p 155.

[139] Roy Goode *Principles of Corporate Insolvency Law* at p 396.

The sale of businesses as operational going-concerns or alternatively, the piecemeal realisation of assets if that process makes creditors better off are all seen as part and parcel of the 'rescue culture' in the UK. Corporate rehabilitation and debt restructuring does not describe the whole universe of the 'rescue culture' at least to UK practitioner eyes. Practitioners have also become adept in using administration and CVAs as more efficient liquidation tools rather than rehabilitation regimes in practice. While this would not be considered a 'reorganisation' in the traditional American sense of the word, a delayed break-up is still a 'rescue' to English eyes.[140]

Another major point of comparison is that the management of insolvency cases in the UK is dominated by insolvency practitioners while in the US the bankruptcy courts appear to play a more central role in bankruptcy administration. Also in the UK, accountants gain control of the insolvency market whereas lawyers dominate the insolvency sector in the US.[141] Because of the courts' general jurisdiction over bankruptcy administration and their close supervision of all aspects of corporate insolvency, reorganisation in the US is largely lawyer-driven.[142] Accountants exercise far less direct control over the governance of insolvency than do their UK counterparts.[143]

A third general point is that there appears to be some convergence in practice between the US and UK. Increased recourse to informal restructurings may be some evidence of this. The last couple of years have also seen the rise of the pre-packaged administration in which the main contours of the proposed administration have been mapped out in advance before the company enters the formal process. This follows on from the earlier rise and use of pre-packaged Chapter 11s in the US. The avowed purpose of the Enterprise Act 2002 has been to tilt UK law in a westerly direction borrowing some of the features of Chapter 11 but, at the same time, avoiding the

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140 N Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 Am Bankr Inst L Rev 367 at 397.

141 See John Flood and Eleni Skordaki 'Normative Bricolage: Informal Rule-making by Accountants and Lawyers in Mega-insolvencies' from G Teubner (ed) *Global Law Without a State* (Aldershot, Dartmouth, 1997) 109 at 112: 'In the UK insolvency is largely accountant-driven: they become the office-holders – that is, the receivers and liquidators. Lawyers mainly act as advisers to office-holders. Accountants are the lawyers' handmaidens.'

142 The US Bankruptcy Code has been described as a full employment bill for lawyers – see B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 302.

143 See John Flood and Eleni Skordaki 'Normative Bricolage' 109 at p 125.

pitfalls. Nevertheless, I would suggest that the main move has been that of US law and practice in a UK direction.[144] This theme is developed in the next chapter.

[144] See also Douglas Baird, Arturo Bris and Ning Zhu 'The Dynamics of Large and Small Chapter 11 Cases' who make the point (at p. 8) that 'changes in Chapter 11 practice over the last 15 years close the gap between Chapter 11 and other regimes that make explicit use of the market and grant senior creditors greater control' – paper available at www.arturobris.com. See also the discussion in S Daydenko and J Franks 'Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK' European Corporate Governance Institute Working Paper No 89/2005 who discuss data to the effect that creditor recovery rates in the US are much closer to those in the UK than would be suggested by the creditor protection rankings put forward by La Porta, Lopez-De-Silanes, Shleifer and Vishny in 'Law and Finance' (1998) 106 Journal of Political Economy 1113.

3. Fundamental features of the US Chapter 11

In the US the law on corporate reorganisation is contained in Chapter 11 of the US Bankruptcy Code. This chapter will look at the basic features of Chapter 11 with subsequent chapters addressing particular aspects of Chapter 11 and making comparisons between Chapter 11 and the relevant English law.

Chapter 11 is generally considered to be pro-debtor rather than pro-creditor though there is much to be said for the view that this label is nothing more than a potentially misleading over-simplification. The pro-debtor label is used for a number of reasons. These include the fact that the Chapter 11 process is normally begun by the company itself seeking protection from its creditors; the existing management is not displaced in favour of some court-appointed outsider; the management itself can prepare a reorganisation plan and put it to creditors and shareholders; there is a specific mechanism for the financing of the company during the Chapter 11 period, which may include the 'priming' or 'trumping' of existing security interests and finally, in certain circumstances, secured creditors can be crammed down, i.e. forced to accept a reorganisation plan against their wishes.[1]

COMMENCING A CHAPTER 11 CASE AND THE AUTOMATIC STAY

Normally, a Chapter 11 case begins when the company voluntarily files a peti-

[1] See generally R La Porta et al 'Law and Finance' (1998) 106 Journal of Political Economy 1113. It should also be noted that under s 365 of the US Bankruptcy Code so-called 'ipso facto' clauses, e.g. a clause in a contract stating that a supplier's contractual commitments to a company will come to an end once the company enters bankruptcy proceedings is generally of no effect, unlike the position in the UK. S 365 and the power of a company to assume or reject 'executory' contracts are discussed further in Chapter 7 particularly in the context of collective bargaining agreements. S 541(c) also strikes at ipso facto clauses. It invalidates contractual provisions or provisions of non bankruptcy law 'conditioned on the insolvency or financial condition of the debtor' that restrict or condition the transfer of property to the bankruptcy estate.

tion with a bankruptcy court, with the petition being accompanied by firstly, a list of creditors, and secondly, a summary of company assets and liabilities. There is no formal requirement that the company should be 'insolvent' and companies sometimes make use of Chapter 11 for strategic reasons. There is however a good faith requirement, which means there must be the intention of bringing about a corporate restructuring or a liquidation or sale of the company. If, for example, the company has no genuine reorganisational purpose, then the Chapter 11 filing may be dismissed.[2]

There is a mechanism whereby creditors may force a company into Chapter 11 in certain circumstances. This possibility is open if creditors are owed at least $10,000 and the company is 'generally not paying debts as such debts become due unless such debts are the subject of a bona fide dispute'. Creditors run a certain risk in invoking this procedure however, because if the statutory standard is not satisfied, the company may recover costs from the petitioning creditors and, if the petition has been filed in bad faith, then punitive damages may be obtained by the company.

It is more often the case though that a company will enter Chapter 11 under pressure from creditors who may be seeking to enforce security interests:

> Congress has asserted that 'the purpose of a reorganization . . . case is to formulate and have confirmed a plan of reorganization . . . It is likely that only a few of the debtors studied came to Chapter 11 for this purpose. A large majority of them entered Chapter 11 with one or more of their creditors in hot pursuit, and filing was probably the only way they could remain in business or avoid liquidation. Their focus, quite naturally, was on short term survival, and only later, if at all, would a substantial number of them turn their attention to the long range prospects for their businesses'.[3]

The automatic stay, so-called, is an intrinsic feature of Chapter 11. Put simply, the commencement of a Chapter 11 case imposes a freeze on proceedings or executions against the company and its assets. This stay or moratorium provides a breathing space during which the company has an opportunity to make arrangements with its creditors and shareholders for the rescheduling of its debts, and the reorganisation and restructuring of its affairs. The existence of the moratorium or stay has been rationalised as follows: [4]

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[2] See *Re SGL Carbon Corporation* (1999) 200 F3d 154.

[3] Se Lynn M LoPucki 'The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code?' (1983) 57 American Bankruptcy Law Journal 99 at 114.

[4] HR Rep No 595, 95th Cong, 1st Session 340 (1977) The statement continued: 'The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganisation plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

A secured creditor, along with anybody else affected by the statutory stay, can apply to have it lifted and there is a specific requirement of 'adequate protection' for the holders of property rights who are adversely affected by the stay.[5] Examples of 'adequate protection' are provided by s 361 although the concept itself is not defined.[6] It should however be stressed that it is only the value of the collateral that is entitled to adequate protection. An undersecured creditor may find itself footing the bill for an unsuccessful reorganisation attempt. It is prevented from enforcing the collateral by the automatic stay yet it is not entitled to interest during what may be a long-drawn-out Chapter 11 process. An oversecured creditor is however entitled to be paid interest out of the security 'cushion' at the plan confirmation stage as a condition of the court approving the plan.

DEBTOR-IN-POSSESSION

Chapter 11 is based on 'debtor-in-possession'. The old management structures should generally remain in place but after having undergone a legal transformation into a quasi-trustee in bankruptcy. In its new guise it is referred to as a 'debtor-in-possession' or 'DIP'.[7] The debtor-in-possession can run the business in the ordinary way but will need court approval for substantial asset sales.[8] Under s 1107 of the Bankruptcy Code the debtor-in-possession has all the powers of a bankruptcy trustee. In *Commodity Futures Trading Commission v Weintraub*[9] the Supreme Court suggested that the willingness of courts to leave debtors-in-possession is premised upon an assurance that the officers and managing employees can be depended upon to carry out their functions with the same fiduciary responsibilities as a trustee. But one might

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other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.'

5 S 361 US Bankruptcy Code.

6 The examples given are cash payments, additional or replacement security interests on other property and, unusually expressed, something that will give the creditor the 'indubitable equivalent' of its security interest.

7 S 1107 US Bankruptcy Code.

8 S 363 of the Bankruptcy Code.

9 (1985) 471 US 343 at 355.

query the extent to which this obligation differs from the normal fiduciary duties of company directors. Directors owe their fiduciary duties to the company and where a company is solvent, this means primarily the shareholders. In the vicinity of insolvency, creditor interests gain a greater prominence though, as one court stated, the board of directors are not merely the agent of the residual risk bearers and are required to exercise informed good faith judgement so as to maximise the company's long-term wealth generating capacity.[10] Another US court has specifically drawn the analogy with directors in the case of a normal run-of-the-mill solvent company:[11]

> The debtor in a Chapter 11 bankruptcy has a fiduciary duty to act in the best interest of the estate as a whole, including its creditors, equity interest holders and other parties in interest . . . The fiduciary duties that a debtor owes the estate are comparable to the duties that the officers and directors of a solvent corporation owe their shareholders outside bankruptcy . . . Officers and directors should have broad latitude to balance competing interests in a bankruptcy case in order to make decisions that are in the best interests of the estate.

An outside trustee can only be appointed to take over the management of the business of the company for cause – s 1104(a)(1) – and their appointment in Chapter 11 is exceptional.[12] In *Re Marvel Entertainment Group*[13] it was stressed that the appointment of an outside trustee should be the exception rather than the rule. Often there is no need for one

> because current management is generally best suited to orchestrate the process of rehabilitation for the benefit of creditors and other interests of the estate . . . The debtor-in-possession is a fiduciary of the creditors and, as a result, has an obligation to refrain from acting in a manner which could damage the estate, or hinder a successful reorganization. The strong presumption also finds its basis in the debtor-in-possession's usual familiarity with the business it had already been managing at the time of the bankruptcy filing, often making it the best party to conduct operations during the reorganization.

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10 *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* 1991 Del Ch Lexis 215.

11 *LaSalle National Bank v Perelman* (2000) 82 F Supp 2d 279 at 292–293. See generally G Varallo and J Finkelstein 'Fiduciary Obligations of Directors of the Financially Troubled Company' (1992) 48 Business Law 244.

12 The legislative statements in s 1104 that a trustee can be appointed only for cause such as fraud, dishonesty or gross mismanagement and that sheer size or large numbers of bondholders or shareholders are not enough have successfully warned the courts away from appointing trustees. It has been held that simple mismanagement is not a sufficient reason for an appointment – *Re Anchorage Boat Sales* (1980) 4 Bankr 635.

13 (1998) 140 F 3d 463 at 471.

In none of the big ticket Chapter 11 cases at the turn of the century – Enron, Global Crossing, Adelphi Communications and Worldcom – where there was at least a suspicion of malpractice at the highest corporate levels, was an outside trustee appointed. Professor LoPucki has remarked sarcastically that through its sympathetic approach to management exhibited in these cases the 'New York bankruptcy court surpassed Delaware in 2002 to become the nation's most attractive bankruptcy court'.[14]

An alternative under s 1104 is for the court to appoint an examiner instead of an outside trustee though, again, such an appointment would not be the norm.[15] The examiner is mandated to carry out such investigations entrusted to it by the court that are appropriate in the particular circumstances of the case. The section states that the examiner may investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the company's affairs. Unlike the appointment of a trustee, the appointment of an examiner does not displace the existing management structures of the company. These may continue to operate in tandem with whatever functions the court assigns the examiner. Often examiners are called upon to consider possible causes of action that a company may have. Such work may be expensive and time consuming and duplicate other work that has already been done or will have to be done as part and parcel of the legal proceedings. Nevertheless, it may prove beneficial to the company in the long run. 'In the bankruptcy of Enron, for example, the examiner's investigation cost nearly $100 million and occupied dozens of lawyers and professionals for nearly two years, but the ensuing settlements exceeded $1 billion.'[16]

In theory, at the start of every Chapter 11 case, a committee of unsecured creditors is appointed. According to s 1102 ordinarily this shall consist of the seven largest creditors who are willing to serve but, in fact, the US trustee often goes to great pains to ensure a representative committee.[17] Service on a

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[14] See Lynn M LoPucki *Courting Failure: How Competition For Big Cases is Corrupting the Bankruptcy Courts* (Ann Arbor, University of Michigan Press, 2005) at p 14. LoPucki suggests that the 'New York bankruptcy court had proven itself a trustworthy protector of managements accused of fraud.' US corporations have virtually a free hand in choosing the venue for filing a bankruptcy case and LoPucki argues strongly that courts wastefully compete for bankruptcy business.

[15] S 1104(c)(2) at first glance, requires the appointment of an examiner where the company's unsecured, non-trade and non-insider debt exceeds $5m i.e. in every medium to large case '[b]ut examiners are not routinely requested or appointed in such cases'; see William D Warren and Daniel J Bussel *Bankruptcy* (New York, Foundation Press, 7th ed, 2006) at p 601.

[16] Douglas G Baird *Elements of Bankruptcy* (New York, Foundation Press, 4th ed, 2006) at p 22.

[17] On the role of the US Trustee in bankruptcy cases see generally the US Department of Justice website www.usdoj.gov/ust.

creditors' committee may provide some informational benefits but in smaller cases it may not be worth the effort. Creditors are not compensated for the time spent on committee work though a creditors' committee may engage lawyers, accountants and other professionals whose fees and expenses are entitled to administrative expense status under s 507. These professionals, for example, may be tasked by the committee with evaluating the merits and feasibility of a proposed reorganisation plan. Creditors' committees are intended to be primary negotiating bodies for the formulation of reorganisation plans and their powers in this regard are spelled out by s 1103.[18] They act as sounding boards for a debtor-in-possession who wants to see whether a particular plan will fly.

FIRST DAY ORDERS – PAYMENT OF ESSENTIAL VENDORS

Immediately upon the commencement of a Chapter 11 case, it is common for the company to seek judicial authority to pay the outstanding unsecured claims of so-called 'critical' vendors – first day orders. These may be suppliers whose goodwill and continuity of supply is essential to the company remaining in business. It has been suggested that the willingness of a bankruptcy court to grant first day orders enhances its attractiveness to 'case-players' and increases the likelihood of the court attracting bankruptcy business.[19] On first blush however, the practice of paying off certain unsecured debts in priority to others seems to cut across the grain of the US Bankruptcy Code which requires equal treatment of similarly situated creditors. The critical vendor doctrine, however, predates the 1978 Bankruptcy Code and, while the doctrine does not receive any specific recognition in the code, one might suggest that the silence of the statute constitutes implied recognition of its existence and viability given the historical backdrop.[20]

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[18] See also HR Rep No 595, 95th Cong Ist Session 401–402 and see generally Daniel J Bussel 'Coalition-Building Through Bankruptcy Creditors' Committees' (1996) 43 UCLA L Rev 1547.

[19] See Lynn M LoPucki *Courting Failure* at p 249 but see his comment that the initial round of court competition is only now coming to a close: 'In that round, the courts focused principally on procedural matters such as establishing omnibus hearings, assuring quick action on first-day motions, and paying professionals monthly . . . The case placers no longer shop for these practices; they can find them in almost any big city court. Courts interested in improving their market share now must offer something more.'

[20] See generally Alan Resnick 'The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases' (2005) 47 Boston College Law Review 183.

On occasions, the critical vendor doctrine has attracted criticism. Most notably, this occurred in *Re Kmart*[21] where the amount of the payments was particularly large – $290m. Section 105 of the Bankruptcy Code authorises the court to issue broad orders that 'are necessary or appropriate to carry out the provisions of this title' and it was argued in *Kmart* that this provision constituted legislative sanction for the critical vendor doctrine, but Judge Easterbrook would have none of this. He said:[22] 'A doctrine of necessity is just a fancy name for a power to depart from the Code.' The payments in *Kmart* seem particularly lavish but it might be argued that this is merely a function of the fact that the overall amount at stake in the case was exceptionally large with the company having an annual pre-Chapter 11 revenue of $36 billion.

Other courts have adopted a more sympathetic approach towards critical vendor payments, authorising them on the application of a general, but strict, value maximising test. In *Re CoServ LLC*[23] it was said that the corporate debtor must demonstrate the existence of three elements:

> First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.

Amendments to the Bankruptcy Code effected by the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 ('BAPCPA') have reduced the practical implications of the critical vendor doctrine in two respects; firstly, by expanding the scope of the reclamation doctrine and secondly, by giving certain pre-petition claims administrative expense status. Sellers, who have sold goods to the company, in the ordinary course of the seller's business, within 45 days prior to the commencement of the bankruptcy, may reclaim these goods if the company was insolvent at the time of receipt.[24] This provision effectively invests sellers with the right to reclaim goods sold on credit and received 45 days before formal bankruptcy proceedings provided that the company was insolvent when it received the goods – a condition that is normally satisfied.

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21 (2004) 359 F 3d 866.

22 (2004) 359 F 3d 866 at 871. Judge Easterbrook did suggest however that s 363 might be used to authorise critical vendor payments in future cases. S 363 states that the debtor-in-possession after 'notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate'.

23 (2002) 273 Bankr Rep 487 at 498–499.

24 See now s 546(c) of the Bankruptcy Code.

Under the second provision, s 503 of the Bankruptcy Code has been amended so as to confer administrative expense status in respect of 'the value of any goods received by the debtor within 20 days' before the date of commencement of a bankruptcy case.[25] The provision is quite broad and, somewhat anomalously, gives suppliers of goods a priority that is denied to suppliers of services or lenders who extended value to the debtor company during the 20-day period. Moreover, the 'new provision is a radical departure from the general rule that only postpetition expenses are afforded administrative priority'.[26] On the other hand, one might draw negative inferences from the amendments saying that they have curtailed, if not abolished, the critical vendor doctrine. If administrative expense status is sought for the value of goods supplied to the company 25 days before the commencement of the bankruptcy, then why should the courts grant this under the critical vendor doctrine when BAPCPA imposes a 20-day cut-off period for such claims?

NEW FINANCING

Almost by definition, companies in financial difficulties need new finance to be able to survive. In the US, new financing is dealt with in s 364 of the Bankruptcy Code. Under this provision, any credit extended to the corporate debtor during the reorganisation process has priority over pre-petition unsecured claims. If the extension of credit is in the ordinary course of business, then priority is automatic whereas if the extension of credit is outside the ordinary course, then the priority must be authorised by the court prior to the granting of credit. In the absence of any agreement by the lender to the contrary, a corporate debtor can obtain confirmation of a reorganisation plan only by ensuring payment of the new lender in full at the confirmation stage. Moreover, even if the reorganisation plan fails, 'new' debts will have priority over unsecured pre-filing debts in the ensuring liquidation.

There may be a significant number of cases where a company's assets are secured to such an extent that the granting of priority over simply pre-filing unsecured creditors offers new lenders little chance of recovery in any subsequent liquidation. In these circumstances, meaningful priority means priority over pre-filing secured creditors and s 364(d) expressly allows the court to authorise this, but only in narrowly defined circumstances. There are safeguards for affected secured creditors in that the debtor must prove that it

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[25] S 503(b)(9).

[26] See Alan Resnick 'The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases' (2005) 47 Boston College Law Review 183 at 204.

cannot obtain the loan without granting such a security interest and that the pre-filing secured creditor is adequately protected against loss. Case law suggests that the statutory requirements are strictly applied and that the 'priming' of prior secured lending should be permitted only on an infrequent and exceptional basis.[27]

A REORGANISATION PLAN

Traditionally, for larger companies at least, a successful Chapter 11 outcome generally results in a plan of reorganisation agreed by a majority of creditors though, certainly for smaller companies, the reality is that most cases are either dismissed or converted into Chapter 7 liquidations. With the larger company paradigm in mind, Stevens J remarked in the Supreme Court in *Bank of America v 203 North LaSalle Street Partnership*[28] that 'Confirmation of a plan of reorganization is the statutory goal of every chapter 11 case. Section 1129 provides the requirements for such confirmation, containing Congress' minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations.'

The confirmation of a reorganisation plan by the court discharges a corporate debtor from fulfilling all the legal obligations that have not been specified in the plan.[29] For the first 120 days after entry into Chapter 11, the DIP has the exclusive right to propose a reorganisation plan but, thereafter, any creditor may make such a proposal.[30] Superficially at least, it is a daunting prospect to try to obtain confirmation of a Chapter 11 plan for the proponent of the plan must affirmatively demonstrate that it has met all the various requirements specified in the statute for confirmation.[31]

Section 1129 enumerates a list of requirements but the list deliberately does not cover all the ground. There are additional implicit requirements that have been omitted from the express list to avoid statutory complexity and also because they are the sort of conditions that would be found by a court to be fundamental to a fair and equitable treatment of a dissenting class of creditors.

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27 See generally George W Kuney 'Hijacking Chapter 11' (2004) 21 Bankruptcy Developments Journal 19 at 48–49.

28 (1999) 526 US 434 at fn 4 of his judgment.

29 S 1141.

30 S 1121.

31 For example, s 1129(a)(9)(c) states that a plan must provide for the deferred cash payment of those taxes afforded priority by s 507(a)(8) including income, excise and withholding taxes. The cash payments have to be made within a 6-year period and must have a value, as of the date of the plan, that is equal to the amount of taxes owing, whether or not the claim would have been paid in full under Chapter 7.

For instance, a dissenting class should be assured that no senior class receives more than 100 per cent of its claims.[32] One explicit requirement is that the whole plan should have been proposed in good faith. It is procedurally cheaper and easier to knock out a plan on other grounds however. If lawyers can present the issue as a question of law, then there is no need for discovery to be taken on the motives of plan proponent. Moreover, if dissenters can raise an objection on the basis, for example, that the classes of claimants have been wrongly classified, then this can be done at the earlier disclosure statement stage rather than during the plan confirmation process.[33]

Every impaired class of creditors must approve the plan though 'cram-down' – confirmation of a plan over creditor objections – is possible. Most confirmed chapter 11 plans are consensual, which means that classes of claims are unimpaired by the plan, or if impaired, have accepted the plan.[34] A class of impaired claims is deemed to accept the plan if at least one-half in number, and at least two-thirds of the dollar amount of the voted claims within the class vote to accept the plan. Majority rule prevails because 'experience makes it certain that generally there will be at least a small minority of creditors who will resist a composition, however fair and reasonable, if the law does not subject them to a pressure to obey the general will'.[35]

Objecting creditors are protected by the courts applying a 'feasibility test' – a debtor must be reasonably likely to be able to perform the promises it made in the plan[36] and also a 'best interests' test – sometimes called the 'liquidation' test since each objecting creditor must receive at least as much under the plan as it would in liquidation. A dissenting creditor (even one in a consenting class) may defeat confirmation of a plan if he can show that he would receive less under the plan than in a liquidation of the company under Chapter 7 of the US Bankruptcy Code. Chapter 11 plans are principally structured around treatment of investors as members of classes but, even if a class votes in favour of

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[32] See the Congressional Record for 28 September 1978 (124 Cong. Rec. H11, 104).

[33] See Bruce A Markell 'Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification' (1994) 11 Bankruptcy Developments Journal 1 at 38–39.

[34] See generally L LoPucki and W Whitford 'Bargaining over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies' (1990) 139 U Pennsylvania Law Review 125; R Broude 'Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative' (1984) 39 Business Lawyer 441.

[35] Cardozo J in *Ashton v Cameron County Water Improvement District* (1936) 298 US 513.

[36] Save with respect to a plan of reorganization that provides for liquidation, s 1129(a)(11) requires the bankruptcy court to establish that confirmation of the plan is not likely to be followed by liquidation or further financial reorganisation of the debtor.

a plan, however, every single member of the class is entitled to insist on compliance with the 'best interests of creditors' test.

At the confirmation stage, most courts will insist on being provided with a liquidation analysis in the disclosure statement accompanying the plan. The analysis will show whether the plan has passed the 'best interests' test but determining liquidation values, however, and how this equates to what is on the table at the moment may not be an easy task.[37] In *Till v SCS Credit Corp*[38] the Supreme Court adopted a formula approach for determining the appropriate interest rate to be used in calculating the present value of a stream of payments. The notional prime rate is used as a starting point and may be increased based on the risk of default in the particular case. The Supreme Court rejected other alternative approaches that were suggested for determining an appropriate interest rate such as a 'coerced loan rate', 'presumptive contract rate' and 'costs of funds' method of calculation.

Essentially, Chapter 11 is a forum for structured bargaining among classes of investors. While it is important to attempt to gain consensus among creditors and shareholders with a view to minimising the administrative costs incurred by the company, and also any loss of public confidence, the cramdown rules set the ultimate parameters for all Chapter 11 plan negotiations. The availability of cramdown limits the ability of a creditor to hold out for better treatment and also permits viable businesses to reorganise even if a few creditors object strenuously. While the size and complexity of the task in reorganising a large company may make it particularly desirable to avoid cramdown litigation, nevertheless, the cramdown rules can work to hold the interests of a small group of powerful creditors in check.[39]

Certain minimum standards are stated for meeting the fair and equitable test. With respect to a dissenting class of secured claims one of three requirements must be met.[40] Firstly, the plan may provide for the secured creditor to retain its security and receive deferred cash payments totalling at least the allowed amount of the claim. The deferred cash payments must have a value, as of the effective date of the plan, that is at least equal to the value of the collateral. On the other hand, as far as the secured creditor is concerned, the ability of the court to impose its own rate of interest upon the deferred payments presents perils since a judicial view on the appropriate interest rate

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37 See generally Douglas G Baird and and Donald S Bernstein 'Absolute Priority, Valuation Uncertainty and Reorganization Bargain' (2006) 115 Yale Law Journal 1930.

38 (2004) 541 US 465.

39 National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at pp 546–547.

40 S 1129(b)(1).

may not necessarily coincide with that of the secured creditor.[41] A consensual rather than a cramdown plan will mitigate the risk of an imposed rate of interest that is unsatisfactory to the secured party. The second alternative is for the sale of collateral free of the security interests with the security interests attaching instead to the proceeds of sale. The third possibility is where the plan provides the secured creditor with the 'indubitable equivalent' of its claims.

Another component of the fair and equitable requirement is spelled out in s 1129(b)(2) which provides that dissenting classes should be paid in full before any junior class receives, or retains, any property under the plan. In other words, pre-liquidation entitlements must be respected. This is the so-called 'absolute priority' principle. The notion seems to be implicit in Chapter 11 that liquidation priorities are sacrosanct but the allocation of the going-concern surplus at the heart of the reorganisation process may be the subject of bargaining among different creditor and other interest groups.

The absolute priority rule seeks to prevent collusive arrangements whereby certain creditors and shareholders conspire to distribute among themselves the value of a company's assets and leave other creditors with little or nothing as a result.[42] The rule is designed to preserve the priority regime between senior and junior stakeholders. In this way, it maintains the assumptions and expectations of those who funded the business whether through debt or equity.[43] It is commonly the case however, that consensual restructuring plans will leave something on the table for equity. In other words, shareholders in the old company will be given a stake in the restructured entity

While some statutory gloss has been applied to the 'fair and equitable' requirement, the Bankruptcy Code does not define the phrase 'unfair discrimination'. It is unclear what exactly is meant by the phrase and what standard it imposes. Nevertheless, it seems that it does not preclude distinctions in meth-

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41 See the discussion in *Till v SCS Credit Corporation* (2004) 541 US 465 about what rate of interest should be imposed.

42 See generally W Blum and S Kaplan 'The Absolute Priority Doctrine in Corporate Reorganizations' (1974) 41 U of Chicago Law Review 651.

43 *Re Loewer's Gambrinus Brewery Co* (1948) 167 F 2d 318 at 320: 'Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditors' interest, if the venture is successful; on the other hand the creditors have only their interest, but they come first in distribution of the assets . . . Every creditor rightly assumes that his risk is measured by the collective claims of other creditors, and by creditors he understands those alone, who like him, have only a stipulated share in the profits [calculated on the basis of their claims]. To compel him to divide the assets in insolvency with those who at their option have all along had the power to take all the earnings, is to add to the risk which he accepted.'

ods of payment that ultimately result in similar treatment of creditors. For example, trade creditors might be paid off in cash, provision for tort claimants could be made out of a newly established trust fund and finance creditors may be issued with bonds by the company. To evaluate whether unfair discrimination exists, some courts use a multi-faceted test that would include considering whether the discrimination has a reasonable basis; whether the company could not confirm or consummate the plan without the discriminatory element; whether the plan is proposed in good faith and whether the degree of discrimination is related to the basis or rationale for the discrimination.[44]

It should be noted however that the prohibition on unfair discrimination applies only to the dissenting class and not to the plan in its entirety. Apparently, the drafters intended that a Chapter 11 plan could discriminate unfairly among various classes of claims, so long as all classes vote in favour of the plan. Section 1129(a)(7) provides appropriate protection for dissenters in a consenting class by requiring that every class member receive at least as much in property under the plan as would be received in a liquidation of the company under Chapter 7.

HOW CHAPTER 11 CAME TO BE ENACTED IN THE FORM THAT IT IS

Chapter 11 did not spring, fully formed, from the head of the US Congress in 1978. In fact the roots of Chapter 11 can be traced back to the railroad receiverships of the nineteenth century.[45] In these cases judiciary developed principles for the restructuring of ailing enterprises without any legislative steer and it was not until the 1930s that Congress included manager-driven reorganisation provisions in the bankruptcy legislation. The most celebrated and famous of all railroad receiverships was the 1884 *Wabash* case where the the railroad's managers took the initiative in requesting the receivership. The court responded affirmatively lest the railroad fail, leaving nothing but a 'streak of iron-rust on the prairie'.[46] In the railroad receivership cases the courts created a procedure under which struggling companies and their management could initiate and attempt a reorganisation of the enterprise under

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[44] National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 584.

[45] See generally David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325; David A Skeel Jr *Debt's Dominion* (Princeton, Princeton University Press, 2001).

[46] *Central Trust Co v Wabash* (1886) 29 Fed 618 at 626.

judicial supervision.[47] Judicially appointed receivers, who generally included members of the railroad's management, worked out the terms of a reorganisation.[48] The courts however refused to extend these special processes to companies outside the railroad industry. Railways were vastly more valuable as going-concerns than in liquidation but this was not so self-evidently true with other companies. Consequently, there was much less of an obvious consensus in favour of manager-driven reorganisation. The special treatment of railways was also justified on the basis that the major obligation of railroads was to serve the public.[49]

Alongside the company's management, investment bankers also exerted particular influence on the receivership process, stemming from their position as underwriters of securities that had previously been issued by the ailing company.[50] The economic collapse of the 1930s put the spotlight on the reorganisation sector with concerns being voiced that underwriters were more concerned about fees and keeping managers happy than with the investors they ostensibly represented.[51] The Chandler Act 1938 was passed to reform bankruptcy law. Chapter X of the Act required that the current managers should be displaced in favour of a bankruptcy trustee and underwriters of securities issued by the company as well as lawyers formerly engaged by the company were prohibited from acting as trustee. Only a bankruptcy trustee

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[47] Bradley Hansen 'The People's Welfare and the Origins of Corporate Reorganization: The Wabash Receivership Reconsidered' (2000) 74 Business History Review 377.

[48] One study of 150 receiverships between 1870 and 1898 found that in over 90 per cent of these cases insiders were appointed as receivers – see Henry Swaine (1898) 3 Economic Studies of the American Economic Association 71 at 77. This study is referred to by Bradley Hansen 'The people's welfare and the origins of corporate reorganization: The Wabash receivership reconsidered' (2000) 74 Business History Review 377 text accompanying footnotes 48–51.

[49] See Hansen ibid, text accompanying footnote 63 'Later decisions, including those by the Supreme Court, continued to emphasize that creditors did not have the same rights in quasi-public corporations that they did in other enterprises. These judges also made clear that the remedies available to railroads were not available to corporations in general but were restricted to enterprises that were regarded as quasi-public, such as railroads or drawbridges. It would be left to Congress to make reorganization available to all corporations' and see generally *Canada Southern v Gebhard* (1883) 109 US 527.

[50] See generally David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 at 1368–1370.

[51] See generally *Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees volumes 1–8* (1937–1940) and see generally the discussion in David A Skeel Jr 'An Evolutionary Theory of Corporate law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 at 1369–1370.

was permitted to propose a reorganisation plan. The Act also introduced government oversight of the process in the shape of the Securities and Exchange Commission (SEC).[52]

Over time, however, the trustee requirement was sidestepped and the role of the SEC in reorganisation cases was weakened. The Chandler Act included a second reorganisation chapter in Chapter XI, which left a company's managers in control and did not provide for SEC intervention. On the surface of the statute, Chapter X was designed for publicly held corporations and Chapter XI for smaller companies. There was nothing, however, in the Act which expressly precluded the managers of a large firm from invoking Chapter XI.[53] In *General Stores Corp v Shlensky*[54] it was held by the Supreme Court that the choice of chapter depended on the 'needs to be served' and that even a public company could invoke Chapter 11 in an appropriate case. Companies increasingly filed for reorganisation under Chapter XI rather than under Chapter X. Mid-sized companies led the way in this regard but larger companies soon followed.[55] In 1973 the National Bankruptcy Commission Report observed that 'it is readily apparent that Chapter XI has evolved into the dominant reorganisation vehicle and very substantial debtors are able to reorganise in Chapter XI'.[56] The SEC still had a role in the process, however, for in return for not challenging a company's use of Chapter XI, it could negotiate benefits for investors.

Chapter XI, however, had several drawbacks principally in its failure to provide for cramdown. Basically, the rights of secured creditors and the interests of shareholders could not be affected in the absence of the unanimous consent of those involved. Despite the law on the books, nevertheless the major focus of Chapter X1 cases as they became more sophisticated and involved larger companies was the negotiations between the company and its secured creditors. The ultimate weapon that could be used by the company if creditor consent to the plan was not forthcoming was to threaten to turn the case into a straightforward liquidation where returns to creditors would be lower.

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52 See generally David A Skeel Jr *Debt's Dominion* (Princeton, Princeton University Press, 2001) chapter 4 'William Douglas and the Rise of the Securities and Exchange Commission'.

53 In *SEC v United States Realty & Improvement Co* (1940) 310 US 434 the Supreme Court however leaned against publicly held companies using Chapter XI.

54 (1940) 350 US 462 at 466.

55 See Benjamin Weintraub and Harris Levin 'A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation' (1957) 26 Fordham Law Review 292.

56 *Report of the Commission on the Bankruptcy Laws of the United States* HR Doc No 93 at p 137.

By the time that the new bankruptcy code was formulated in the 1970s the mood music clearly favoured corporate reorganisations. Chapter X of the Chandler Act was consigned to history and the new Chapter 11 took over from the old Chapter XI, but without any status for the SEC. In certain respects, Chapter 11 mixes together two distinct models of reorganisation or debt-restructuring statutes. The first model is based on creditor democracy and minimises the involvement of the court. Under this model, the function of the court is to give effect to the decision of a certain number or percentage of creditors as to the form and extent of debt relief.[57] Creditors and shareholders are relied upon to engage in negotiations towards resolution of the difficulties facing the company and their conflicting interests. Creditors as a group are permitted to determine whether the plan lies in their best interests. It is not for the court, or an administrative agency, to evaluate the company's prospects and the merits of the plan.[58] The second model embodies more of a creditor-protective approach, with a court or administrative agency being integral to the process of determining whether a particular form of debt relief is proper. Chapter 11 has an aspect of this for the court is called upon to decide the feasibility of a reorganisation plan.

In its combination of approaches, Chapter 11 also reflects the historical legacy of the Chandler Act.[59] While primarily Chapter XI, Chapter 11 also mixes elements from Chapter X of the Chandler Act.[60] For example, under Chapter X there was a fair and equitable requirement. This was interpreted by the Supreme Court as requiring the imposition of the absolute priority rule, i.e a senior class of claimants should be paid in full before a junior class receives anything.[61] Chapter 11 incorporates this specifically but it allows classes of

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57 See Bruce A Markell 'Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification' (1994) 11 Bankruptcy Developments Journal 1 at 5–6.

58 See *Bank of America v 203 North LaSalle Street Partnership* (1999) 526 US 434 at fn 28 'Congress adopted the view that creditors and equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees or the SEC . . . Consistent with this new approach, the Chapter 11 process relies on creditors and equity holders to engage in negotiations towards resolution of their interests' referring to G Eric Brunstad, Mike Sigal & William Schorling 'Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One' (1998) 53 Business Lawyer 1381, 1406 n 136.

59 See generally D Baird and R Rasmussen 'Control Rights, Priority Rights and the Conceptual Foundations of Corporate Reorganizations' (2001) 87 Virginia Law Review 921.

60 The convention is to use Roman numerals for chapters of the pre-1978 Bankruptcy legislation and arabic numerals for chapters in the 1978 statute.

61 See *Northern Pacific Railway Co v Boyd* (1913) 228 US 482; *Case v Los Angeles Lumber Products* (1939) 308 US 106.

creditors to waive what before had been individual absolute priority entitlements. A class of claimants can agree that a lower-ranked class should be paid before it. Individual absolute priority rights are therefore subordinated in many instances to a majority determination that the company should be reorganised.

CALLS FOR THE ABOLITION OR REFORM OF CHAPTER 11

There have been many calls for the abolition or reform of Chapter 11 and for its replacement by a new regime. The criticisms of Chapter 11 take various forms but, in the main, centre around the proposition that the process is too expensive and takes too long.[62] To use economic jargon, there is considerable scope for opportunistic, rent-seeking behaviour by management. Because undersecured creditors do not receive interest on their collateral while the company is in Chapter 11, and such creditors are stayed from enforcing their collateral, the company has an incentive both to invoke, and to drag out, Chapter 11 proceedings. The whole process, it is argued, involves the transfer of wealth from creditors to shareholders and to managers.

Perhaps the most famous attack on Chapter 11 is that made by Professors Bradley and Rosenzweig who suggest that the procedure invests company management with inappropriate incentives.[63] They see Chapter 11 'as a mechanism that permits managers to abridge contractual agreements with creditors and other stakeholders in order to enhance their own welfare'[64] and to the detriment of other corporate constituencies. Professors Bradley and

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[62] Empirical studies about the direct costs of Chapter 11 proceedings have produced somewhat different results or at least results that are open to varying interpretations. Stephen J Lubben suggests that the direct costs of reorganising large public companies in Chapter 11 consists of 3 per cent of the value of company assets – see 'The Direct Costs of Corporate Reorganization' (2000) 74 American Bankruptcy Law Journal 509. See also Stephen P Ferris and Robert M Lawless 'The Expenses of Financial Distress: The Direct Costs of Chapter 11' (2000) 61 U Pittsburgh L Rev 629. A more recent study suggests that the median Chapter 11 case takes up around 8 per cent of the pre-bankruptcy value of the company in legal fees – see Arturo Bris, Ivo Welch and Ning Zhu 'The Costs of Bankruptcy: Chapter 7 Liquidations vs Chapter 11 Reorganizations' (2006) 61 Journal of Finance 1253. They also suggest (at p 1254) that 'bankruptcy costs are measurement sensitive. For example, the conclusions one draws depend on whether one uses at-bankruptcy declared values or end-of-bankruptcy declared values, whether one believes the value declarations filed by management, and whether one reports means or medians.'

[63] M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' (1992) 101 Yale Law Journal 1043.

[64] See M Bradley and M Rosenzweig ibid at 1048.

Rosenzweig suggest that, contrary to the beliefs of the pro-Chapter 11 lobby, it is frequently the case that corporate bankruptcy is more likely to be an endogenous event rather than an exogenous one.[65] Managers can choose the proportion of debt financing and whether to allow the company to become 'insolvent' by not maintaining a sufficient balance of liquid assets.

Chapter 11 protects managers if they take this step and even incentivises them to do so. Bradley and Rosenzweig see the debtor-in-possession concept underlying Chapter 11 as a two-edged sword. Allowing existing management to remain in control as a debtor-in-possession may smooth the transition into Chapter 11. It also ensures that professional managers, rather than judicially appointed non-business specialists, make ongoing business decisions. But there is also the risk that debtors-in-possession, especially shareholder-managers, will take actions that have the effect of devaluing claims by creditors. Law and Economics scholars like Bradley and Rosenzweig talk about asset substitution, claim dilution, and underinvestment as common ways in which the value of debt is decreased.[66] Asset substitution, for example, involves opting for high-risk investment projects in place of safer ones since the shareholders have nothing to lose through the failure of the high-risk projects. Underinvestment involves the rejection of positive net present value projects on the basis that the benefits of such projects will accrue exclusively to the creditors.[67]

The likelihood of these risks occurring will vary from case to case, and the degree to which managers are under the direct influence of shareholders and/or have a personal financial stake in the company. Moreover, the more that a company is 'under water', so to speak, the greater is the incentive for the company to forego positive net present value projects in favour of more speculative projects that have a larger potential pay-off.[68] While this practice may

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[65] M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' at 1046–1047.

[66] See generally Robert K Rasmussen 'The Ex Ante Effects of Bankruptcy Reform on Investment Incentives' (1994) 72 Washington University Law Quarterly 1159 at 1168–1171 – 'Asset substitution occurs when a firm exchanges assets with a stable value for assets with fluctuating value. Problems arise only when asset substitution leads shareholders to invest in projects that have a negative net present value.' Claim dilution 'is to have the firm issue new debt'. 'Underinvestment occurs when a firm's capital structure causes it to bypass projects that have a positive net present value.'

[67] M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' at 1052–53 and CW Smith and JB Warner 'On Financial Contracting' (1979) 7 J Fin Econ 117 at 118–119.

[68] RK Rasmussen 'The Ex Ante Effects of Bankruptcy Reform on Investment Incentives' (1994) 72 Wash U LQ 1159 at 1171.

not be the norm, there is an appreciable risk of it occurring and the longer that a distressed company continues operations under a bankruptcy regime, the greater is the risk.[69] The economic and social costs of these suboptimal managerial decisions are part and parcel of the costs of the restructuring regime.[70] There are also so-called 'deadweight costs', which include the direct costs of the restructuring proceedings themselves, including professional fees paid to lawyers, accountants and financial advisors and the spend on judicial resources[71] as well as indirect costs 'which arise because the managers of the firm must focus on the bankruptcy proceeding rather than on running the firm'.[72]

This provocative thesis about the unsustainable case for Chapter 11 has met with an equally vigorous response from other commentators.[73] Certainly, it seems that the Bradley and Rosenzweig thesis, while it may have some merit, is overstated. Although reorganisation may be a more palatable alternative than liquidation, corporate distress is almost always an absolutely unwanted event as far as managers are concerned. It stretches plausibility to suggest 'that management affirmatively embraces bankruptcy and plans more high risk business activities than it otherwise would because of the protection available in Chapter 11'.[74] Not least this is because of senior management turnover when a company hits the financial buffers. According to one empirical study, senior management turnover in financially distressed publicly listed companies is over 50 per cent in any given year; almost three times the corresponding turnover rate for companies that are not in financial distress.[75] Normally

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69 RK Rasmussen ibid 1159; MC Jensen and WH Meckling 'Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure' (1976) 3 J Fin Econ 305.

70 M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' at 1052.

71 M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' ibid at 1050 footnote 23.

72 See RK Rasmussen 'The Ex Ante Effects of Bankruptcy Reform on Investment Incentives' 1159 at 1160.

73 E Warren 'The Untenable Case for Repeal of Chapter 11' (1992) 102 Yale Law Journal 437; DR Korobkin 'The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig' (1993) 78 Iowa L Rev 669; L LoPucki 'Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig' (1992) 91 Michigan Law Review 79.

74 E Warren ibid at 451–452.

75 'Management turnover is defined as any change in the group of individuals who together hold the titles of CEO, president, and chairman of the board.' – see SC Gilson 'Management Turnover and Financial Distress' (1989) 25 Journal of Financial Economics 241 at 243. The corresponding turnover rate of solvent but highly unprofitable firms was only 19 per cent – see p 242. See however, Ethan S Bernstein 'All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO

these management changes will come about at the prompting of bank creditors.[76] Moreover, the data also reveals that senior managers who resign, or are retrenched, from these financially distressed firms' companies will experience difficulty in landing a commensurate position in the job market.[77]

As well as diagnosing the ills of Chapter 11, US commentators have also provided prescriptions for its perceived problems. In the main, reform proposals are of two kinds. One set of proposals involves a compulsory debt/equity swap under which the existing shares in an insolvent company are automatically cancelled and replaced by new shares that are allocated to creditors in accordance with the priority of their debt. The basic proposal has many variants but fundamentally it entails the cancellation or evaporation of a company's shares once the company has defaulted on its loan obligations. Existing shareholders and other lower-ranking claimants are given, however, the option to buy out senior-ranking claimants. Another set of proposals involves the mandatory auction of the company assets under the supervision of the bankruptcy court and the distribution of the proceeds to creditors. Again there are variations on the proposals but, in one version, the auction procedure would only take effect after reorganisation efforts have been made, and failed, for a certain period of time.

The reform proposals all involve the move to a more market-driven process from what is perceived to be a court-dominated process. There is the assumption that a process involving negotiations under the supervision of the bankruptcy court – the hallmark of Chapter 11 – does not determine asset values as efficiently as a more market-oriented regime.[78] The Chapter 11 process often produces divisions of assets among claimants that deviate substantially from non-insolvency entitlements. Junior classes of claimant can often manipulate and delay the process so as to produce a restructuring plan that will grant them

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Turnover in Financial Distress' (2006) 11 Stanford Journal of Law, Business & Finance 298 who presents new evidence that 'filing for bankruptcy did not change the rate of CEO turnover when one controls for financial condition. This statistically significant finding indicates that the "shadow of bankruptcy" has lengthened, making bankruptcy law a central tenet of governance policy regardless of whether a Chapter 11 petition is ever filed.'

[76] See SC Gilson 'Management Turnover and Financial Distress' at 241.

[77] See SC Gilson ibid at 254.

[78] See I Ayres and R Gertner 'Strategic Contractual Inefficiency and the Optional Choice of Legal Rules' (1992) 101 Yale Law Journal 729 at 733 'Even in a world of imperfect markets, it seems doubtful that courts have a comparative advantage over capital market agents in determining the intrinsic value of corporations and their equity claims. Judicial intervention is warranted only if there are significant information asymmetries, transactions costs, or ambiguous property rights' and see also M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' at 1054.

more value than they deserve under a regime that respects strictly pre-insolvency entitlements.[79]

The reform proposals, particularly those involving a mandatory debt-equity swap, have however been criticised on the basis that they pay insufficient regard to transaction costs. They may also have the effect of triggering bankruptcy proceedings almost accidentally such as where the company's failure to meet its loan commitments is due to some technical glitch in payment mechanisms or on account of temporary liquidity problems. In the real world of business, transaction costs matter enormously.[80] The mandatory transubstantiation of debt into equity is likely to have little practical appeal. As one English observer remarks[81]

> It is one thing, perhaps, for a major creditor – such as a financial institution – to agree to convert a portion of outstanding debt into equity as part of a negotiated solution to the debtor company's financial difficulties. It is quite another thing for all categories of creditor to wake up and discover that they have become overnight the 'owners' of their debtor, due to its inability to meet its cumulative liabilities. The further elements of the proposal, involving the formulation of bids for the company from various categories of its erstwhile creditors (now designated as its equityholders), seem to hold little promise of operating properly in the real world, where markets are nothing if not imperfect, and the personal affairs and judgments of the parties who find themselves locked into this bidding process – as though engaged in some surreal game of poker – will inevitably generate internal conflicts and tensions, precluding the attainment of the 'idealized' or 'perfect' solution so beloved by economic theory.

The same commentator also suggests that a mandatory debt/equity conversion may perpetrate injustice by expropriating junior creditors who cannot afford to provide further value as part of the required bid.

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[79] See LA Bebchuk 'A New Approach to Corporate Reorganizations' (1988) 101 Harvard Law Review 775 at 780: 'Management will use delay to take unjustified risks with the firm's assets in a feeble hope of returning the firm to solvency and providing equity holders with residual value. . . . Because high-priority creditors of an insolvent firm may have more to lose than low-priority creditors, the low-priority creditors may be able to force concessions from high-priority creditors by threatening to prolong bankruptcy through litigation over their relative entitlements' and see also Barry E Adler 'Financial and Political Theories of American Corporate Bankruptcy' (1992) 45 Stan L Rev 311 at 316.

[80] See Stephen J Lubben 'Some Realism about Reorganization: Explaining the Failure of Chapter 11 Theory' (2001) 106 Dickinson Law Review 267 at 302–303: 'Existing models are not simplified versions of the reality of corporate reorganization, but instead models of a highly stylized process. This is the ultimate failing of existing Chapter 11 theory.'

[81] See Ian F Fletcher 'Commentary on Aghion, Hart, and Moore, Improving Bankruptcy Procedure' (1994) 72 Washington U L Q 879.

Under the mandatory auction procedure put forward by Professor Douglas Baird, Chapter 11 would be replaced by a procedure that separated the question of how to deploy the assets of the company from the question of how to allocate these assets among stakeholders.[82] The mandatory auction regime requires that an insolvent company's assets should be sold to the highest bidder. Then the court would divide the sale proceeds among claimants strictly in accord with their legal priorities established by non-bankruptcy law. The primary justification for the auction regime is that it would put a market value on the company by the broad solicitation of bids for company assets, either individually or collectively.[83] These bids could reflect the company's going-concern value more objectively than judicial evaluation.[84] The auction procedure is also anticipated to be cheaper and faster than Chapter 11, with a saving in direct costs and also the costs of suboptimal managerial decisions being reduced, if not entirely eliminated.[85]

There are of course variants on a basic auction model. Professor Mark Roe, for example, has proposed a partial auction regime under which the reorganisation value of the publicly listed insolvent company would be extrapolated from the sale price of a slice, possibly 10 per cent, of new ordinary shares in the open market.[86] This proposal is said to 'eliminate the prolonged negotiation and litigation expenses that are inherent in the typical battle over a firm's going concern value'.[87]

There are many reasons, however, for supposing that auctions may not function as well in maximising company value as optimists would expect. In the case of large public companies, their going-concern value can hardly be realised in auctions that take place shortly after the Chapter 11 filing.[88] A

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[82] Douglas G Baird, 'The Uneasy Case for Corporate Reorganizations' (1986) 15 Journal of Legal Studies 127 and Douglas G Baird 'Revisiting Auctions in Chapter 11' (1993) 36 Journal of Law and Economics 632.

[83] Douglas G Baird, 'The Uneasy Case for Corporate Reorganizations' at 136–137.

[84] See Mark J Roe 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 Columbia Law Review 527 at 530: 'The judicial solution thereby mimics the market, attempting to reach an idealized value of the bankrupt that the court believes would arise if a perfect market were at work. Both the bankruptcy bargain and the litigation mechanisms are slow, costly, and often unpredictable.'

[85] Douglas G Baird 'The Uneasy Case for Corporate Reorganizations' ibid 127.

[86] Mark J Roe 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 82 Columbia Law Review 527 at 559.

[87] See Barry E Adler 'Financial and Political Theories of American Corporate Bankruptcy' (1992) 45 Stan L Rev 311 at 319.

[88] See Lynn M LoPucki and William C Whitford 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 U Pa L Rev 669 at 760: 'Consistent with this view, when there was a sale of all or most of the assets of a firm in our study, it commonly occurred more than a year after filing.'

majority of such companies will suffer massive losses from an immediate sale in that few potential bidders can assemble the necessary financing to bid at short notice. These problems are compounded if the company is operating in a depressed sector of the economy.[89] Even in a more competitive market, 'the potentially enormous costs of gathering and analyzing information, of choosing an appropriate capital structure for the firm, and of the bidding process itself' and the formidable 'winner-win-all, loser-lose-all' result would deter many bidders.[90] There is a natural bias for potential bidders to depress their bids so as to cover the costs of engaging in the bid process and also to compensate for the risks of the bid turning out to be unsuccessful.[91] This point is highlighted by the fact that in a non-insolvency context it is not uncommon for sellers to sign a sort of exclusivity deal with a would-be buyer under which the potential buyer is promised a 'breakup' fee that is designed to cover the cost of preparing a bid that is topped by another later bidder.

Compared with the current Chapter 11 bargaining approach, the auction alternative may appear inflexible and neither is it cost free. There are the direct costs of the sale proceedings themselves and indirect costs that stem from the time spent by potential bidders on investigation, information gathering and seeking appropriate advice.[92] One leading US bankruptcy judge has stated that companies in distress require the opportunity to suspend creditors' rights because markets are so inefficient and because bankruptcy is overwhelmingly the result of imperfect markets and high transaction costs.[93]

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[89] David A Skeel 'Markets, Courts, and the Brave New World of Bankruptcy Theory' [1993] Wisconsin Law Review 465 at 479 'Auctions work well if raising cash for bids is easy and there is plenty of competition among bidders . . . both the financing problem and the lack-of-competition problem are likely to be exacerbated to the extent that the natural bidders for a bankruptcy firm are other firms in the same industry; these firms may also be suffering financial distress and may therefore find it hard to raise capital' and see also P Aghion, O Hart and J Moore 'The Economics of Bankruptcy Reform' (1992) 8 J L Econ & Org 523 at 528.

[90] David A Skeel. 'Markets, Courts, and the Brave New World of Bankruptcy Theory' [1993] Wisconsin Law Review 465 at 479.

[91] See Lynn M LoPucki and William C Whitford 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' at 762: 'Potential purchasers will need to develop a business plan for the company before they can estimate the level of profitability the reorganized company could achieve. They may need to obtain financing for the purchase and perhaps pay a commitment fee for that financing. An outsider will not incur these costs unless it has reason to believe that it can buy the assets at a price sufficiently below their going concern value (hereinafter called the 'differential') to cover both the costs of preparing a bid and the risk that it will not be accepted. There is reason to believe that the size of this differential is substantial.'

[92] Kevin A Kordana and Eric A Posner 'A Positive Theory of Chapter 11' (1999) 74 New York University Law Review 161 at 162.

[93] See Samuel L Bufford 'What is Right About Bankruptcy Law and Wrong About Its Critics' (1994) 72 Wash U LQ 829 at 846.

Another set of reform proposals is based on bankruptcy becoming an optional rather than a mandatory procedure. Again there are variants on the basic model with one possibility allowing a company at the time of incorporation to choose from a menu of bankruptcy options including restructuring. Professor Rasmussen has been an advocate of this approach, arguing that a company's ability to file for reorganisation should be determined by those who have invested in the company rather than by outside policy makers.[94] Liquidation and restructuring options for the company should be left to the wisdom of stakeholders in the company who will be guided by the nature of the company and the sector of the economy in which it operates. As Professor Rasmussen stated: [95]

> The question then becomes how this diversity in the types of firms should be addressed. Congress could legislate different bankruptcy regimes for different firms as some have proposed, it could leave the entire matter to private contract, or it could allow firms to sort themselves at the time the firm is formed by adopting a bankruptcy regime that allows the owners of the firm to select the set of bankruptcy rules that they believe best serves the firm's needs.

Under the so-called menu approach to bankruptcy law, a company on its formation may select one alternative from a menu of available bankruptcy options.[96] All potential consensual creditors would be governed by the same chosen bankruptcy regime and the rights of nonconsensual creditors such as tort victims should be set by mandatory rules unless the chosen regime provides them better protections.[97] Others, such as Professor Alan Schwartz, have gone further than menu options with mandatory default rules and advocated a pure contract approach.[98] Simply stated, creditors would opt in to a particular bankruptcy regime when making their contracts with the company and only where their contractual choices were incomplete would they be subjected to default rules. The rights of nonconsensual creditors, on the other hand, should be set by mandatory rules. In other words, in the domain out of the reach of private contracts, mandatory rules of bankruptcy law govern.

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94 Robert K Rasmussen 'The Ex Ante Effects of Bankruptcy Reform on Investment Incentives' (1994) 72 Wash U LQ 1159 at 1207–108.

95 Robert K Rasmussen ibid at 1164 and 1209–1210.

96 Robert K Rasmussen 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Tex L Rev 51.

97 See Robert K Rasmussen ibid at 63: 'Contract theorists generally agree that mandatory rules can be justified either by society wanting to protect the contracting parties themselves (paternalism) or by society wanting to protect third parties (externalities).'

98 A Schwartz 'Bankruptcy Workouts and Debt Contracts' (1993) 36 Journal of Law and Economics 595.

The 'menu' and pure contract approaches suffer from complexity and a lack of flexibility. On the complexity front, there may be considerable costs in weighing up the available alternatives and choosing an appropriate bankruptcy structure in advance. It may also be the case that just as one bankruptcy procedure does not suit all types of company well, the same bankruptcy procedure might not be suitable at all times for the same company throughout its existence.

> [C]hoosing an insolvency capital structure in advance requires the parties to predict the future. If the firm guessed wrong about the likely source of financial difficulties, changed significantly between its inception and the time it encountered trouble, or both, the special insolvency structure could prove wholly ineffective. To be sure, the parties could attempt to adjust their prearranged structure midstream in an effort to address changed conditions, but negotiations of this sort would be costly and frequently unsuccessful. In short, the initial negotiating costs and the possibility that midstream adjustments might become necessary would significantly limit the usefulness of preplanned adjustments for many, and perhaps almost all, firms.[99]

The requirement of flexibility calls for a mechanism by which a company can change its original, thought now inappropriate, bankruptcy option to an alternative and more suitable one. But there is considerable difficulty in devising such a mechanism. If the unanimous consent of creditors was required there is the risk of 'hold-out' behaviour by certain creditors, but anything less than a unanimity requirement opens up the possibility of advantage gaining by the company at the expense of creditors.[100]

In recent years, full frontal attacks on Chapter 11 have diminished substantially.[101] Calls for its abolition have become much more muted. In part, this may be because critics have achieved many of their objectives in an indirect fashion through changes in Chapter 11 practice. There has been a marked rise in the number of pre-packaged Chapter 11 filings where the outcome is more or less a done deal at the time of the filing. Creditors, in particular, have gained increased influence over the Chapter 11 process through contractual arrange-

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[99] See David A Skeel 'Markets, Courts and the Brave New World of Bankruptcy Theory' at 482.

[100] The proposed solution to this problem is to provide 'sensible restraints on the amendment process to ensure that a firm cannot reallocate its value from the debt holders to the equity holders' – see RK Rasmussen 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' at 117.

[101] See Melissa B Jacoby 'Fast, Cheap and Creditor-Controlled: Is Corporate Reorganization Failing?' (2007) 54 Buffalo Law Review 401: 'Academic support for American-style corporate reorganization has been at all-time high, or, at least, calls for the repeal of Chapter 11 have been at an all-time low. Critics of Chapter 11 now say, approvingly, that the process has become faster, cheaper, more creditor-controlled, and more integrated with market forces.'

ments with the debtor company. There have been statutory reforms in the area of small business bankruptcy. Each of these developments will now be discussed in this chapter.

CHANGES IN CHAPTER 11 PRACTICE – THE RISE OF PRE-PACKS

US bankruptcy practice and innovations in the same did not come to a stop with the enactment of the Bankruptcy Code in 1978. In the 1980s there was the rise of the 'pre-pack' or 'pre-packaged' bankruptcy.[102] 'Pre-packs' were seen to have significant advantages over both a traditional Chapter 11 and corporate restructuring that took place fully out of court. A pre-pack permits a company to conduct restructuring negotiations outside of Chapter 11 thereby reducing the costs and disruption to all parties that are often associated with a long-drawn-out Chapter 11 process.[103] The pre-pack is a hybrid animal, mixing elements from private restructuring and the traditional Chapter 11 process. A 'pre-packaged' case should be disposed of faster and more cheaply, provided, of course, that the company has made adequate disclosure of its financial condition to creditors before the bankruptcy filing. A clearly predefined exit strategy will minimise the time that the company needs to be in Chapter 11 and definitely increase the company's chances of emerging from the process. It has been suggested that the following four interrelated ingredients are essential to the success of a pre-pack:

> Foresight of management in realistically assessing and evaluating financial problems; willingness and ability of management to incur the professional fees necessary to implement the prepackaged reorganization; formulation of a viable exit strategy and a business plan that is acceptable to the bulk of a business's creditors and equity holders and a creditor group that is willing to negotiate the prepackaged reorganization.[104]

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[102] See generally SC Gilson 'Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11' in JS Bhandari and LA Weiss ed *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) p 308.

[103] National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 590. Pre-packaged bankruptcies are also more likely to have financing arrangements in place. On this see generally S Dahiya, K John, M Puri and G Ramirez 'Debtor-in-possession Financing and Bankruptcy Resolution: Empirical Evidence' (2003) 69 Journal of Financial Economics 259 at 269–270 and see also S Chatterjee, S Dhillon and G Ramirez 'Debtor-in-possession Financing' (2004) 28 Journal of Business and Finance 3097.

[104] See TJ Salerno and CD Hansen 'A Prepackaged Bankruptcy Strategy' [1991] Journal of Business Strategy 36 at 39.

With a pre-pack, an agreement can be reached that satisfies the majority of creditors and then Chapter 11 is used for the purpose of giving effect to, and implementing, the agreement. This takes away or, at least reduces, the leverage of minority groups of creditors who could otherwise hold up, and prevent, an out-of-court workout. On the other hand, a pre-packaged bankruptcy is not likely to be successful in resolving 'complex, litigious disputes among hundreds of creditor groups with sharply divergent interests – the kind we often see in a traditional, highly contentious Chapter 11 reorganization'.[105]

The process of obtaining creditor consent to a reorganisation plan is, however, different inside and outside bankruptcy, and the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 (BAPCPA) removed what may have been a significant procedural obstacle in the way of 'pre-packs'. The 2005 Act adds a new section 1125(g) to the Bankruptcy Code and makes it clear that 'an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if such holder was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law'.

In a pre-pack, a company will file both the bankruptcy petition and the reorganisation plan at the same time, having first obtained at least the informal consent of creditors to the plan.[106] The voting on the pre-packaged plan may take place either before or after the Chapter 11 filing has been made.[107] In a 'pre-voted' pre-pack, the outcome of the vote is filed alongside the Chapter 11 petition and the reorganisation plan. Unless the court finds some fault with the voting process, the court can proceed directly to considering whether the plan should be confirmed.

Pre-packs have their undeniable advantages but they also have their downsides. The process of soliciting acceptances to a pre-pack provides creditors with an opportunity to make a pre-emptive strike against corporate assets of the company in anticipation of a general default by the company. Moreover, more so than a completely private restructuring, a pre-pack broadcasts the

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[105] See J McConnell and H Servaes 'The Economics of Pre-packaged Bankruptcy' in JS Bhandari and LA Weiss ed *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) 323.

[106] See SC Gilson 'Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11' in JS Bhandari and LA Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) 308 at 321.

[107] The latter, 'post-voted' pre-packs with the vote being conducted under the auspices of the bankruptcy court, have always been permitted but the former, 'pre-voted' pre-packs, were first specifically allowed under the 1978 Bankruptcy Code – see generally E Tashjian, RC Lease, JJ McConnell 'Prepacks An Empirical Analysis of Prepackaged Bankruptcies' (1996) 40 Journal of Financial Economics 135 at 138.

financial problems of the company widely, and therefore increases the likelihood that the business might wind up in the hands of competitors or other third parties.[108]

There are also procedural risks. A court may find that the disclosure statement is inadequate in some respects, which means that the company will have to amend and redistribute the disclosure statement, and also resolicit plan acceptances, resulting in lengthy delays in confirmation.[109] There is also the suggestion that some groups of creditors may receive more favourable treatment than others in a pre-pack. The requirement that similarly situated claimants should receive similar treatment is one of the fundamental features of the US Bankruptcy Code,[110] but this principle may not have been strictly followed in some pre-packs.[111] In a conventional Chapter 11 case, the company negotiates in the open, under the scrutiny of a bankruptcy court, with all types of creditors and their committees or representatives. In a pre-pack however, the negotiations typically take place in secret and the company may hand-pick its negotiation partner at will.

Furthermore, it has been suggested in some empirical studies that companies with pre-packaged Chapter 11s[112] are more likely to go forum shopping and have a greater propensity to refile for Chapter 11 protection at some later stage.[113] 'Forum shopping' could be defined as the filing of a Chapter 11 case in a court other than that which serves the location of the company's head office.[114] In recent decades, firstly, the southern district of New York (Manhattan) and secondly, Delaware have become popular as 'shopping' venues.[115]

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108 TJ Salerno and CD Hansen 'A Prepackaged Bankruptcy Strategy' [1991] Journal of Business Strategy 36 at 40.

109 'Adequate information' is defined in s 1125(a)(1) of the Bankruptcy Code.

110 Bankruptcy Code s 1123(a)(4).

111 Mark D Plevin, Robert T Ebert and Leslie A Epley 'Pre-packaged Asbestos Bankruptcies: A Flawed Solution' (2003) 44 Texas Law Review 883 at 913.

112 See T Eisenberg and LM LoPucki 'Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations' (1999) 84 Cornell L Rev 967 at 976–977.

113 Ibid and see also LM LoPucki and SD Kalin 'The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom" ' (2001) 54 Vand L Rev 231.

114 T Eisenberg and LM LoPucki 'Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations' at 975.

115 See generally Lynn M LoPucki *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* (Ann Arbor, University of Michigan Press, 2005) which is a full-blooded critique of the American bankruptcy court system. For just a taste see p 23: 'The process by which pressure to compete is brought to bear on the judges is brutal and intimidating. The lawyers who place cases are among the most

It is possible to view 'forum shopping' as an overall social good in that the Delaware Bankruptcy Court has developed expertise in handing pre-packaged bankruptcies.[116] On the other hand, there is empirical evidence that the Delaware Bankruptcy Court does not handle pre-packaged cases with any greater speed than other courts.[117] According to some commentators, the real reason why a company may prefer Delaware is to shop for judges:

> Although bankruptcy law and procedure are uniform throughout the United States, the perception that case processing is different across cities induces forum shopping. Thus, the system's worst fears about the reasons for shopping are likely correct: debtors shopped to New York and now shop to Delaware in large part to secure particular judges or to avoid judges in their home districts.[118]

Moreover, the apparently higher refiling rate for pre-packaged cases become quite comprehensible if one considers the dynamic of the pre-pack process. In one empirical study, approximately half of the refilings examined were pre-packaged cases in which the company sought, and obtained, the creditors' consent to the initial filing.[119] Time costs money, and there is a clear incentive for the company and its main creditors to formulate and propose a pre-pack which may benefit themselves at the expense of other creditors in the

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powerful and prestigious of the bankruptcy bar. They publicly laud the judges who give them what they want and harshly criticize those who do not. Some of the latter become pariahs of the national bankruptcy bar – judges considered so bad they drive the cases away. Lawyers – and other judges – malign them as "toxic judges'' '.

[116] David A Skeel 'Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware' (1998) 1 Del L Rev 1; 'What's So Bad About Delaware' (2001) 54 Vand L Rev 309; Robert K Rasmussen and Randall S Thomas 'Chapter 11 Reorganization Cases and the Delaware Myth' (2002) 55 Vand L Rev 1987. See also T Chang and A Schoar 'The Effect of Judicial Bias in Chapter 11 Reorganization' (October 2006) available on www.ssrn.com/ website.

[117] T Eisenberg and LM LoPucki 'Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations' at 971 and Lynn M LoPucki and Sara D Kalin 'The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom'' ' (2001) 54 Vand L Rev 231 at 264.

[118] See T Eisenberg and LM LoPucki ibid at 1002 and see also their comments at 971 'Though the term "forum shopping" has a pejorative connotation, forum shopping is far from universally condemned. . . . One type of forum shopping, however, has received uniform condemnation and likely will lead to disciplinary proceedings against the attorney involved – shopping for judges. Observers seem to agree that judge shopping 'breeds disrespect for and threatens the integrity of our judicial system and undermines the aphorism that "ours is a government of laws, not men".'

[119] Lynn M LoPucki and Sara D Kalin 'The Failure of Public Company Bankruptcies in Delaware and New York at 236.

hope of emerging from Chapter 11 as quickly as possible.[120] Once the plan has been presented, the bankruptcy court may experience difficulty in evaluating the proper merits of the request to confirm the plan or in providing an independent assessment of the feasibility of the plan.

The bankruptcy courts have the power to confirm a plan over the objection of dissenters and, in order to generate bankruptcy filings, courts may compete by applying lax standards for plan confirmation. The appeal of Delaware as a 'shopping' venue may have been partly in its willingness to confirm reorganisation plans on, more or less, a 'no-questions-asked' basis. Some proportion of refilings is inevitable because of changing business conditions, but some commentators conclude that there has been an excessive refiling rate and this has been partly generated by courts wastefully competing among themselves for bankruptcy business.[121]

CHANGES IN CHAPTER 11 PRACTICE – SMALL BUSINESS BANKRUPTCIES

The use of Chapter 11 in small business cases has long been criticised as being too complex, expensive and slow. Throughout the 1980s and 1990s many observers noted that Chapter 11 adopted a 'one size fits all' approach towards corporate reorganisation in which so-called 'mom-and-pop' stores followed the same reorganisational steps as large conglomerates. The 'one size fits all' paradigm did not produce efficient results when applied to small businesses.[122]

Many Chapter 11 small business cases failed, although, typically, they died a lingering death and when the cases were finally converted to a Chapter 7

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[120] See George W Kuney 'Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process' (2002) 76 Am Bankr LJ 235 at 282–283: 'Any increased reliance upon an expedited preplan sale procedure enhances the interests of insiders, their professionals, secured creditors, and those who are intimately involved with the debtor. A relatively quick preplan sale instead of the plan process makes it more likely that smaller creditors and interest holders, as well as slower moving government agencies and the public at large, will be caught unaware and unrepresented.'

[121] Lynn M LoPucki and Sara D Kalin 'The Failure of Public Company Bankruptcies in Delaware and New York' at 237 and 264. For a different perspective see Todd J Zywicki 'Is Forum Shopping Corrupting America's Bankruptcy Courts' (2006) 94 Georgetown Law Journal 1141 who in answer to his question, says 'it all depends'.

[122] James B Haines and Philip J Hendel 'No Easy Answers: Small Business Bankruptcies after BAPCPA' (2005) 47 Boston College Law Review 71 at 73.

liquidation, unsecured creditors rarely received a dividend. Professors Warren and Westbrook have calculated that on the standard criteria, small businesses comprised more than 80 per cent of Chapter 11 filings[123] and, for many of these cases, an expeditious liquidation from the outset might have been the best way forward. On the other hand, small business cases, while looming large in terms of sheer numbers, are not nearly so significant in terms of financial importance.[124] It seems that the total assets or liabilities of companies in this group are no more than 5 per cent of those of all the companies in Chapter 11.

The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) 2005, while primarily concerned about redressing perceived abuses in the consumer bankruptcy sphere,[125] also makes significant amendments to Chapter 11.[126] In particular, Title IV, called the 'Small Business Bankruptcy Provisions', aims to make Chapter 11 'work more efficiently in general and to decrease costs and delay in small business cases in particular'.[127] The new provisions attempt to identify early on, and to weed out, cases for which there is no reasonable likelihood of reorganisation. In other words, it is to prevent 'dead on arrival' debtors from languishing in Chapter 11 to no good end.

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123 E Warren and JL Westbrook 'Financial Characteristics of Businesses in Bankruptcy' (1999) 73 Am. Bankr LJ 499 at 543–544 and footnotes 80–82.

124 See generally Douglas G Baird and Edward R Morrison 'Serial Entrepreneurs and Small Business Bankruptcies' (2005) 105 Columbia Law Review 2310 and especially at 2317 'Perhaps only ten to fifteen percent of all failing businesses ever file a bankruptcy petition. An even smaller fraction use Chapter 11. For the typical corporations that enter Chapter 11, the benefits and costs are both modest.' For information on the number of Chapter 11 filings (generally running at about 10,000 a year) and other bankruptcy filings. see www.uscourts.gov.

125 See Harvey R Miller and Shai Y Waisman 'Is Chapter 11 Bankrupt' (2005) 47 Boston College Law Review 129 at 161: 'The legislative history of the Abuse Act indicates several motivations for reform: (1) an increase in the number of consumer bankruptcy filings and alleged associated creditor losses, as well as adverse financial consequences for the economy as a whole; (2) the use of loopholes and other abusive practices; and (3) the lack of a clear mandate for debtors to repay their debts to the best of their abilities.'

126 R Levin and A Ranney-Marinelli 'The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005' (2005) 79 Am Bankr LJ 603 at 603.

127 TE Carlson and JF Hayes 'The Small Business Provisions of the 2005 Bankruptcy Amendments' (2005) 79 Am Bankr LJ 645 at 645. The provisions are based largely on the recommendations contained in the Bankruptcy Review Commission report, *Bankruptcy: The Next Twenty Years* (1997) available at http://govinfo.library.unt.edu/nbrc.

A 'small business' debtor is now defined as one engaged in commercial or business activities that, at the date of the commencement of the bankruptcy, has aggregate non-insider, non-affiliate, non-contingent liquidated secured and unsecured debts of not more than $2 million, provided that there is no active creditors' committee. It seems that this figure puts the vast majority of Chapter 11 cases within the framework of the small business provisions.[128] The 2005 Act, for the first time, creates mandatory deadlines for the filing and confirmation of a reorganisation plan by small business debtors. The debtor must file a plan and a disclosure statement, if any, within 300 days of the order for relief and the court is required to confirm the plan within a further 45 days. In standard Chapter 11 cases, the debtor-in-possession is given the exclusive right to file a plan for the first 120 days following the order for relief but there is a longer exclusivity period of 180 days for small business debtors. A small business debtor is also faced with the requirement to increase the amount of financial information made available. The amended s 308 of the Bankruptcy Code lays down supplemental reporting requirements for small business debtors who are now obliged to file periodic financial and other reports containing financially sensitive information as prescribed.

There is an expanded role for the United States Trustee, whose office is heavily relied upon to provide close oversight of the debtor in a way that, typically, has not been provided by creditors' committees.[129] Before the first meeting of creditors, the US Trustee is now required to hold an 'initial debtor interview' which aims at investigating the debtor's viability. The US trustee monitors the debtor's activities; identifies cases where there is unlikely to be a confirmed plan, and generally expedites the administration of cases. Perhaps the most important role of the US trustee is to move under an amended s 1112, where appropriate, either for dismissal of the case, conversion of the case into a Chapter 7 liquidation, or the appointment of an outside trustee or examiner to displace existing management. Bankruptcy judges are also given authority to combine the hearings on the adequacy of the disclosure statement and on whether to confirm the plan.[130] In addition,

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128 The National Bankruptcy Review Commission suggested in its 1997 report that under the $5 million debt limit it proposed, small business treatment would apply to approximately 85 per cent of all Chapter 11 cases. National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years* (E Warren, Reporter, 1997) at p 632, available at http://govinfo.library.unt.edu/nbrc/.

129 On the role of the United States Trustee see www.usdoj.gov/ust.

130 The BAPCPA amendments grant the courts broad authority to approve conditionally a disclosure statement and to combine the hearing on the adequacy of disclosure with the hearing on plan confirmation. Courts also have options: (1) to approve a standard-form disclosure statement – s 1125(f)(2); or (2) to dispense with the disclosure statement altogether when the plan itself provides adequate information – s 1125(f)(1).

there are standard-form disclosure statements although the use of these official forms is not made mandatory.[131]

In summary, by imposing plan filing and confirmation deadlines, additional financial reporting requirements and expanding the role of the US Trustee, the new small business provisions are designed to increase oversight of the debtor and to filter out cases where there is no genuine prospect of a successful reorganisation. Coupled with provisions simplifying the process, the objective is to reduce cost and increase efficiency. The reforms introduced by BAPCPA have not met with universal support however. Some observers have argued that the value of the reforms is outweighed by the procedural burdens that the statute imposes on small business debtors.[132] A small business may not survive the cure for its financial ills. It has been said that for

> a debtor with all its ducks in a row before filing, BAPCPA may offer a quick trip to confirmation and beyond. But for the larger share of small business debtors, those upon whom the enormity of their distress dawns late and those who do not know how many ducks they have, let alone how to line them up, BAPCPA's reformed reorganisation process will prove daunting. The breathing space historically provided by bankruptcy will be reduced to a panting space without real opportunity for the debtor to catch its breath and move forward.

Since large public companies and small businesses, in many respects, are like apples and oranges, there have been suggestions that it would be appropriate to create an entirely separate reorganisation regime for small businesses. The BAPCPA provisions have been criticised for failing to offer truly innovative reforms that could streamline small business reorganisations. Under one proposed model, a reorganisation plan could be confirmed with the blessing of an independent trustee who is not responsible for running the business. The need for soliciting and obtaining creditor acceptances of the plan would be removed.[133] The US Congress, however, has consistently rejected the idea of having two business reorganisation chapters with different substantive rules. The fear is that this would provoke wasteful litigation and 'gaming' of the system. Previous Bankruptcy legislation in the US (the Chandler Act) contained two separate reorganisation chapters but this approach was considered to be a failure because it generated uncertainty and invited dispute about

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131 According to the conclusion of the National Bankruptcy Review Commission, the drafted-from-scratch disclosure statement and plan typical in previous Chapter 11 practice are a major cause of the high cost of the process (at pp 635–637 of the report).

132 James B Haines and Philip J Hendel 'The Future of Chapter 11: No Easy Answers: Small Business Bankruptcies after BAPCPA' (2005) 47 Boston College Law Review 71.

133 The model proposed is however controversial in that it involves altering the substantive rights of creditors without their consent.

where a case properly belonged.[134] The 1978 Bankruptcy Code collapsed the previous provisions into a single reorganisation chapter – Chapter 11.[135]

CHANGES IN CHAPTER 11 PRACTICE – INCREASED ROLE OF CREDITORS

Another Chapter 11 development that should be noted is the increased emphasis now placed on maximising returns to creditors rather than reviving the corporate vehicles as such. When the Bankruptcy Code was first enacted in 1978 considerable attention was paid to employment preservation and the reorganisation and rehabilitation of the debtor.[136] There were a lot of concerns about helping troubled businesses and the community impact of bankruptcy. The tone of the debate has now changed with creditor concerns gaining the ascendancy. This change in emphasis has been acidly observed by one commentator[137]

> Few free market law and economics scholars were around to make the cruel argument that society would prosper if the free market were allowed to kill off weak and inefficient companies. That the dismissed workers of a dead company might be better off in the long run as a result of that death (or that a competitor's workers would be) was hardly considered. The incantation, 'reorganization, yes, liquidation, no' echoed through the Commissions meetings and in the Halls of Congress. Firms should be given every chance to save their goodwill; no one seems to have thought much of the firms with badwill that could be liquidated for a greater sum than they would command as going concerns, nor did anyone seem to believe that a large percentage of firms that would use chapter 11 might possess badwill, not good. So even in 1978 . . . the right was a pale and moderate version of its later self, and many of the arguments one might hear from the law and economics crowd today were but whispers then.

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134 See B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 255: 'Managers and shareholders of troubled firms pushed together for the Chapter XI option. Nevertheless, secured creditors often contested the use of Chapter XI (since they fared better under Chapter X) and so courts expended considerable time deciding which was the appropriate chapter to file under. Although Congress intended Chapter X to apply to big corporations, and Chapter XI to small debtors, the statute provided little direct guidance to courts over who should file where, and so insolvent corporations made their own choice.'

135 See James B Haines and Philip J Hendel 'No Easy Answers: Small Business Bankruptcies after BAPCPA' at 96.

136 US House of Representatives HR Rep No 95-595, p 220 (1977).

137 J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139.

The ailing company and its incumbent management no longer seem to dominate the bankruptcy picture as they did once upon a time. Creditor issues have come to the fore and Chapter 11 is no longer an anti-takeover device for managers. In its new dynamic it has become part of the market for corporate control and this is coupled with asset sales and faster turnaround of cases.[138] There are a number of factors to explain this transformation. One factor is the rise of distressed-debt trading, which has grown to dimensions that were not seriously contemplated when the 1978 Act was enacted[139] and is connected to globalisation and the development of financial markets. Institutions that buy up the debt of financially distressed companies have no real interest in sustaining a long-term relationship with the company. In the past, and in a more intimate and interdependent world, suppliers may have valued the preservation of a particular company because of the trading links that had grown up between them. Also, suppliers may have seen little alternative but to nurture an ailing company through a complicated Chapter 11. Now they have the option of getting an immediate, albeit discounted, return from a distressed-debt trader.

Distressed-debt traders are sophisticated participants in financial markets who are generally unwilling to sacrifice speedy recovery of their investment for the sake of a company's rehabilitation. As one commentator remarks:

> Distressed-debt traders have different motivations from commercial creditors providing goods and services or lenders. They buy claims of all types at substantial discounts. Rather than nurture long-term relationships, distressed-debt traders purchase debt claims to reap material profits and, in certain situations, to obtain control of the debtor and dominate the administration of the reorganization case . . . Put another way, the focus of the distressed-debt trader is on profit maximisation. The longer that a debtor lingers in Chapter 11 the longer that the trader is prevented from reaping a return on its investment. The emergence of such traders into the world of Chapter 11 may have turned the Chapter into something that was not originally intended. Instead of being focused on rehabilitation it has become a vehicle for the 'fulfilment of laissez-faire capitalism focused on the realization of substantial profit-taking'.[140]

This has meant pressure for speedier cases. It has also meant more emphasis on asset sales. A sale of assets may take place as part of a confirmed plan of reorganisation but this is a long-drawn-out and potentially cumbersome process with the full paraphernalia of obtaining the consent of creditors and

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138 See David A Skeel Jr 'Creditors' Ball: The "New"' New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917 at 918.

139 See generally Harvey R Miller and Shai Y Waisman 'Is Chapter 11 Bankrupt' (2005) 47 Boston College Law Review 129 at 152–154.

140 Harvey R Miller and Shai Y Waisman ibid at 153.

the division of creditors into appropriate classes.[141] Far more straightforward is the sale of assets before the plan confirmation stage. Sales of assets by the debtor-in-possession outside the ordinary course of business requires judicial authorisation under s 363(b) of the Bankruptcy Code.[142] Such consent is generally forthcoming, with the courts articulating the test of whether there is a good business reason to justify a sale.[143] A s 363(b) sale also comes 'free and clear' of existing claims and this may be a significant incentive that encourages recourse to the Chapter 11 process. 'This unique ability to cleanse the assets of a distressed company attracts potential purchasers because it potentially removes the uncertainty of successor liability, fraudulent transfer claims, and lien issues that often accompanies asset purchases. Chapter 11 thus facilitates the creation of a market for the sale.'[144]

Another factor that explains the transformation has been the development of DIP financing arrangements, which now function both as a financing device and also as a corporate governance device. 'Before they even file for bankruptcy, corporate debtors must arrange an infusion of cash to finance their operations in Chapter 11. To an increasing extent, lenders are using these loan contracts to influence corporate governance in bankruptcy.'[145]

Moreover, key corporate executives are often given performance-based compensation packages in Chapter 11. The executive may be promised a large bonus if the reorganisation is completed quickly but the amount on the table decreases if the case takes longer.[146] One court has portrayed the process in the following stark terms:[147]

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141 See s 1123.

142 Notice to the creditors' committee is also required.

143 *Re Lionel Corp* (1983) 722 F 2d 1063 at 1071. Professor LoPucki argues in *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* at p 168 that the sale of an entire business under s 363 improperly bypasses the typical protections associated with Chapter 11 and gives opportunistic or corrupt management the possibility of purchasing the company at the expense of the creditor body. For a different perspective see Todd J Zywicki 'Is Forum Shopping Corrupting America's Bankruptcy Courts' (2006) 94 Georgetown Law Journal 1141 at 1168–1173.

144 See Harvey R Miller and Shai Y Waisman 'Is Chapter 11 Bankrupt' at 156. For a critical look at s 363 sales see L LoPucki and J Doherty 'Bankruptcy Fire Sales' (2007) 106 Michigan Law Review 1.

145 See David A Skeel Jr 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917 at 918–919.

146 See David A Skeel Jr 'Creditors' Ball: The "New"' New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917 at 918–919.

147 *In re Tenney Village Co* (1989) 104 Bankr 562 at 568 and see the discussion in Bruce A Henoch 'Postpetition Financing: Is There Life after Debt?' (1991) 8 Bankruptcy Developments Journal 575 at 602–604.

> Under the guise of financing a reorganisation, the bank would disarm the debtor of all weapons usable against it for the bankruptcy estate's benefit, place the debtor in bondage working for the bank, seize control of the reins of reorganisation, and steal a march on other creditors in numerous ways.[148]

While this may overstate the position, certainly by means of provisions in the DIP loan agreement, lenders can bring about changes in management structures. The refusal to implement management changes brings about a denial of necessary funds to the company. The control by lenders of the company's cash lifeline can be used to produce what is effectively a slow liquidation. The amount of cash made available to the company is decreased in succeeding disbursements. In consequence, the company is forced to sell assets to satisfy cash flow needs.[149]

There is no doubt that DIP financing has emerged as a major governance lever in many Chapter 11 cases but its side features have not escaped criticism. Even some supporters of the new world of Chapter 11 governance do see downsides to DIP lending agreements. For instance, the personal interests of senior company managers may often be in acute conflict with the interests of the company itself when the company is teetering on the brink of possible collapse.[150] The potential conflict with the interests of company employees may be even sharper. Corporate executives may, for instance, negotiate a 'sweetheart' deal with a DIP lender under which the executives receive substantial financial inducements if the company cuts its costs through shedding much of its workforce, or by forcing wage levels downwards. BAPCPA 2005 attempts to curtail the abuse however, by amending s 503 of the Bankruptcy Code and limiting the amount that may be paid in retention bonuses to existing staff.

There is also the fear that DIP lending agreements will tighten the screws on the company too much and discourage even appropriate risk-taking. Too many companies may be pressured to liquidate assets rather than to reorganise.[151] In the new era of creditor-controlled corporate reorganisations, corporate managers may delay the Chapter 11 filing until it is too late to bring about

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[148] George W Kuney 'Hijacking Chapter 11' (2004) 21 Bankruptcy Developments Journal 19 at 110.

[149] See generally on the importance of control during the bankruptcy process Jay Lawrence Westbrook 'The Control of Wealth in Bankruptcy' (2004) 82 Texas Law Review 795.

[150] See David A Skeel Jr 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) 25 Cardozo Law Review 101 at 118.

[151] D Skeel ibid at 120. If too many firms liquidate rather than reorganise industry may become concentrated in the hands of a few major players.

an optimal resolution of the company's financial woes.[152] Talking in broad generalisations, 2001 is often said to mark the changeover from the old period of debtor-in-possession to a new regime of secured party-in-possession. Empirical evidence suggests that in the period after 2001 there has been a noticeable deterioration in the financial and economic health of companies that enter the bankruptcy process compared with the preceding period. It appears that this decline is not explicable on the basis of general economic conditions or on related changes in respect of companies that do not enter bankruptcy. There has also been a higher proportion of liquidations in the new era. These results tend to support at least two hypotheses. Firstly,[153] '[m]anagers increasingly file for bankruptcy only after financial distress becomes acute, or they cede the filing decision to a dominant secured creditor who delays filing until the debtor's finances are desperate.' Secondly, 'delayed filing in the post 2001 period delays inevitable, efficient liquidation, renders an otherwise salvageable company unsalvageable, or both'.[154]

The influence of creditors and particularly that of secured creditors, has grown in Chapter 11. Of that there is little doubt. These developments have found intellectual justification and support and have been called contractualism. As a result of these developments, Chapter 11 has come to resemble much more the traditional corporate insolvency process in the UK. Somewhat ironically, while increased attention in the UK has been paid to Chapter 11 and the attractions of the same, in the US the move has been to a system that is much closer to the UK model. Some commentators might see this as part of a convergence towards an Anglo-American model of corporate and corporate bankruptcy governance but the 'Anglo' aspect has assumed greater significance than the American aspect.

CONCLUSION

Chapter 11 appears to be premised on the assumption that society has an interest in the preservation or rehabilitation of the corporate entity. Moreover, shareholders are regarded as interested parties with a stake, though subordinate to that of creditors, in the reorganisation. Chapter 11 may be described as a bargaining-oriented rather than a market-oriented procedure. The emphasis

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152 See generally Barry E Adler, Vedran Capkum and Lawrence A Weiss 'Destruction of Value in the New Era of Chapter 11' available on www.ssrn.com website.

153 Ibid at p 29.

154 See generally Barry E Adler et al 'Destruction of Value in the New Era of Chapter 11' at p 11.

is on classes of creditors and shareholders working to resolve their differences through a process of bargaining and negotiation; coming up with a reorganisation plan under which the company may survive, and then this plan going before the court for its blessing. The court evaluates the feasibility of the plan on the table and generally plays a central role in the process through holding the ring between the various participants. The bankruptcy courts play a central role and lawyers appear to dominate the reorganisation sector to an extent that they do not do in the UK.[155]

In recent years Chapter 11 has taken on much more of a market-oriented focus and indeed one might argue also that it has taken on some UK features. In particular, there has been more emphasis in Chapter 11 on asset sales and the speedier throughput of cases rather than on reorganisations in the traditional sense. Creditors have also gained greater influence over the process and the terms of any restructuring, by means of provisions in debtor-in-possession financing agreements. Lenders may control the release of necessary funds to the company depending on the speed at which restructuring is implemented. Companies come under pressure to sell off assets to meet funding needs if agreed restructuring proposals are not carried through. Company executives may also be offered financial inducements to move the company through Chapter 11 quickly. There has been increased recourse to pre-packaged cases and informal restructurings. Informal restructurings, and indeed pre-packs, are good options for service-focused businesses or those whose business model is founded on reputational value or intellectual property rights more generally. In these cases, the going-concern value of the business may be significantly and rapidly diminished by formal insolvency procedures.

Nevertheless, despite these changes in practice, certain crucial differences remain between Chapter 11 and equivalent UK procedures. Chapter 11 is centred on ensuring the survival of the existing business entity and even now, in an era of increased creditor influence, the corporate rescue outcome is much more likely than in the UK. Contrary to the claim that corporate reorganisations have all but disappeared,[156] there is evidence that many large companies do in fact use Chapter 11 as a forum for reorganisation. One empirical study of companies that enter Chapter 11 as a going-concern during the 1997–2004

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155 See John Flood and Eleni Skordaki 'Normative Bricolage: Informal Rulemaking by Accountants and Lawyers in Mega-insolvencies' in G Teubner (ed) *Global Law Without A State* (Dartmouth, 1997) 109 at 112: 'In the UK insolvency is largely accountant-driven: they become the office-holders – that is, the receivers and liquidators. Lawyers mainly act as advisers to office-holders. Accountants are the lawyers' handmaidens.'

156 See Douglas G Baird and Robert K Rasmussen 'The End of Bankruptcy' (2002) 55 Stanford Law Review 751.

period found that 36.7 per cent reorganise, 42.2 per cent were acquired in whole or in part and 21.1 per cent were liquidated.[157] Broadly comparable studies of UK administrations suggest that the 'corporate rescue' outcome is achieved in very few cases. Perhaps driving the corporate rescue result, Chapter 11 contains a special funding mechanism for companies in financial difficulties. More fundamentally, it is also based on the notion of 'debtor-in-possession' and it is easier for the company to access the process. These latter features of Chapter 11 will be explored in the next chapter.

[157] See Greg McGlaun 'Lender Control in Chapter 11: Empirical Evidence' (February 2007) available at http://ssrn.com/abstract=961365. See also on Chapter 11 outcomes the bankruptcy research database compiled by Professor Lynn LoPucki available on http://lopucki.law.ucla.edu/. See also Arturo Bris et al 'The Costs of Bankruptcy: Chapter 7 Liquidations vs Chapter 11 Reorganizations' (2006) 61 Journal of Finance 1253.

4. Entry routes and corporate control

This chapter looks at entry routes into Chapter 11 in the US and the administration procedure in the UK and considers, in particular, the different role that creditors play in channelling companies into these procedures. It also considers who is in control of the company during the course of these procedures – existing management or an externally appointed officer. One of the reasons that the US Bankruptcy Code, and in particular Chapter 11, has traditionally been seen as 'pro-debtor' is that proceedings are almost always begun by a voluntary petition filed by the corporate debtor.[1] The filing brings about a moratorium or stay on enforcement proceedings against the company or its property and the incumbent management normally remain in place during the early stages at least of the reorganisation proceedings. In the UK, by way of contrast, companies will normally enter administration at the instigation of creditors though the formal appointment of an administrator may be made by the company. A general security interest holder has more or less an unfettered right to appoint an administrator to the company out of court. While an automatic stay or moratorium on creditor enforcement actions is also an intrinsic feature of the legislative landscape in the UK, administration is manager displacing. The appointment of an administrator means that the board of directors lose their management responsibilities.

The chapter begins by looking at how companies may access the administration procedure/Chapter 11. It then considers the concept of 'debtor-in-possession' which is at the heart of Chapter 11 and contrasts it with the prevailing norm of management displacement in the UK. The chapter tries to rationalise the existence of this distinction.

ENTRY ROUTES INTO ADMINISTRATION

It is generally considered to be critical to a successful reorganisation that a company should invoke the reorganisation procedure at an appropriately early stage. It is important that legislation creates the right set of incentives for

[1] Under s 301 of the Bankruptcy Code.

companies to make use of reorganisation alternatives. If administration is seen as a rescue or reorganisation procedure then it is appropriate that the legislation should not erect too high a set of hurdles in the way of companies accessing the procedure. Entry routes should be swift and significantly clear of blockages.

Under the Insolvency Act 1986 as originally drafted the only route into administration was by court appointment. The Enterprise Act 2002 transformed this position and while the option of going to court for the appointment of an administrator remains, there are now a variety of routes into administration. Under the new regime, an administrator can now be appointed by the company itself upon giving prior notice to a qualified floating charge holder or by a qualified floating charge holder out of court. In overall terms, however, a general security interest holder has considerable control over whether and when a company will enter administration and a more or less de facto power of veto on the identity of a proposed administrator.

Out-of-Court Appointments by the Company or its Directors

The company or its directors are enabled to appoint an administrator out of court on giving five days notice which identifies the proposed administrator to qualified floating charge holders. An appointment must be made not later than ten days after notice of intention to make an appointment is filed with the court. There are provisions designed to prevent abuse of the procedure. A company cannot use the out-of-court procedure if the company has come out of administration under such procedure within the previous 12 months or if the company has been the subject of a moratorium under a 'small company' company voluntary arrangement in the previous 12 months or a winding up petition has been presented and has not yet been disposed of. The limitations built into the legislation have been explained as

> a necessary protection to prevent a small minority of unscrupulous companies and directors from making serial use of moratorium procedures to the detriment of their creditors. If there are genuinely good reasons for the company to go into administration during this period, it can apply through the courts, but it should not be using the out-of-court route. . . .

The notice of intention to appoint must be accompanied by a statutory declaration stating, inter alia, that the company is or is likely to become unable to pay its debts, that the company is not in liquidation and that none of the other factors precluding an appointment is present. The existence of this insolvency requirement may be criticised on the basis that it encourages directors to leave things until it is too late. Also, it may be contrasted with the position in the US where there is no such requirement. It seems, too, that the architect

of the administration procedure, Sir Kenneth Cork, tried unsuccessfully to convince the UK government not to incorporate such a requirement:[2]

> In my report, you could have an administrator even if the company was not insolvent. My idea was that go back to Rolls Royce, which should never have gone into liquidation. Rolls Royce ought to have gone into administration, and you wouldn't have the trauma of this famous British company going broke which was ridiculous. It wasn't even insolvent, it paid twenty shillings a pound . . . I wanted a provision in the Act where the shareholders, or the Department of Trade could say, 'Look, this company is going down with a loony body of directors.' Apply to get an administrator without it being insolvent . . . I never intended the administrator should be an act of insolvency. But the Department of Trade, particularly the OR, as we call the receivers department, couldn't understand how anything could happen when it wasn't insolvent.

At the time that the Enterprise Act was enacted there was a widespread assumption that the main route into administration would be through out-of-court appointments by the floating charge holder. The reality has been somewhat different however. According to a study conducted on behalf of the Insolvency Service, most appointments have been made by the company itself, though perhaps after consultation with the floating charge holder.[3] If the company serves a charge holder with notice of the intention to make an appointment, the charge holder has sufficient time to step in and make its own appointment but the charge holder is usually reluctant to do so for public relations reasons. It may have a negative reputational impact if a bank, exercising its remedies under a floating charge, puts a company into administration against the company's wishes. What usually happens is some negotiation between the company and the bank over the appropriateness of the person who should be appointed as administrator.

In terms of the formal law, before the bank can make an out-of-court appointment it must be secured by a 'qualifying floating charge'. Under para 14(2) Schedule B1 Insolvency Act 1986 a floating charge qualifies if it is created by an instrument which:

a. states that this para applies to the floating charge;

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[2] B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 292.

[3] 'Report on Insolvency Outcomes' at p 4 – a paper presented to the Insolvency Service by Dr Sandra Frisby. The paper is available on the Insolvency Service website www.insolvency.gov.uk and is summarised in S Frisby 'Not Quite Warp Factor 2 Yet? The Enterprise Act and Corporate Insolvency' (2007) 22 Butterworths Journal of International Banking and Financial Law 327.

b. purports to empower the holder of the floating charge to appoint an administrator of the company;
c. purports to empower the holder of the floating charge to appoint an administrative receiver.

This definition is not free from controversy. For example, it is not entirely clear whether the conditions stated are disjunctive or conjunctive conditions. In other words, whether the relevant debenture must provide both that the relevant part applies and also empower the floating charge holder to appoint an administrator/administrative receiver or whether it suffices if the debenture does one of these things. There is also some ambiguity about the 'property' condition in para 14(3). The simpler scenarios are where the floating charge, or a number of floating charges collectively, together relate to the whole, or substantially the whole, of the company's property. Para 14(3) also refers however to a situation where 'charges and other forms of security' relate to the whole or substantially the whole of the company's property and at least one of which is a qualifying floating charge. What is meant by other forms of security is not totally free from doubt and, in particular, whether it embraces 'quasi-security', i.e. functionally equivalent legal devices.[4]

Before appointing an administrator, a qualifying floating charge holder must give two days written notice to the holder of a prior qualifying floating charge. A floating charge is treated as prior if it was first in point of time or, if it is entitled to priority by virtue of a priority agreement between the two charge holders. The floating charge holder is not obliged to notify the company of the intention to appoint an administrator and so a company may have administration foisted upon it against its wishes. While an administrator must perform his functions with the overarching objective of rescuing the company as a going-concern, a company may wish to be saved from this fate particularly where the existing management are of the view that any temporary trading difficulties can be alleviated without recourse to formal insolvency processes. In certain respects, there are similarities between administration via the floating charge holder and administrative receivership. A floating charge holder is not required to notify the company of his intention to appoint a receiver.[5] Moreover, a charge holder who is contractually entitled to appoint a receiver is under no duty to refrain from doing so on the grounds that it might cause loss to the company or its creditors. It has been held that,

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[4] There is a somewhat circular definition of security in s 248 of the Insolvency Act as meaning 'any mortgage, charge, lien or other security'.

[5] Unlike the position in comparable common law jurisdictions like Canada which introduced a statutory notice requirement in 1992 by means of s 244 of the Bankruptcy and Insolvency Act.

in exercising the right to appoint, no duty of care is owed to either the debtor or to guarantors of the secured debt. A charge holder is empowered to appoint a receiver to protect its interests, and the decision to exercise that power cannot be challenged, except possibly on the ground of bad faith. Likewise, the decision of a qualified floating charge holder to appoint an administrator cannot be impeached by the company even though the company may be concerned about the destruction of economic value that such an appointment might entail. As one commentator notes:[6]

> Banks will be able to use the streamlined appointment procedure in all cases, not merely situations of urgency, and they will be able to determine who should be appointed to the post of administrator. This gives the banks the power to insert their chosen administrator with speed and without regard to the other creditors or the courts.

Court Appointment of Administrators

The judicial route into administration is still available and an application to the court for the making of an administration order may be made by the company itself, by its directors, or by one or more of its creditors. Notice of the application has to be served, inter alia, on any qualified floating charge holder who then has the opportunity of appointing an administrator out of court. Before an administration order may be made there is a threshold insolvency criterion – the court must be satisfied that the company is unable to pay its debts or is likely to become unable to do so. Moreover, it must also be satisfied that the 'administration order is reasonably likely to achieve the purpose of administration'. Superficially at least, this marks a substantial change from the old wording under which the court was required to consider that the making of an order 'would be likely to achieve' one or more of the statutory purposes. The predominant judicial interpretation merely required a 'real prospect' of these statutory purposes being accomplished.[7] A higher standard that required evidence demonstrating that the purpose or purposes would more probably than not be achieved was favoured in a few early cases[8] but that standard was generally rejected in favour of the less rigorous test.

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6 V Finch 'Re-invigorating Corporate Rescue' [2003] JBL 527 at 535.

7 *Re Harris Simons Construction Ltd* [1989] 1 WLR 368; *Re SCL Building Services Ltd* (1989) 5 BCC 746; *Re Primlaks (UK) Ltd* [1989] BCLC 734; *Re Rowbotham Baxter Ltd* [1990] BCC 113; *Re Chelmsford City Football Club (1980) Ltd* [1991] BCC 133; *Re Arrows Ltd (No 3)* [1992] BCLC 555.

8 *Re Consumer and Industrial Press Ltd* (1988) 4 BCC 68; *Re Manlon Trading Ltd* (1988) 4 BCC 455.

While the Enterprise Act does not entail a full-blown balance-of-probabilities test, it does appear to raise the evidentiary hurdle. On the other hand, it may not be a particularly productive exercise to compare the old and the new legislation in this respect. Under the old regime there were four disjunctive statutory purposes whereas under the new regime there is a clear hierarchical list of objectives. It should also be remembered that there are alternative avenues into administration under the new regime. Qualified floating charge holders, and the company itself, may now appoint out of court and the inevitable additional expense of seeking a court appointment hardly seems warranted in most cases. Court appointments may be confined to a minority of cases where a company has no major secured borrowings but where unsecured creditors are disenchanted with existing management and wish to see corporate restructuring proceed under outside guidance.[9] Another possibility is where the company has substantial assets overseas and a court-appointed administrator is perceived to have greater status and authority in the relevant foreign jurisdictions. Floating charge holders may prefer a court appointment in this situation. Schedule B1 para 35 facilitates applications by qualified floating charge holders. The court is required automatically to accede to such applications and there is no threshold insolvency test to be satisfied. While Schedule B1 para 5 provides that an administrator is an officer of the court (whether or not he is appointed by the court), this statement does not bind a foreign tribunal which may not accord equivalent recognition to an administrator appointed out of court.

CHAPTER 11 ENTRY ROUTES

In the US, a typical Chapter 11 case begins when the debtor company voluntarily files a petition with a bankruptcy court. The petition has to be accompanied by a list of creditors and also a summary of company assets and liabilities. Technically there is no requirement that the company should be 'insolvent' and so-called strategic bankruptcies are a conspicuous part of the US scene. In other words, companies may have a number of reasons, other than insolvency strictly so-called, to invoke the protective cloak of Chapter 11. For instance, a company may be faced with large potential tort liabilities and attempts to reach

[9] It should be noted that under Schedule B1 para 36 where an administration application is made by somebody other than a qualified floating charge holder the latter may intervene in the proceedings and suggest to the court the appointment of a specified person as administrator. The court is obliged to respond positively to this intervention unless it thinks it right to refuse the application 'because of the particular circumstances of the case'.

a global settlement with plaintiffs have broken down. Well-publicised examples of this include the *Johns-Manville* case involving asbestos-related liabilities where the court stated that a business foreseeing insolvency was not required to wait until actual inability to pay debts before entering Chapter 11.[10] Another example concerns the reorganisation of the AH Robins Company brought about by its liability to women who suffered injury as a result of using the Dalkon Shield intrauterine birth control device.[11]

During the period of Chapter 11 protection the plaintiffs are barred from prosecuting their claims and the company is provided with an opportunity to work out a structured settlement plan. The primary objective of Chapter 11 was to try to rescue companies that were in serious financial difficulties but the scope for reorganisation under Chapter 11 has been made use of for many purposes: 'to settle a mass tort liability or legal judgment, reduce labor costs, reject pension obligations, or resolve toxic waste-related liabilities. . . .' As Carruthers and Halliday note:[12]

> [S]olvent firms have filed for Chapter 11 bankruptcy to take advantage of the considerable powers incumbent managers have to remake the corporation, undo its commitments, and reduce its obligations . . . In many cases, the reorganizing firm was not insolvent, and may in fact have been performing rather well. Such creative adaptations of Chapter 11 by innovative bankruptcy lawyers was completely unanticipated by its designers.

Applications for Chapter 11 relief must however be made in 'good faith'. This means that the application must have been filed with the intention of achieving a corporate restructuring or to bring about a liquidation or sale of the company. If this is not the case, then creditors may apply to have the Chapter 11 petitions dismissed. *SGL Carbon Corporation*[13] is a case in point, where a Chapter 11 petition was dismissed on the basis that the company had failed to manifest a genuine 'reorganizational purpose'.

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10 (1984) 36 Bankruptcy Rep 727.

11 For an account of this case see Richard B Sobol *Bending the Law: The Story of the Dalkon Shield Bankruptcy* (Chicago, University of Chicago Press, 1991) and see his comment at p. 326: 'Bankruptcy is the appropriate response when a business is unable, or can foresee that it will be unable, to pay the cost of mass tort liability. Novel and difficult questions are presented when the liabilities of a financially distressed business arise primarily out of personal injury claims, but no other mechanism is available and, with due regard for the exceptional context, these questions must be addressed and resolved within the bankruptcy system.'

12 B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 266.

13 (1999) 200 F.3d 154.

A large company may find itself pushed into Chapter 11 against its wishes if three creditors holding unsecured non-contingent, undisputed claims aggregating more than $10,000 file an involuntary petition against the company, and if the company is 'generally not paying debts as such debts become due unless such debts are the subject of a bona fide dispute'. The company may decide to contest the petition and if the above standard is not met, may recover costs from the petitioning creditors plus legal expenses. Moreover, if the involuntary petition had been filed in bad faith, punitive damages are potentially available to the company.

Far more likely, however, is where a company enters Chapter 11 ostensibly of its own volition but in reality under pressure from creditors, whether secured or unsecured. Secured creditors may in a sense compel a company to seek Chapter 11 protection by threatening to enforce security interests.[14]

In summary, there are clear differences about entry into formal corporate restructuring procedures in the UK and US. In the UK, the court has a discretion whether or not to make an administration order. In terms of the out-of-court route, which is the main avenue into administration, the holder of a qualifying floating charge is entitled to appoint an administrator as of right, as are the directors and company if there is no holder of a qualifying floating charge, or the holder of the qualifying floating charge consents. As a matter of practice, the holder of a general floating charge has an effective veto on the identity of a proposed administrator.

There are no similar 'gating' or entry issues in the case of Chapter 11. The company has a legal right to invoke the procedure irrespective of the wishes of creditors. Similar differences exist between UK and US law when it comes to control of the company during the formal restructuring process.

CONTROL OF THE COMPANY DURING RESTRUCTURING

US law is based on debtor-in-possession – presumptively the existing management remain in control of the ailing company during the reorganisation period but are legally invested with a new status, that of 'debtor-in-possession' (DIP). UK law, on the other hand, is manager displacing. Although the board of directors remain in office, as we have seen they lose their management functions to

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[14] See Lynn M LoPucki 'The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code?' (1983) 57 American Bankruptcy Law Journal 99 at 114.

an administrator.[15] The US and UK are like, however, in that share ownership in public companies tends to be widely dispersed. Given capital market structures in the UK, it has been suggested that UK corporate reorganisation law should not be manager displacing. The UK is something of a problem child for certain corporate governance theorists who see something of a mismatch or incompatibility between dispersed corporate ownership structures and manager-displacing insolvency laws.[16] Various reasons have been proffered to explain the differences between US and UK law in this respect. The rest of this chapter will examine these reasons and consider whether they can withstand critical scrutiny. It also considers whether the UK system will eventually come to resemble the US system as certain 'evolutionary theorists' would have us believe.[17] Doubt is cast on this proposition and it is suggested that, if convergence occurs, it is more likely to occur half way or even to be tilted in a UK direction. This process may already be taking place with increased creditor influence in Chapter 11 by means of provisions in DIP financing agreements.

The rest of this chapter explores the suggested reasons for the differences under the following headings: attitudes towards entrepreneurship, debt and risk-taking; carrots and sticks and the encouragement of early filing; nature of the task to be performed during the reorganisation process – professionalism and expertise; path dependency and finally, the nature of the lending markets.[18]

Attitudes towards Entrepreneurship, Debt and Risk-taking

Professor Sir Roy Goode has commented that insolvency law in the UK is predicated on the assumption that where a company becomes insolvent this is

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15 What is now Schedule B1 Insolvency Act 1986 para 64 provides that a company in administration or an officer of a company in administration may not exercise a management power without the consent of the administrator. Management power is defined as meaning a power which could be exercised so as to interfere with the exercise of the administrator's powers.

16 On the relative merit of debtor-in-possession versus management displacement insolvency regimes see D Hahn 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 JCLS 117. See also V Finch 'Control and co-ordination in Corporate Rescue' [2005] Legal Studies 374; O Brupbacher 'Functional Analysis of Corporate Rescue Procedures: A Proposal from an Anglo-Swiss Perspective' (2005) 5 JCLS 105.

17 See generally on similarities and differences between the two systems John Armour, Brian R Cheffins and David A Skeel Jr 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 Vand L Rev 1699.

18 An earlier version of what follows appears in an article by the author 'Control and Corporate Rescue – An Anglo-American Evaluation' (2007) 56 ICLQ 515.

usually due to a failure of management, and therefore the last people to leave in control are those who were responsible for the company's plight in the first place.[19] These arguments have been developed by a leading QC, Gabriel Moss, who suggests that having a debtor-in-possession regime could be equated with leaving an alcoholic in control of a pub.[20] In his view, insolvency in England, including corporate insolvency, is regarded as a disgrace. While the stigma may have worn off to a degree, insolvency nevertheless still remains a reality.[21] He speaks of a general English judicial bias towards creditors which reflects a general social attitude that is inclined to punish risk-takers when the risks go wrong and side with creditors who lose out. Creditors tend to feel very strongly that once disaster strikes, the management of the company's business should be taken out of the hands of the management and given to a professional person chosen by the creditors.[22]

Similar sentiments have been articulated by American commentators.[23] Professor Nathalie Martin, in a study of common law bankruptcy systems, remarks that while the UK certainly has more bankruptcies than the rest of the EU, these are still considered major embarrassments, even if they result from the failure of a business.[24] She suggests, though without adducing much in the way of empirical evidence, that executives in a company that fails can have a difficult time finding another job and often are shunned socially.

> Thus, despite all the new credit available, the British marketplace comes down hard on those who have gotten into financial difficulty. The attitude is once a bankrupt, always a bankrupt. The English government currently is attempting to change these

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19 See Roy Goode *Principles of Corporate Insolvency Law* (Thomson 3rd ed, 2005) at p 328.

20 G Moss 'Chapter 11: An English Lawyer's Critique' (1998) 11 Insolvency Intelligence 17 at 18–19.

21 See also B Carruthers and T Halliday *Rescuing Business* at p 246.

22 See generally G Moss 'Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law – England' (1997) 23 Brooklyn Journal of International Law 115.

23 See the comment by JL Westbrook 'A Comparison of Bankruptcy Reorganisation in the US with Administration Procedure in the UK' (1990) Insolvency Law and Practice 86 at 88: 'In the U.S. a variety of factors, including a deep emotional commitment to the entrepreneurial ethic, make the owners of the corporation central to a salvage proceeding. In the UK, the prevailing view seems to be that the prior owners were the ones whose venality or incompetence created the problem and their interests disappear from moral or legal consideration once a formal proceeding has begun. Americans are much more willing to believe that financial difficulty is the result of external forces and that preservation of the company, not just the business, is a crucial social concern.'

24 Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367 at 374.

> attitudes in order to encourage people who have failed to go back into business and help fuel Britain's flagging economy. Yet it is unclear that one can change attitudes by changing laws. The government is likely to be unable to tell people how to think or whom to invite to parties, even through drastic legal change.[25]

On the existence of stigma associated with business failure it is very difficult to find hard empirical evidence, but within the European Union context there is certainly the opinion that stigma exists and this works as a deterrent to entrepreneurial initiative. The European authorities suggest that some failure is consistent with responsible initiative and risk-taking and must be envisaged as a learning opportunity. With a view to promoting a change in attitudes, the EU has launched the 'Restructuring, Bankruptcy and Fresh Start' initiative, which is premised on the assumption that current national bankruptcy laws and stigma associated with business failure negatively influence entrepreneurship.[26] There is a call for assessing national bankruptcy laws in the light of good practice, with the implication that 'good practice' means American practice.

In the European context, the UK is not alone in having a manager-displacing insolvency regime. In Germany, for example, under a comparatively new process, all proceedings begin as a liquidation but can then be converted into reorganisation proceedings.[27] Whatever the nature of the proceedings, however, management loses its power to dispose of corporate assets once the insolvency proceedings commence. The company is then administered by an administrator appointed by the court or elected by the creditors. The administrator has the exclusive right to dispose of company assets. On application by the company, however, and subject to the creditor's consent

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[25] Ibid at 374–375. While more anecdotal than anything else one might point to the biography of England's most capped international footballer (soccer player in American speak) *Peter Shilton The Autobiography* (London, Orion, 2004) at p 279 who agreed to pay off his creditors via a voluntary arrangement because 'I didn't want to bear the stigma of being a bankrupt for the rest of my life . . .'.

[26] See generally the EU website on the subject – www.ec.europa.eu/enterprise/entrepreneurship/support-measures/failure-bankruptcy/ and the EU commissioned Phillipe & Partners/Deloitte & Touche report *Bankruptcy and a Fresh Start: Stigma on Failure and Legal Consequences of Bankruptcy* (Brussels, July 2002).

[27] See generally on the German Insolvency Law M Balz 'Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law' (1997) Brooklyn Journal of International Law 167; K Kamlah 'The New German Insolvency Act' (1996) 70 American Bankruptcy Law Journal 417; M Schiessl 'On the Road to a New German Reorganization Law' (1988) 62 American Bankruptcy Law Journal 233. See more generally P Omar 'Four Models for Rescue: Convergence or Divergence in European Insolvency Law?' [2007] International Company and Commercial Law Review 127 and 171.

where insolvency proceedings have been initiated by the creditor, the court may order that the company should instead be administered by existing management under the supervision of an insolvency practitioner. But the court can only authorise this course of action if this does not unduly prejudice the creditors, and a creditors' committee may, at any time, apply to the court to replace the DIP with an administrator. In addition, the DIP must obtain the supervisor's consent to incur liabilities outside the ordinary course of business. On the whole, a German debtor-in-possession is subject to much tighter control than its US counterpart and, even then, the stripped down debtor-in-possession procedure is hardly used.[28]

In the process of formulating and refining the new insolvency process, German insolvency experts were particularly hostile towards the DIP concept, asking whether it was it really sensible to let existing management administer the workout procedure given the fact that the company declined into insolvency during their stewardship. It was feared that use of the DIP concept could lead to companies seeking insolvency protection with a view to delaying payment to creditors. This was a perceived defect of Chapter 11. There was also a feeling that the supervisor appointed in a DIP situation could be viewed as a second-class administrator with limited powers, especially because such supervisors were entitled to only half the fees allowed to administrators. The Insolvency Commission, whose report led to the legislation, doubted the value of the management's skills and expertise in the new insolvency context and also questioned the extent to which creditors could be expected to rely on the old management.[29] In its view, there was a greater guarantee of independence if an external administrator ran the company during this period, and this also provided for a more harmonised and integrated procedure if liquidation of the company was the eventual outcome.

Germany seems to share the same suspicion of the DIP concept as did the UK, but what is perhaps more surprising is that other 'Anglo-Saxon' economies tend to follow the UK rather than the US approach.[30] Despite very similar economies, reorganising a business is not the same process in the UK,

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[28] See generally C Pochet 'Institutional Complementarities within Corporate Governance Systems: A Comparative Study of Bankruptcy Rules' (2002) 6 Journal of Management and Governance 343; S Franken 'Creditor and Debtor Oriented Corporate Bankruptcy Regimes Revisited' (2004) 5 European Business Organisation Law Review 64; M Brouwer 'Reorganization in US and European Bankruptcy Law' (2006) 22 European Journal of Law and Economics 5.

[29] M Schiessl 'On the Road to a New German Reorganization Law' at 247–248.

[30] The merits of the Australian approach has been commended by the Banking Law Sub-Committee of the City of London Law Society – see Geoffrey Yeowart 'Administrative Receivership: Abolition or Reform?' [2002] Butterworths Journal of International Banking and Financial Law 6 at 9.

Australia or Canada as it is in the US.[31] Other common-law countries are far more sceptical of the DIP concept than the Americans.[32] In Australia, leaving management in control of an ailing company has been likened to leaving the fox in charge of the henhouse. It has been suggested that Australian laws on corporate reorganisation are even more stringent towards existing management than those of the English mother country. The Australian attitude appears to be that if a business fails, it should be pushed aside so that others can fill the gap.[33] The notion of the debtor-in-possession is said to encourage wasteful, strategic behaviour by the company directors. In other words, the members of the management team who brought about the company's financial difficulties not only have an incentive but also the power and authority to initiate high-risk strategies. They have nothing to lose, and possibly a lot to gain, by speculative investment of the company's resources.[34] Moreover, since shareholders do not bear the burden of the company's risky behaviour, they also have an incentive to persuade the company to behave in such a fashion.[35]

In the United States it is widely believed that there is a different attitude towards risk and risk-takers. One might cite in this connection the observations of former Secretary of State for Trade and Industry, and current EC Commissioner, Peter Mandelson:[36]

> We need to examine all our regulatory systems to ensure that they do not needlessly deter entrepreneurs, such as our bankruptcy laws. Are we sure that they create confi-

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31 See however Brian R Cheffins 'Corporate Governance Convergence: Lessons from Australia' (2002) 16 Transnational Lawyer 13 who makes the point, inter alia, that Australia's listed companies exhibit a far higher degree of ownership concentration than do those of UK listed companies. Cheffins also discusses the implications of the Australian example for theories of Anglo-American insolvency law at pp 37–38. See also Alan Dignam 'The Role of Competition in Determining Corporate Governance Outcomes: Lessons from Australia' (2005) 68 MLR 765.

32 See generally Paul B Lewis 'Trouble Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide' [2001] Utah Law Review 189 at 223–225.

33 Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367 at 404.

34 Concerning perverse incentives there is a famous American story involving Federal Express: 'Federal Express was near financial collapse within a few years of its inception. The founder, Frederick Smith, took $20,000 of corporate funds to Las Vegas in despair. He won at the gaming tables, providing enough capital to allow the firm to survive' – see Stephen Ross et al *Corporate Finance* (New York, McGraw-Hill/Irwin, 7th ed, 2002) at p 428.

35 See generally Paul B Lewis 'Trouble Down Under' at 223–225.

36 Addressing the British-American Chamber of Commerce – see *The Times*, 14 October 1998 and see the discussion in Muir Hunter 'The Nature and Functions of a Rescue Culture' [1999] JBL 491 at 519–520.

> dence in enterprise and commerce? I don't think that we are confident. I think we need fundamentally to re-assess our attitude in Britain to business failure. Rather than condemning it, and discouraging anyone from risking failure, we need to encourage entrepreneurs to take further risks in the future. Here in the US, I am told that some investors actually prefer to back businessmen and women with one or more failures under their belt, because they appreciate the spirit of enterprise shown, and recognise the experience that has been gained. Can you imagine that in Britain?

One American commentator has remarked:[37]

> Americans may have a different relationship with money than most other people. The American emphasis on economic conditions, consumerism and material things makes money one of the strongest forces in society. Money is power in American society. It defines Americans' worth and status in a way unmatched elsewhere. If Americans lost money, they fear that they will lose themselves. Material things appear to play a smaller role in most other societies. . . . Americans are encouraged by society to buy things, also need material things in order to be valued in society. They also need a safety net if they are ultimately unable to pay for all these necessities. Given these differences in societal views and economic goals, as well as those quirks of history and culture, the differences among the common law bankruptcy systems should not be surprising. In fact, perhaps the many similarities among these systems should surprise us instead.

A leading empirical study by two prominent American bankruptcy lawyers and a sociologist, *The Fragile Middle Class*,[38] concluded that bankruptcy debtors are not outliers in society but 'people we know'; in other words, students, neighbours, and associates who are victims of America's 'market-driven, highly competitive, compulsively consuming and anti-welfarist environment'.[39]

Two prominent English QCs have articulated much the same sentiments. Gabriel Moss suggests that in the US, business failure is very often thought of as the result of misfortune rather than wrongdoing. In his view, the US is still a pioneering country where the taking of risks is thought to be a good thing and creditors are perceived as being greedy. The secured creditor is often seen as the oppressor of the enterprising debtor and does not have the general sympathy of the public or the courts. By way of contrast, judges in England tend to favour the financiers: bankers appear to have acquired respectability over the centuries whereas those who take risks in business

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[37] Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367 at 409–410.

[38] Teresa Sullivan, Elizabeth Warren and Jay Lawrence Westbrook *The Fragile Middle Class: Americans in Debt* (New Haven, Yale University Press, 2000).

[39] See the review by Jacob Ziegel (2001) 79 Texas L Rev 1241 at 1244.

have not.[40] In addition, the English judiciary is inclined to be sympathetic towards insolvency practitioners as opposed to debtors: insolvency practitioners are professionals generally known to the court, whereas the debtor's descent into insolvency tends to be treated as a ground for suspicion. Furthermore, insolvency practitioners act either in the interests of a secured financier or at the direction of the court. Muir Hunter QC has praised US judicial efforts which he sees as being pragmatic and compassionate, facilitating enterprise and initiative and contributing to the creation of the most successful economy in the world.[41]

Carrots and Sticks or Encouraging Early Filing

It might be argued that having a policy of debtor-in-possession goes hand in glove with that of encouraging a company to invoke the reorganisation procedures when there are signs of financial distress rather than waiting until the disease may become terminal.[42] This proposition was advanced during the legislative debates on the US Bankruptcy Code 'Proposed Chapter 11 recognises the need for the debtor to remain in control to some degree or else debtors will avoid the reorganisation provisions in the bill until it would be too late for them to be an effective remedy.'[43]

In short, company directors in the US know that filing for Chapter 11 protection will safeguard their position, as well as providing them with the exclusive right to propose a reorganisation plan. It may be critical to the outcome that a company seeks Chapter 11 relief stage where there is a realistic prospect of a sensible reorganisation, rather than later when the potential for reorganisation is exhausted. If managers believe that their jobs will be preserved in a Chapter 11 context, then they will be more likely to seek Chapter 11 protection at an early stage while the company may still be viable.[44] As a bonus, those most familiar with the company will continue

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40 See generally G Moss 'Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law – England' (1997) 23 Brooklyn Journal of International Law 115.

41 'The Nature and Functions of a Rescue Culture' [1999] JBL 491 at 519.

42 David Hahn in 'Concentrated Ownership and Control of Corporate Reorganisations' [2004] JCLS 117 at 127 suggests that three primary factors affect the efficiency and fairness of corporate reorganisation regimes '(a) the ownership structure of corporate debtors and its effect on the extent of independent judgment the debtor's management is capable of exercising, (b) the effect of the respective regimes on the firm's decision-making concerning the commencement of bankruptcy, and (c) the professional qualification of the person controlling the reorganisation case.'

43 HR Rep No 595 95th Cong, 1st Session 231 (1977).

44 See Lynn M LoPucki *Courting Failure: How Competition for Big Cases is*

managing it. To put it another way, the presumption in favour of a debtor-in-possession regime advances reorganisation objectives in that management is not penalised for seeking Chapter 11 protection. In the US, early filing is encouraged by the carrot of retaining control of the company and acquiring debtor-in-possession status. There is a general lack of sticks however, in the US if directors fail to put the interests of creditors first by filing early for reorganisation. There are no statutory equivalents to the English law on wrongful trading and company director disqualification. There is however the general law on directors' duties, and in a growing number of US cases the courts have held that managerial allegiance must shift from the shareholders to the creditors when a company approaches insolvency.[45] Influential judicial statements emphasise that, in the vicinity of insolvency, the board of directors have an 'obligation to the community of interests that sustained the corporation to exercise judgment in an informed good faith effort so as to maximize the corporation's long term wealth creating capacity'.[46] It is not surprising that managerial allegiance should depend upon the fortunes of the business because upon insolvency, the residual claims of shareholders become economically worthless and creditors, who go unpaid in the event of complete financial failure, now occupy the position of residual owners.[47] On the other hand, while a number of courts have held that fiduciary duties extend to creditors upon insolvency, duties are still owed to the shareholders as well.[48]

In the UK, it is also incumbent upon directors to take heed of creditor interests in the vicinity of insolvency. The proprietary rights of creditors against the assets of the company in the event of formal insolvency proceedings entitle them to be regarded as 'the company' in situations approaching

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Corrupting the Bankruptcy Courts (Ann Arbor, University of Michigan, 2005) at p 143: 'bankruptcy lawyers convinced Congress that if managers lost their jobs too frequently or too easily in bankruptcy, managers would not bring their companies into bankruptcy until it was too late to save them.'

[45] See *Federal Deposit Insurance Corp v Sea Pines Co* (1982) 692 F2d 973 at 976–977 'when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors' and see generally RT Nimmer and RB Feinberg 'Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity' (1989) 6 Bankruptcy Developments Journal 1.

[46] *Credit Lyonnais Bank Nederland NV v Pathe Communications* No CIV.A. 12130, 1991 Del. Ch. LEXIS 215 at 108–109.

[47] *Geyer v Ingersoll Publications Co* (1992) 621 A2d 784 at 787: 'when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors' and see generally B Adler 'A Re-Examination of Near-Bankruptcy Investment Incentives' (1995) 62 U Chi Law Review 575 at 590–598.

[48] *Commodity Futures Trading Commission v Weintraub* (1985) 471 US 343 at 355–356.

formal insolvency.[49] But additionally, there are strong statutory sticks to encourage directors to put an ailing company into administration. Under the so-called 'wrongful trading' provision contained in s 214 Insolvency Act 1986, once a director or shadow director knows or ought to have concluded that there is no reasonable prospect that a company would avoid going into insolvent liquidation s/he must take every step with a view to avoiding potential loss to company creditors.[50] If a director fails to take such steps s/he runs the risk of being declared personally liable for the debts of the company. Further, causing a company to trade while insolvent may occasion disqualification proceedings against a director on grounds of unfitness.[51] In extreme cases, a director may be disqualified from taking part in company management for up to 15 years on the basis of unfitness.[52]

On the other hand, there is no particular prize or carrot in the UK if the directors invoke the reorganisation processes promptly. There is nothing, however, to prevent an administrator from retaining the services of some part of the existing management and, in many businesses, this will be essential in preserving value or in ensuring a successful rescue or sale of the business. Apart from that, and the voluntary moratorium for smaller companies introduced by the Insolvency Act 2000, there is a superficially harsh manager-displacing insolvency regime.

It has been argued that in a manager-displacing insolvency regime the commencement of reorganisation is liable to be so late that creditors will lose the going-concern value premium that is otherwise available for capture.[53] The argument is that only the existing management, and not the creditors, can be expected to initiate a timely reorganisation effort. In the interim period, during which management struggles to avoid insolvency, the going-concern premium is at risk of being lost to the detriment of the creditors. 'Risk averse

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[49] See generally *Lonrho v Shell Petroleum Ltd* [1980] 1 WLR 627 at 634 per Lord Diplock and *West Mercia Safetyware Ltd v Dodd* [1988] BCLC 250 at 252–253. See also A Keay *Company Directors' Responsibilities to Creditors* (London, Routledge-Cavendish, 2005); P Davies 'Directors' Creditor-Regarding Duties to in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 European Business Organisation Law Review 301.

[50] See generally Andrew Keay 'Wrongful Trading and the Liability of Company Directors: a Theoretical Perspective' [2005] Legal Studies 431.

[51] Sections 6 and 8 Company Directors Disqualification Act 1986. Liquidators and others are required to report suspected cases of unfitness to the Department of Trade and Industry disqualification unit.

[52] 'Unfitness' is considered by reference to the factors listed in Schedule 1 to the 1986 Act.

[53] See D Hahn 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 JCLS 117 at 139.

management may become less motivated to work hard under a strictly enforcing regime which not only removes them from office upon business distress but also severely penalizes them as a bonus if they are later found to have effectively resigned too late.'[54]

Creditors, it is suggested, cannot be relied on to initiate a timely reorganisation effort.[55] In particular, banks have their own ways and means of addressing a company's financial distress once this is revealed, perhaps by taking additional collateral. Alternatively, a bank may be put into 'sleep mode', so to speak, by the company keeping up the payments schedule on that particular bank debt. That is not possible in all instances, however, especially where the company's financial plight is particularly pressing. More generally, the Enterprise Act 2002 has bolstered the collective nature of the administration process, inter alia, by removing the power of veto which a floating charge holder once enjoyed on the appointment of an administrator. It also stresses that an administrator must not unnecessarily harm the interests of company creditors as a whole.[56] More positively, the first statutory objective of administration is to try to rescue the company as a going-concern.

Nature of the Task to be Performed during the Reorganisation Process – Professionalism and Expertise

It seems to be stating the obvious to suggest that there is a need for professional management in keeping the company's business alive notwithstanding the commencement of the reorganisation process. This begs the question whether the services of an accountant/insolvency practitioner-type person are appropriate to this end. Specialised professionals whose main expertise is in financial analysis of corporate performance or even legal advice and litigation hardly seem the most worthy candidates for these managerial tasks.[57] The doyen of Law and Economics scholarship, Richard Posner, has stated:[58]

> The reason for giving [the right to continue the operation of the firm] to management is that only management, and not a committee of creditors or a trustee, auctioneer, or venture capitalist or other acquirer has the know-how to continue the firm in operation, as distinct from reviving it (maybe) after an interruption for a change in control.

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54 See D Hahn ibid at 141.

55 See Hahn 'Concentrated Ownership' at pp 142–143.

56 Schedule B1 Insolvency Act 1986 para 3.

57 See Hahn 'Concentrated Ownership' at p 146.

58 See Richard Posner 'Foreword' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996).

Under Chapter 11, it is the norm for all companies to operate as debtors-in-possession. With the DIP in control, managers are far more likely to keep their jobs during reorganisation whereas, in the UK, the automatic consequence of administration is that the company directors are displaced from management functions in relation to the company or its affairs.[59] It may be that administration is viewed very differently from Chapter 11 in the US and this accounts for the contrast. On a close reading of the relevant legislation in the UK, overall creditor wealth maximisation, possibly accomplished by a sale of assets, may come out first in the list when it comes to the objectives of administration. Its prominence however, is masked by the emphasis placed on corporate rescue in the statement of statutory objectives.[60] An administrator is required to perform his/her functions with the objective of (a) rescuing the company as a going-concern, or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors.[61] While, in general, the administrator can only go down the list of objectives if s/he thinks that it is not reasonably practicable to achieve any of the preceding objectives, the administrator has to move from (a) to (b) if s/he thinks that (b) would achieve a better result for the company's creditors as a whole. Rescuing the company as a going-concern cannot be pursued if the administrator thinks that it is not a reasonably practicable achievement or where it would not achieve the best result for the company's creditors as a whole.[62] It might be argued that, at its base, administration is about producing better returns for company creditors. The statutory weight is on preservation of the business of the company rather than preservation of the corporate shell, and as a government spokesperson pointed out: 'We would not want the administrator to rescue the company if it is to the detriment of creditor value.'[63]

It seems that in the UK there is much more emphasis on asset sales and preserving jobs and wealth through that route rather than through the preser-

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59 See Schedule B1 Insolvency Act 1986 para 64 'A company in administration or an officer of a company in administration may not exercise a management power without the consent of the administrator.'

60 See S Frisby 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 MLR 247 at 262 and more tentatively Vanessa Finch 'Control and Co-ordination in Corporate Rescue' [2005] Legal Studies 374 at 395–396.

61 Insolvency Act 1986 Schedule B1 para 3(1). An administrator must also perform his/her functions in the interests of the company's creditors as a whole.

62 Schedule B1 para 3(4).

63 See the comments by the relevant Minister, Lord McIntosh of Haringey, in HL Debates col. 766, 29 July 2002.

vation of existing corporate structures.[64] A speedy sale of company assets to a purchaser who will put them to better use and, in the process, maintain employment is often seen as the better result than the tedious process of restructuring the existing corporate vehicle and getting a restructuring plan approved. The point has been made that, to American eyes, even the revamped administration procedure still looks to have a different mission than Chapter 11. In Chapter 11 the business of the company tends to remain in the hands of the existing corporate set-up. While one can liquidate a company in Chapter 11 pursuant to a going-concern sale, US lawyers see this as liquidation.[65]

> English rehabilitation law recently has been overhauled to promote reorganization and fuel a failing economy. Even in its new form however, this law is very different from American rehabilitation law. Existing management cannot stay in place, there is an insolvency requirement, and the process is entirely creditor controlled. This form of rescue culture may achieve its goals of saving some businesses from piece-meal liquidation by allowing them to be purchased while still operational. It also may save jobs and avoid harm to suppliers who deal with the troubled company. It is not, however, a reorganisation in the traditional American sense of the word.

If administration is really very different from Chapter 11 then this could explain the differences as to who runs the respective procedures. Having an accountant at the helm makes sense if the process is really about valuation and asset sales, rather than running the business with a view to bringing about the return of profitable trading. On the other hand, administration and Chapter 11, at least in its present guise, are not poles apart. In 1978 at the time of the promulgation of the US Bankruptcy Code, as we have seen in the previous chapter, there were plentiful discussions about the community impact of bankruptcy and about how best to save jobs. Great attention was paid to corporate rehabilitation but now the emphasis seems to have shifted.[66]

> In more recent times the melodies have played out differently with a higher priority assigned to the maximization of creditor recoveries. Asset sales have come to the fore rather than reorganisations in the traditional sense. Whereas the debtor and its manager seemed to dominate bankruptcy only a few years ago, Chapter 11 now has

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[64] See the comment at para 193 of the 1982 Cork Committee Report on *Insolvency Law and Practice* (Cmnd 8558): 'In the case of an insolvent company, society has no interest in the preservation or rehabilitation of the company as such, though it may have a legitimate concern in the preservation of the commercial enterprise.'

[65] See the comment by Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367 at 397.

[66] See the comments in James J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139 at 139–140.

> a distinctively creditor-oriented cast. Chapter 11 no longer functions like an anti-takeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with asset sales and faster cases.[67]

There may have been something of a functional convergence between procedures on either side of the Atlantic, with the common ground being more on British lines rather than on traditional Chapter 11 territory.

Path Dependency

One factor, or theory, that may go partly towards explaining the difference between the debtor-in-possession regime in the US and the manager-displacing reorganisation regime in the UK is that of path dependency. In other words, because procedures have historically developed in different ways these differences will remain even though the reasons for the differences no longer exist. Path dependency theory has been used in the corporate governance context to explain the persistence of different conceptions of corporate ownership and accountability. Some commentators consider the Anglo-American shareholder-oriented model, under which directors and corporate managers owe their duties primarily to the holders of equity in the company, to be normatively superior than other models where the constituencies that benefit from such duties are more diffuse.[68] Nevertheless, other models of corporate governance survive in many parts of the world partly because of inertia and partly because the historical circumstances that produced them exert a continued gravitational pull.[69]

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[67] See David A Skeel Jr 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917 at 918.

[68] See generally Henry Hansmann and Reinier Kraakman 'The End of History for Corporate Law' in Jeffrey Gordon and Mark Roe ed *Convergence and Persistence in Corporate Governance* (Cambridge, Cambridge University Press, 2004) 33. See generally on this area John Parkinson 'Inclusive Company Law' in John De Lacy ed *The Reform of UK Company Law* (London, Cavendish, 2002) at p 43 who suggests that the priority afforded to shareholders 'reflects not so much a belief that their interests are inherently more deserving of protection than those of other groups, as acceptance of the traditional economic analysis that argues that the greatest contribution to "wealth and welfare for all" is likely to be made by companies with a primary shareholder focus.'

[69] On 'path dependency' see generally Ronald J Gilson 'Corporate Governance and Economic Efficiency: When Do Institutions Matters?' (1996) 74 Washington University Law Quarterly 327; Mark J Roe 'Chaos and Evolution in Law and Economics' (1996) 109 Harv Law Rev 641; Lucien A Bebchuk and Mark J Roe 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127.

The corporate insolvency and reorganisation regimes in both Britain and the US are each the product of a different conjunction of circumstances. As we saw in Chapter 2, administration in the UK grew out of receivership, which was essentially a creditor-oriented procedure, though often viewed in a favourable corporate rescue light. For example, the Cork committee on Insolvency Law and Practice, which reported in 1982, waxed lyrical on the virtues of receivership, stating that the procedure had ensured the preservation of the profitable parts of an enterprise and been of great benefit to 'employees, the commercial community, and the general public'.[70]

It is highly arguable that this is an idealized conception of receivership rather than a realistic one since receivership specifically served the interests of the charge holder who made an appointment.[71] There was no need to give prior notice of the intention to make an appointment to the company. All that was required was the occurrence of certain stipulated events in the debenture.[72] A receivership appointment could only be made, however, where a company had created a floating charge.[73] Administration was brought into being to fill the resultant vacuum but its potential application was not limited to such cases.

Political and business dynamics had changed in the late 1990s and receivership was now seen as excessively creditor-centred. The concerns of other parties potentially interested in corporate recovery were not taken into account sufficiently under the receivership model. The Enterprise Act 2002 severely limited the ability to appoint a receiver, with administration taking over as a generally prescribed vehicle for business rescue and the enforcement of security. Admittedly, the administrator has a different set of functions to perform than a receiver but one of these functions of administration is still making distributions to secured and preferential creditors. If this function is performed and the person appointing the administrator is the floating charge holder then there are obvious similarities between administration and receivership. Some observers have therefore suggested that administration is best understood as 'receivership-plus'. By this is meant receivership with a few add-ons such as

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70 Cmnd at para 495.

71 For somewhat more critical voices see J Zeigel 'The Privately Appointed Receiver and the Enforcement of Security Interests: Anomaly or Superior Solution' in J Zeigel ed *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford: Clarendon Press, 1994) 451 at p 461 and D Milman 'A New Deal for Companies and Unsecured Creditors' (2000) 21 Company Lawyer 59–60.

72 Receivership was essentially a creditor-centred rather than a public interest centred remedy – see *Downsview Nominees Ltd v First City Corp Ltd [*1993] AC 295; [1993] 3 All ER 626.

73 For a defence of receivership see J Armour and S Frisby 'Rethinking Receivership' (2001) 21 OJLS 73.

somewhat wider duties. On another analysis, the new legislative dispensation may be described as a 'transmutation' or 'merger' of receivership and administration rather than as being the end of administrative receivership.[74] Irrespective of the particular analysis adopted, the resemblance between administration and receivership can hardly be denied. Administration was conceived out of receivership and still shows the marks of its parentage.

In the United States the antecedents of Chapter 11 of the 1978 Bankruptcy Code can be traced back to the railroad receiverships of the nineteenth century.[75] As we saw in Chapter 2, in these cases, the judiciary developed principles for corporate restructuring that were entirely outside the framework of federal bankruptcy laws and it was not until the 1930s that analogous principles were enshrined in statute. The courts nevertheless refused to extend these judicially developed reorganisation procedures to companies outside the railroad industry. The special treatment of railroads was justified on the grounds that the foremost obligation of railroads was to serve the public. The primary obligation of a railroad was seen as being to the public and not to its creditors or shareholders, but this was not self-evidently true in the case of other companies.[76]

The railroads formed part of the American frontier mentality and their continued operation was essential to 'taming the frontier', which forms a large part of American mythology. There was a wide and deep ideological consensus that railroads should not be permitted to fail.[77] Legislative and executive solutions to the problems of ailing railroad companies were largely foreclosed, nevertheless, for a number of reasons. In the federal jurisdiction that is the United States there were doubts about the legislative competence of

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[74] See generally S Davies (ed) *Insolvency and the Enterprise Act 2002* (Bristol, Jordans, 2003) at pp 40–41.

[75] See generally David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 and by the same author *Debt's Dominion* (Princeton, Princeton University Press, 2001).

[76] See Hansen op cit text accompanying footnote 63 'Later decisions, including those by the Supreme Court, continued to emphasize that creditors did not have the same rights in quasi-public corporations that they did in other enterprises. These judges also made clear that the remedies available to railroads were not available to corporations in general but were restricted to enterprises that were regarded as quasi-public, such as railroads or drawbridges. It would be left to Congress to make reorganization available to all corporations' and see generally *Canada Southern v Gebhard* (1883) 109 US 527.

[77] See generally for a discussion of these issues David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 at 1353–1358; David A Skeel Jr *Debt's Dominion* (Princeton, Princeton University Press, 2001) Chapter 2.

Congress[78] and clearly, individual States had no jurisdiction to pass laws governing the overall affairs of railways that passed through more than one State. Moreover, it is possible that some interest groups might have preferred that a particular railroad should be allowed to fail and it is possible that these interest groups lobbied against specific legislative intervention. A solution whereby the railroads' lawyers and bankers used the judicial system to bring about a negotiated workout carried certain tangible benefits, not least because in the courtroom setting only the parties directly interested in the fate of a particular railroad would have standing to support or oppose the restructuring process. The choice of institutions significantly affects the interest-group dynamic and, for this reason, railroad managers, through their lawyers and investment bankers, turned to the judicial system. Judicially appointed receivers, who generally included members of the railroad's management, worked out the terms of a reorganisation.[79] For non-railroad companies however, conditions were different: interest-group dynamics were different and creditors often controlled the receivership process. The perception that railroads were public in nature and could not be allowed to fail simply did not apply. Moreover, railroads were vastly more valuable as going concerns than in liquidation but this was not so self-evidently true with other corporations. Consequently, there was much less of an obvious consensus in favour of manager-driven reorganisation.

In general, investment bankers exerted particular influence in the receivership process arising from their role as underwriters of corporate securities.[80] JP Morgan & Co played an important role in several reorganisations and while there were various efforts to neutralise the role of large financial intermediaries in corporate governance generally, major banks continued to retain enormous influence until the sweeping reforms of the New Deal era under President Roosevelt in the 1930s. The New Deal led to a sea change for New Deal Reformers like William O Douglas (later President of the Securities and Exchange Commission (SEC) and Supreme Court Justice) characterised underwriters and restructuring lawyers as being more concerned about their

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78 See generally Bradley Hansen 'Commercial Associations and the Creation of a National Economy: The Demand for Federal Bankruptcy Law' (1998) 72 Business History Review 86.

79 One study of 150 receiverships between 1870 and 1898 found that in over 90 per cent of these cases insiders were appointed as receivers – see Henry Swaine (1898) 3 Economic Studies of the American Economic Association 71 at 77. This study is referred to by Bradley Hansen 'The people's welfare and the origins of corporate reorganization: The Wabash receivership reconsidered' (2000) 74 Business History Review 377 text accompanying footnotes 48–51.

80 See generally David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 at 1368–1370.

fees and keeping managers happy than the investors whose interests they were supposed to champion.[81] The Chandler Act 1938 was part of an SEC campaign to reform bankruptcy law. Chapter X of the Act ended the perceived hegemony of corporate managers and underwriters over the restructuring process for, in every substantial case, it required that the current managers should be displaced in favour of a bankruptcy trustee. Moreover, previous corporate underwriters or lawyers were prohibited from becoming the trustee. In consequence, their ability to manage the reorganisation process and to shape its outcome was also eliminated. Only a trustee was permitted to propose a reorganisation plan. It has been pointed out that in many respects, the Chandler Act changed the face of US corporate bankruptcy law since, by effectively cutting Wall St bankers out of corporate reorganisation, the Chandler Act also eliminated Wall St lawyers whose position and status was closely linked to that of their clients. Removing the investment banks opened up and eventually transformed bankruptcy practice.[82]

Over time however, the position of the SEC in reorganisation cases was sidestepped and ways were found around the mandatory trustee requirement. The Chandler Act had a second reorganisation chapter in Chapter XI under which the SEC did not play a role and a company's managers were left in control of corporate affairs. The legislation seemed premissed on the assumption that Chapter X should be the appropriate vehicle for publicly held companies and Chapter XI for smaller companies, yet nothing in the statute precluded the managers of a large firm from steering the firm towards the more hospitable waters of Chapter XI. This defect in the eyes of the SEC was noticed immediately but left unrepaired.[83] In *General Stores Corp v Shlensky*[84] the Supreme Court ruled that there was no implied prohibition on public companies invoking Chapter XI. The choice of chapter depended on the 'needs to be served'. The SEC won on the facts of Shlensky but it was a classic Pyrrhic victory in that the decision helped to ensure that the SEC became marginalised in large-scale corporate reorganisations. Bankruptcy practice circumvented the effective operation of Chapter X in that companies increas-

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[81] See generally *Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees volumes 1–8* (1937–1940) and see generally the discussion in David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 at 1369–1370.

[82] See generally David A Skeel Jr *Debt's Dominion* (Princeton, Princeton University Press, 2001) Chapter 4 'William Douglas and the Rise of the Securities and Exchange Commission'.

[83] In *SEC v United States Realty & Improvement Co* (1940) 310 US 434 the Supreme Court however leaned against publicly held companies using Chapter XI.

[84] (1940) 350 US 462 at 466.

ingly filed for reorganisation under Chapter XI. Middle-sized companies with publicly held securities, rather than large companies, first opened the doors to Chapter XI which subsequently became increasingly ajar.[85] In 1973 the National Bankruptcy Commission Report concluded that 'it is readily apparent that Chapter XI has evolved into the dominant reorganization vehicle and very substantial debtors are able to reorganize in Chapter X1'.[86] Chapter X1 became the popular choice. On the other hand, the SEC still retained a role when companies reorganised in Chapter XI for it could negotiate benefits for public investors in return for an agreement not to challenge the company's use of Chapter XI.

Professor Skeel has pointed out that two, sometimes clashing, ideological threads tend to come together in bankruptcy. Firstly, there is a general antipathy towards large businesses and secondly, the desire to give failed businesses a second chance.[87] By the 1970s, however, investment banks and Wall St firms were but a distant memory in bankruptcy practice. The US Congress was less troubled by the elimination of SEC oversight that it might otherwise have been and the general background sentiment, favouring corporate reorganisations, prevailed. Chapter X of the Chandler Act was laid to rest and the new Chapter 11 took over where the old Chapter XI left off, minus any role for the SEC. Section 1107 of the Bankruptcy Code invests the debtor-in-possession with all the powers of a bankruptcy trustee. Outside trustees can only be appointed for cause – s 1104(a)(1) – and their appointment in Chapter 11 is exceptional.[88]

The trajectory of corporate insolvency law is clearly different in the US than it is in England. The interest-group dynamics are different and have played out differently. There are important issues in the American context which do not merit a mention on this side of the Atlantic, such as the whole issue of Federalism versus Localism and the competence of Congress under the Bankruptcy Clause of the US Constitution. These factors explain some of the legislative choices in the US. General hostility towards Wall St, i.e. big

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[85] See Benjamin Weintraub and Harris Levin 'A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation' (1957) 26 Fordham Law Review 292.

[86] *Report of the Commission on the Bankruptcy Laws of the United States* HR Doc No 93 at p 137.

[87] See generally David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325 at 1375.

[88] See Lynn M LoPucki *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* at p 145: 'Appointment of a trustee is a drastic remedy. . . . Typically, the trustee will retain some members of former management for those members' company-specific knowledge, but it is the trustee who is in charge. Bankruptcy courts have always been reluctant to appoint trustees in situations where the business will continue to operate.'

banks, has also played a role in the United States. The banking and lending markets are much more concentrated in England, and this fact alone has been used to develop an explanation as to why US law is based on debtor-in-possession whereas English law is manager displacing.

Nature of the Lending Markets

The UK is seen as something of a problem child as far as certain US-oriented corporate governance theorists are concerned.[89] Patterns of share ownership are widely dispersed and broadly similar in Britain and the US. Moreover, there is an active market for corporate control in both countries via the stock exchanges and takeover bids, contested or otherwise. In the strong version of the theory, dispersed ownership is compatible with, and compatible only with, a debtor-in-possession corporate reorganisation regime.[90] By way of contrast, concentrated ownership corporate structures are compatible only with a manager-displacing regime. The US conforms to this theory – a dispersed pattern of share ownership coupled with debtor in possession reorganisation law – whereas, broadly speaking, the UK does not. Dispersed share ownership sits alongside manager-displacing bankruptcy. The evolutionary theory favoured by American commentators suggests that such a regime mixing 'ex post' corporate governance[91] with 'ex ante' bankruptcy is unstable over time. Subsequent developments would either push corporate governance in an ex ante direction through concentrated shareholdings or managers would somehow re-establish a manager-driven bankruptcy process. It is suggested that this is just what happened in the United States where by the early 1960s market-driven governance, through the takeover mechanism rather than concentrated shareholding, had become the norm. The upsurge in market-driven corporate governance was accompanied by a shift in the insolvency law component towards a more flexible, manager-driven regime, with Chapter X of the Chandler Act sidelined in favour of Chapter XI and its ultimate replacement in 1978.

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89 See Mark J Roe 'Political Foundations for Separating Ownership from Control' in Joseph A McCahery ed *Corporate Governance Regimes: Convergence and Diversity* (Oxford, Oxford University Press, 2002) 113 at p 129.

90 See generally John Armour et al 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 Vand L Rev 1699 and see also D Hahn 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 JCLS 117.

91 This is referred to as 'ex post' because of the after-the-fact nature of the correctives – see David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' at 1328.

Of course, one could look at the matter through different ends of the same telescope. One might emphasise the effect of a particular corporate-insolvency regime on the shaping of a country's corporate governance structure, more or less a 'law first' analysis.[92] In other words, the prospect of being supplanted in a reorganisation context would cause management to avoid saddling a company with large debts. Moreover, management would likely seek out large, stable shareholders who would implicitly promise not to sell their shares to outside bidders and therefore the corporate governance of a country would gravitate towards concentrated shareholdings. Alternatively, one could look at matters the other way around and explain, for example, the concept of debtor-in-possession in the US as deriving from the principal characteristic of US publicly traded corporations, namely, the separation of ownership and control.

Normatively, it has been argued that in jurisdictions where there is a separation of ownership and control, management can be relied upon to continue controlling the company though the restructuring process and to cooperate with the creditors. On the other hand, where there are concentrated shareholdings, allowing management to keep control of the company jeopardises the creditors and leaves them vulnerable to manipulation by shareholders. In concentrated ownership systems, the management of a company is closely associated with the dominant shareholders, and leaving the incumbent management in control plays into the hands of the dominant shareholders and exacerbates the risk of loss to the creditors. To neutralise this risk, and better represent the creditors' interest during the reorganisation process, management should be removed from control of the company.[93]

In the so-called Berle-Means company typified by a separation of ownership and control, the relative independence of management vis-à-vis shareholders may serve the interests of creditors. Management is not so clearly and generally identified with shareholders' interests and the normative shift of management's fiduciary duties from shareholders to creditors in insolvency can comport easily with the factual realities. To put the matter another way, because management aligns itself with shareholders by virtue of legal norms, any change in the nature of these norms can reasonably be implemented by management. Management is likely to abandon the focus on shareholders' interests in a reorganisation situation and cooperate with creditors in devising a reasonable restructuring plan.

The United States fits neatly into the state of affairs postulated by this analysis – not surprisingly since the theory was framed with reference to US conditions. The position of the UK with regard to the model is somewhat

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92 See D Hahn 'Concentrated Ownership and Control of Corporate Reorganisations' at 128–130.

93 See D Hahn ibid at 120.

awkward however.[94] The UK possesses a corporate governance system which is close to that of the US[95] yet a manager-displacing insolvency regime. One explanation for the divergence is that aggregate holding of shares by UK institutional investors is considerably higher than that of their US counterparts and UK institutions are closely knit with the result that collective action costs are significantly reduced. This would suggest that share ownership in the UK is de facto concentrated, but most commentators are of the view that the explanation is far from convincing given the generally wide dispersion of shares in the UK market and the relative passivity of investors.[96] Despite the potential for exercising control by institutional shareholders, the UK is generally characterised as having an outsider or arm's-length system of corporate governance.

An alternative explanation is a lack of synchronisation between legislation and conditions in the marketplace with legislation always being one or more cycles behind economic developments. When the Cork Committee drafted its report which led to the creation of the administration procedure, the UK capital markets were in the final stages of their transition from concentrated to dispersed ownership. Given the present configuration of the UK corporate ownership landscape, the evolutionary theory of insolvency law would predict that the corporate reorganisation regime is likely to exhibit manager-driven characteristics. The legislative cycle however may work at a slower pace than the economic cycle and currently, the UK is less manager-friendly than evolutionary theory would predict for a country with dispersed share ownership.

One explanation that has been proffered stems from the concentrated nature of corporate debt in the UK compared with the US where corporate debt is widely diffused through the bond markets.[97] In the UK, the norm for public companies is to have dispersed equity and concentrated debt. A manager-displacing insolvency law is a valuable governance lever as far as concentrated creditors are concerned but much less so in a situation of dispersed debt. Dispersed creditors face considerable coordination difficulties in deciding whether to pull the lever and displace the directors by initiating insolvency proceedings. Certain commentators have suggested that the UK is in a state of transition. The UK debt markets will become more diffuse over time and will ultimately fall into line with the dispersed pattern of share ownership. Consequently, pressure will build for the establishment of an increasingly manager-driven process and the predicted alignment between an outsider or

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94 See Hahn 'Concentrated Ownership' at p 134.

95 See Brian R Cheffins 'Law, Economics and the UK's system of Corporate Governance: Lessons from History' (2001) 1 Journal of Corporate Law Studies 71.

96 See generally John Armour et al 'Corporate Ownership Structure and the Evolution of Bankruptcy Law' at 1754.

97 Ibid at 1766–1772.

arm's-length system of ownership and control and manager-friendly insolvency laws will occur.[98]

It is submitted that a single theory like this justifying differences in US and UK insolvency law is much too pat. Single, unifying theories hold considerable intellectual appeal. They also have the ineluctable advantage of simplicity. Grand imperialistic visions of this nature should however be resisted. Complex realities almost never can be reduced to a simple proposition. The explanation that 'it's all to do with the bond markets' may be part of a comprehensive justificatory web but, standing alone, it seems much too thin an explanation. For a start, it hardly fits the facts. Yes, debt and bond markets are much more concentrated in the UK than in the US but the UK is not alone among Anglo-Saxon economies in having a manager-displacing insolvency regime. In fact, the US is more of an outlier than the UK. For instance, analyses of the equivalent Australian legislation conclude that it manifests much harsher manager-displacing features than the UK yet Australia has basically an outsider or arm's-length system of corporate governance.[99] Canada is somewhere in between.[100]

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[98] See Armour et al at 1775–1776: 'If such pressure develops and ultimately yields the creation of a Chapter 11 option for larger firms, the end result would be what our refined evolutionary theory of corporate bankruptcy and corporate governance would suggest: diffuse share ownership, dispersed debt, and manager-driven bankruptcy law. The available evidence suggests that these various predictions are turning out to be true. To start, there is evidence that banks already are losing their near hegemony over debt finance for widely held UK firms. In recent years, British firms have increasingly turned to other institutional lenders, such as insurers and pension funds for debt financing. Although the market for public debt remains much smaller than in the US, it has significantly increased in recent years. . . . With respect to law reform, there has been lobbying of the type the reconfigured evolutionary theory would predict.'

[99] See Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' at 397: 'Aussies share the English distrust of the American debtor in possession system, finding it mired by the potential misdeeds of existing management' and her comment at p 404: 'The attitude down under seems to be if a business fails, it should be pushed aside so others can fill the gap.' For a somewhat different perspective see Brian R Cheffins 'Corporate Governance Convergence: Lessons from Australia' (2002) 16 Transnational Lawyer 13, who makes the point, inter alia, that Australia's listed companies exhibit a far higher degree of ownership concentration than do those of UK listed companies. Cheffins also discusses the implications of the Australian example for theories of Anglo-American insolvency law at pp 37–38. For a fuller and more nuanced but general picture see Alan Dignam 'The Role of Competition in Determining Corporate Governance Outcomes: Lessons from Australia' (2005) 68 MLR 765.

[100] See generally L LoPucki and G Triantis 'A Systems Approach to Comparing US and Canadian Reorganization of Financially Distressed Companies' in JS Ziegel (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford, Clarendon Press, 1994) p 109.

A second reason for failing to embrace 'it's the bond markets, stupid' theory in its entirety lies in the fact that UK legislation may be moving in the opposite direction than these evolutionary theorists suppose should happen. It is suggested that a manager-displacing insolvency framework aligns well with concentrated ownership companies, since in these companies management is subject to manipulation by shareholders and is more likely to respect shareholders' interests to the detriment of creditors.[101] The Insolvency Act 2000 however, introduced in effect a stand-alone debtor-in-possession procedure for smaller companies proposing a restructuring plan, namely the Company Voluntary Arrangement (CVA) with a moratorium. The moratorium lasts for 28 days, bars creditor recovery actions during this period and is designed to facilitate shareholder and creditor approval of the plan.[102] The existing management remain in control, but to obtain the moratorium they must persuade the insolvency supervisor who is going to act as supervisor of the CVA that the proposal is likely to be approved and that the company will have sufficient funds to carry on business during the period. Only smaller companies as defined in s 247 Companies Act 1985 may avail themselves of the procedure and the section uses turnover, balance sheet totals and number of employees as the qualifying conditions.[103] Of course, these smaller companies are the very ones where there is more likely to be a convergence, rather than a divergence, of ownership and control.

Convergence in Practice

There are undoubtedly significant differences between US and UK corporate bankruptcy law, not least with respect to the issue of who runs the company during the reorganisation period. In the US it is the existing management in the new guise of debtor-in-possession whereas in the UK it is an outside administrator acceptable to, if not appointed by, a dominant creditor. Various reasons have been put forward to explain this divergence between the two systems. It is submitted that no one reason has sufficient independent explanatory power. The various factors are best looked at in conjunction and collectively they may tell the story of why there is this difference.

But the story would not be complete without a degree of blurring between the two systems and not just at the edges. The debtor-in-possession procedure

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101 See Armour et al at p 1733.

102 See Insolvency Act 1986, s 1A and Schedule A1 as amended by s 1 and Schedule 1 Insolvency Act 2000.

103 Basically a company is a small company if it meets two of the following three criteria: (1) annual turnover not greater than £5.6m, (2) balance sheet total not more than £2.8m and (3) not more than 50 employees.

for smaller companies in the UK through CVAs with a moratorium has already been highlighted. One might also mention the so-called 'London Approach' or private consensual workout procedure for larger companies in the UK, which has been discussed in the first chapter.[104] The London Approach is an example of a debtor-in-possession restructuring process but it would be unwise to exaggerate the similarities between it and Chapter 11. A company in Chapter 11 enjoys a great deal of autonomy whereas a company undergoing a London Approach restructuring is subject to the dictates and actions of its lender banks. The lenders determine whether the company shall enter the restructuring process and at any stage during the course of the workout negotiations they may decide to withdraw from them and initiate formal manager-displacing administration or liquidation proceedings. The existence of the London approach, however, may have acted as something of a safety valve and muted to some degree any momentum in favour of the introduction of formal Chapter 11-type procedures in the UK.[105] The concentrated nature of UK corporate debt has also helped to create the right conditions for London Approach rescues to flourish.[106]

Further on the theme of blurring, the US procedures take on a UK hue in a couple of respects: the replacement of existing management in the course of Chapter 11 and secondly, creditor control over the process through onerous provisions in debtor-in-possession financing agreements. While Chapter 11 is based on debtor-in-possession, that does not mean that the same individuals will be in control of the company before, during and after the restructuring. In fact, key management personnel are often replaced during the Chapter 11 process particularly in cases involving large companies. These changes are often instigated by creditors. One empirical study has found that over half of Chief Executive Officers (CEOs) and directors of companies lost their jobs

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104 On the 'London Approach' see generally P Brierley and G Vlieghe 'Corporate Workouts, the London Approach and Financial Stability' [1999] Financial Stability Review 168; P Kent 'Corporate Workouts – A UK Perspective' (1997) 6 International Insolvency Review 165; J Armour and S Deakin 'Norms in Private Bankruptcy: the 'London Approach' to the Resolution of Financial Distress' [2001] Journal of Corporate Law Studies 21.

105 See Armour et al at 1774.

106 See B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 299: ' Structurally, the great dispersion of large American companies over many states and the fragmentation of the banking industry favoured leaving managers in place who understood the complexities of their own industry and organization. In the UK, smaller companies drew most of their financing from only five or six national banks. The concentration of banking and the less complex forms of companies lent themselves to decisive intervention by banks and to quick appraisals and formulation of business plans by independent professionals.'

during the restructuring period.[107] Another examination revealed that in over 90 per cent of the sample cases the CEO was replaced at least once in the period dating from 18 months before filing to six months after confirmation.[108] Where the financial distress of a company was due to endogenous events, management replacement is even more of a probability because creditors are likely to condition their continued cooperation on these changes taking place.[109] It may be, however, that Chapter 11 provides managers with enough leverage so that they can sweeten the pill of the sack. In other words, 'even tainted managers can negotiate for a more favorable exit rather than simply be fired'.[110]

THE INFLUENCE OF CREDITORS AND THE NEW CHAPTER 11 GOVERNANCE

Changes in personnel were always a de facto part of Chapter 11, but what appears to have accelerated in recent years is creditor influence over, or control of, the Chapter 11 process by way of onerous clauses in debtor-in-possession financing agreements. This has been accompanied by an apparent change in the nature of corporate reorganisation as traditionally understood in the United States going hand in hand with the rise of the New Economy. For example, Professors Baird and Rasmussen[111] have argued that to the extent

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107 S Gilson 'Management Turnover and Financial Distress' (1989) 25 Journal of Financial Economics 241, 261 finding that 'in any given year, 52% of sampled firms experience a senior management change if they are either in default on their debt, bankrupt, or privately restructure their debt to avoid bankruptcy' and see also S Gilson 'Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default' (1990) 27 Journal of Financial Economics 355, 386 stating that 'on average, only 46% of incumbent directors and 43% of CEOs remain with their firms at the conclusion of the bankruptcy or debt restructuring'.

108 L LoPucki and W Whitford 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 U Pa Law Rev 669.

109 According to B Carruthers and T Halliday *Rescuing Business* at p 265 the Chapter 11 process 'is not a safe haven for management'. But see however, Ethan S Bernstein 'All's Fair in Love, War & Bankruptcy?' Corporate Governance Implications of CEO Turnover in Financial Distress' (2006) 11 Stanford Journal of Law, Business & Finance 298 who presents new evidence that 'filing for bankruptcy did not change the rate of CEO turnover when one controls for financial condition. This statistically significant finding indicates that the "shadow of bankruptcy" has lengthened, making bankruptcy law a central tenet of governance policy regardless of whether a Chapter 11 petition is ever filed.'

110 See B Carruthers and T Halliday *Rescuing Business* at p 265.

111 'The End of Bankruptcy' (2002) 55 Stan L Rev 751.

that corporate reorganisation law is conceived of as creating a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, that era has come to an end. They suggest that Chapter 11 is capable of playing its traditional role only in environments where specialised assets exist; where those assets must remain in a particular firm; where control rights are badly allocated and where going-concern sales are not possible. Generally speaking, large companies no longer fit this paradigm although the necessary ingredients may be present in small enterprises where firm-specific assets can exist, often in the form of the human capital of the owner-manager.[112]

> Small firms are more likely to have haphazard capital structures. Their size makes them more vulnerable to exogenous shocks. . . . The principal value of preserving such small firms is that it allows their owners to continue to enjoy the psychic benefit of running their own business. The costs fall disproportionately on nonadjusting creditors. One can make the case for a law that facilitates the survival of such firms, but the case is not an easy or compelling one. The days when reorganization law promised substantial benefits are gone.

Baird and Rasmussen also make the point that by virtue of revolving credit facilities and DIP financing mechanisms, lenders have gained greater practical control over the Chapter 11 process. The control that managers once enjoyed has been greatly reduced. In the case of companies that are likely to survive as going-concerns, bank lenders and other professional investors ensure that they are in the driving seat. In Chapters 1 and 3 attention has been drawn to the fear that as a result of DIP lending agreements, the screws on hard-pressed companies will be tightened too much. This would have the effect of discouraging even appropriate risk-taking and pressuring companies to liquidate assets rather than to reorganise.[113] But however one views the phenomenon, and the possible downsides, the control exercised by lenders over the Chapter 11 process demonstrates an increasingly functional convergence in practice between it and the administration process in the UK.[114] The DIP lending lever

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112 Ibid at 788.

113 If too many firms liquidate rather than reorganise, industry may become concentrated in the hands of a few major players.

114 See however, the comment by Karen Gross 'Finding Some Trees but Missing the Forest' (2004) 12 American Bankruptcy Institute Law Review' 203 at 217–218 'Yes, secured creditors did make some gains, some of which were not originally contemplated. Yes, they may control some cases through DIP financing packages. But, there are a host of other things that have been operating since 1978 that explain how large Chapter 11 cases are working and why secured creditors have done that which they have done and why, in some instances, they are not the star of the show. . . . At the end of the day, the world got more complex, more markets opened, new uses of

may be trying to achieve through the backdoor an element of 'creditor-in-possession' though without the checks and balances that are a feature of the UK regime.[115]

Marrying Debtor-in-Possession and Management-Displacement Approaches

It is worth pointing out that the choice between debtor-in-possession and management displacement is not necessarily an 'all-or-nothing' one. Some jurisdictions also have formal legislative procedures that may go half-way towards debtor-in-possession corporate restructuring. The 'examinership' procedure in Ireland bears scrutiny in this connection.[116] Under this procedure, an examiner may be appointed by the court to an ailing company to investigate and report and to prepare a restructuring plan, but there is a presumption that the existing management should continue to direct the affairs of the company during the period of examinership. It should be noted however that examinership has been consciously designed as a restructuring process and not as a 'more advantageous realization of assets' process. The only proposals that the examiner is permitted to formulate are those which make it likely that (a) the company and (b) the whole or part of its undertaking will survive as a going-concern.[117] The examiner has no authority to prepare proposals that involve the sale of the company's assets and/or business or the liquidation of the company. The examiner does not have functions equivalent to those of a liquidator or receiver, nor does s/he have any executive functions. Murphy J said in *Re Edenpark Construction Ltd*:[118]

Chapter 11 were invented, new parties came to the table, lawyers and other professionals developed new strategies, and financial sophistication increased.'

115 See Elisabeth Warren and Jay L Westbrook 'Secured Party in Possession' (2003) 11 American Bankruptcy Institute Journal 12.

116 The relevant law is contained in the Companies (Amendment) Act 1990 as amended principally by the Companies (Amendment) (No 2) Act 1999. There was significant American influence on the legislation – on this see 'Foreword' to Weil, Gotshal & Manges LLP *Reorganizing Failing Businesses* (American Bar Association 1999) 'Weil, Gotshal & Manges LLP was privileged to help the country of Ireland draft its Companies Act of 1990 to help attract investment by assuring investors a reorganization statute that would help businesses, notwithstanding defaults, if a healthy core business could emerge.' See generally on the legislation Thomas B Courtney *The Law of Private Companies* (Dublin, Butterworths, 2nd ed, 2002) chapter 23.

117 See the comments of Costello J in *Re Clare Textiles Ltd* [1993] 2 IR 213 Under s 24 of the Act the court has no power to confirm proposals which do not provide for the survival of the company and at least part of its undertaking as a going-concern.

118 [1994] 3 IR 126 at 136.

> In the absence of some particular order of the High Court, he may not usurp the functions of the board of directors of the company over which he is appointed and it is the board or its officials who will continue to manage the business of the company during the period of protection and the continuance of the examinership.

An examiner may apply to the court for a transfer of functions and in considering this application the court has to have regard, inter alia, to whether:[119]

a. the affairs of the company are being conducted, or are likely to be conducted, in a manner which is calculated or likely to prejudice the interests of the company or of its employees or of its creditors as a whole, or
b. it is expedient for the purpose of preserving the assets of the company or of safeguarding the interests of the company or of its employees or of its creditors as a whole, that the carrying on of the business of the company by, or the exercise of the powers of, its directors or management should be curtailed or regulated in any particular respect.

Even without the transfer of executive functions, the examiner performs a certain supervisory role in relation to the company. For example, where the examiner becomes aware of any

> actual act or proposed act, omission, course of conduct, decision or contract, by or on behalf of the company . . . which is likely to be to the detriment of the company, or any interested party, he shall, subject to the rights of parties acquiring an interest in good faith and for value . . . have full power to take whatever steps are necessary to halt, prevent or rectify the effects of such act or omission etc.[120]

S/he has power to convene, set the agenda for and preside over both board meetings and meetings of company members. The directors are obliged to provide the examiner with a statement of the company's affairs.[121] S/he has a right to see all the company's books and documents.[122] More generally, the examiner is given all the powers of a company auditor in relation to ascertaining information and extracting cooperation from company officers. S/he is also entitled to make contracts on behalf of the company in performance of his or her functions. While personally liable on such contracts, s/he is entitled to an indemnity from company assets in respect of the liability.[123]

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119 S 9.
120 S 7.
121 S 14.
122 S 8.
123 S 13.

One must be conscious of the risks associated with co-determination models like the Irish one. For example, the partition of authority caused by the dual decision-making structure may create an arena for clashes of opposing egos and interests:

> First, one of the fallibilities of shared authority and collective decision-making is human miscommunication. The flow of information between the various decision-makers is susceptible to errors, miscommunication and hence distortion. Secondly, between management and the trustee, the former enjoys superior access to information concerning the debtor. Because the two decision-makers represent different interest groups, management has an incentive to withhold information from the other representative (the trustee), undermine the latter's effective decision-making and thus tip the scale of power and risk taking in favor of its own constituency, the equityholders.[124]

Clashes between the examiner and existing management do not appear to have the norm in Ireland. Certainly, in cases where the company has initiated the examinership procedure, the relationship between management and the examiner has worked relatively harmoniously. The real friction and clashes have occurred between management and the examiner on one side of the fence, and secured and preferential creditors on the other side.[125] The main criticism of the Examinership legislation has come from creditors and those representing their interests, with the suggestion being that the Act entails too severe a restriction on the rights of creditors. Some measure of restriction was conscious and deliberate. In *Re Atlantic Magnetics Ltd*[126] McCarthy J in the Supreme Court referred to the purpose of the statute as being

> protection of the company and consequently of its shareholders, workforce and creditors. It is clear that parliament intended that the fate of the company and those who depend upon it should not lie solely in the hands of one or more large creditors who can by appointing a receiver pursuant to a debenture effectively terminate its operation and secure as best they may the discharge of the monies due to them to the inevitable disadvantage of those less protected. The Act is to provide a breathing space albeit at the expense of some creditor or creditors.

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124 D Hahn 'Concentrated Ownership and Control of Corporate Reorganizations' (2004) 4 Journal of Corporate Law Studies 117 at 52.

125 See generally I Lynch, J Marshall and R O'Ferrall *Corporate Insolvency and Rescue* (Dublin, Butterworths, 1996) at pp 272–275.

126 [1993] 2 IR 561 at 578. These comments were approved by Finlay CJ in *Re Holidair Ltd* [1994] 1 ILRM 481 at 487.

CONCLUSION

Substantial differences do undoubtedly exist between corporate reorganisations under Chapter 11 of the US Bankruptcy Code and the UK administration procedure for ailing companies. A company has an unfettered right to access Chapter 11 whereas creditors have a more substantial say on whether companies enter administration. Chapter 11 is based on debtor-in-possession while in administration the board of directors lose their management powers and functions to an administrator. Many reasons have been offered to explain the difference. These reasons relate to different attitudes towards entrepreneurship and risk-taking in the UK and US: a different jurisdictional mix of carrots and sticks in encouraging early invocation of corporate rescue procedures; different conceptions of the nature of the two processes as well as their aims and objectives; path dependency and the continued gravitational pull of historical circumstances and finally, differences in the nature of the lending markets, and in particular the bond markets in the two countries.

All of these factors have been examined and it is submitted that no one factor adequately explains the divergence. There is no single knockout or standout reason that adequately captures the phenomenon of transatlantic dissonance. The reasons given in combination, however, may contain the explanatory force that, viewed individually, they lack. To American observers, the UK compared with the US, is often seen as unforgiving in its treatment of companies in financial distress and indeed a bankers' Valhalla where creditors exercise control over the corporate restructuring process.[127] It has been submitted that this characterisation is more a caricature and that the UK, far from being an outlier in terms of corporate governance/corporate insolvency structures among Anglo-Saxon economies, is more in the mainstream than the US. Nor are creditors bereft of influence in US corporate restructurings. Creditors in the US have acquired increased control through the terms of debtor-in-possession financing agreements.

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[127] See JL Westbrook 'A Comparison of Bankruptcy Reorganisation in the US with the Administration Procedure in the UK' (1990) 6 Insolvency Law and Practice 86.

5. The automatic stay – barring individual creditor enforcement actions

The automatic stay or moratorium on creditor enforcement actions is an intrinsic feature of both administration in the UK and Chapter 11 in the US.[1] Put simply, the commencement of administration or the initiation of the Chapter 11 process imposes a freeze on proceedings or executions against the company and its assets. This moratorium provides a breathing space during which the company has an opportunity to make arrangements with its creditors and shareholders for the rescheduling of its debts, and the reorganisation and restructuring of its affairs. In the US, the existence of the moratorium or stay has been rationalised as follows:[2]

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganisation plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

A secured creditor, along with anybody else affected by the statutory moratorium, may apply to have the stay lifted. This is the position both in the UK and in the US though, in the latter, there is a specific requirement of 'adequate protection' for the holders of property rights.[3] Examples of 'adequate protection' are provided in the legislation although the concept

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1 The stay on entry into administration is similar though more extensive in its effects than the stay that accompanies the commencement of liquidation (Insolvency Act 1986 s 130). The main difference is that, in a liquidation, actions by secured creditors are stayed whereas secured creditors are bound by the administration moratorium.

2 HR Rep No 595, 95th Cong, 1st Session 340 (1977) The statement continued: 'The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.'

3 S 361 US Bankruptcy Code.

itself is not defined.[4] In the UK, there is no such explicit requirement of adequate protection and it is inherent in the scheme of the legislation that the interests of secured creditors and other property interest holders should yield to the interests of creditors as a collective body.[5] As Nicholls LJ said in *Re Atlantic Computers plc*:[6]

> To the extent that the [statutory moratorium] precludes an owner of land or goods from exercising his proprietary rights, [it] does have an expropriatory effect. But that is provided for in unequivocal terms. The safety valve which Parliament has built into the system is the owner's ability to make an application to the court.

The US and UK differ about the factors that should be taken into account in deciding whether the stay should be lifted and whether a secured creditor be compensated for the delay in realising his collateral brought about by the stay. In general, protection for secured creditors and other holders of property rights is fairly explicit and specific in the US whereas in the UK matters are left largely to judicial discretion.[7]

This chapter looks at the statutory stay and considers when it should be lifted. Shining the spotlight on the automatic stay involves consideration of who should bear the costs of corporate reorganisation. Should it be the secured creditors, the unsecured creditors or shareholders in the ailing company? Normatively, what factors should be decisive in deciding whether secured creditors should be given permission to exercise their proprietary rights. Addressing these issues follows on from the discussion in Chapter 1 about the underlying objectives of corporate rescue law.

SCOPE OF THE STATUTORY STAYS

In the UK there has not been much theoretical discussion concerning the effect of the moratorium on property rights though there have been many judicial decisions clarifying the effect of the moratorium and setting out the principles for the exercise of property rights notwithstanding the moratorium. According to para 42 the stay applies to a company in administration. When an administration order takes effect, any administrative receiver of the company shall

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4 The examples given are cash payments, additional or replacement security interests on other property and, unusually expressed, something that will give the creditor the 'indubitable equivalent' of its security interest.

5 See generally David Milman 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue' [2004] Conv 89.

6 [1992] Ch 505 at 530.

7 *Re Atlantic Computers plc* [1992] Ch 505.

vacate office and moreover, any receiver of part of the company's property shall vacate office if the administrator requires this.[8]

By virtue of the stay

1. no resolution may be passed or order made for the winding up of the company though this does not apply to winding-up petitions on public interest grounds under s 124A Insolvency Act nor to winding-up petitions presented by the Financial Services Authority under s 367 Financial Services and Markets Act 2000;[9]
2. no steps may be taken to enforce any security over the company's property[10] or to repossess goods in the company's possession under any hire-purchase agreement[11] except with the leave of the court and subject to such terms as the court may impose; and or else with the consent of the administrator;
3. no legal process[12] may be instituted or continued against the company or its property except with the leave of the court and subject to such terms as the court may impose or else with the consent of the administrator;
4. where premises have been let to the company a landlord may not forfeit the lease by peaceable re-entry, save with the consent of the administrator or the consent of the court.[13]

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[8] There is also provision in broadly similar terms in para 44 for an interim moratorium and this begins to bite from the time that an administration application is presented. The interim moratorium is intended to ensure that the status quo is maintained and the company's business and assets are protected pending the outcome of the hearing. The operation of the moratorium is qualified in one case: if the administration application is presented at a time when there is an administrative receiver of the company, the moratorium applies only from the time when the appointor of the administrative receiver consents to the making of the order.

The interim moratorium is also brought into being by the filing of a notice of intention to appoint an administrator out of court either by a qualified floating charge holder or by the company or its directors.

[9] Schedule B1 para 42.

[10] Schedule B1 para 43(2).

[11] Schedule B1 para 43(3). Defined by para 111(1) as including conditional sale agreements, chattel leasing agreements and retention of title agreements.

[12] The proceedings in question are legal proceedings or quasi-legal proceedings such as arbitration: *Bristol Airport v Powdrill* [1990] Ch 744. This can include applications to industrial tribunals: *Carr v British International Helicopters Ltd* [1993] BCC 855. A 'legal process' requires the assistance of the court and therefore the service of a notice making time of the essence is not within this category: *Re Olympia and York Canary Wharf Ltd* [1993] BCC 154; *McMullen & Sons Ltd v Cerrone* [1994] BCC 25.

[13] Schedule B1 para 43(4). Under 11(3) Insolvency Act 1986 no steps could be taken to enforce any security over the company's property with security being defined as 'any mortgage, charge, lien or other security'. Although it was held in one case that

At the margins, however, there has been some degree of judicial uncertainty about exactly what proceedings are covered by the moratorium. There were certain dicta in *Air Ecosse Ltd v Civil Aviation Authority*[14] which suggested that the moratorium only caught proceedings where the plaintiff took on the role of creditor. This view was however rejected in *Re Rhondda Waste Disposal Ltd*[15] where the company operated a landfill site under the terms of a waste management licence. The Environment Agency served an enforcement notice on the company requiring it to comply with the terms of the licence and an injunction was subsequently obtained reflecting the terms of the notice. The company was then given a period in which to remedy the deficiencies but failed to do so and went into administration. The regulator then brought criminal proceedings and the question arose whether leave was required to commence or continue these proceedings. It was contended that for the purpose of the statutory stay, 'other proceedings' meant proceedings for the recovery of money or property. The court however, had no truck with this submission holding that no proceedings of any kind, criminal proceedings included, were to be permitted in the absence of leave. The Court of Appeal noted that other sections in the Act referred to criminal offences by the company, and if the intention had been to exclude criminal proceedings, there would have been a specific proviso to that effect. Furthermore, administration was intended to provide a short-term opportunity for a company to produce proposals for its creditors which it would then hopefully achieve. Such a purpose could be frustrated if criminal and civil proceedings were permitted to proceed unhindered. Public policy also provided support for the view that leave should be required for criminal proceedings having regard to the wide range of potential offences and the fact that a prosecution might prove detrimental to the interests of creditors. It was suggested that the court concerned with the administration was uniquely placed to balance the arguments in relation to the grant of leave. Nevertheless, on the particular facts of the case, and having regard to the serious and longstanding nature of the breaches involved, it was held that the interests of the company's creditors should not override all other considerations. Leave for the continuation of the criminal proceedings was therefore granted.

'security' for the purposes of relevant provisions of the Insolvency Act 1986 included a landlord's right to forfeit a lease (*Exchange Travel Agency v Triton Property Trust* [1991] BCLC 396), this has not been followed in later decisions: *Razzaq v Pala* [1998] BCC 66; *Re Lomax Leisure Ltd* [1999] 2 BCLC 126. See also *Re Park Air Services plc* [2002] 2 AC 5. A right of re-entry was not security over a lease but simply a right to terminate the lease and restore the lessor to possession of his own property. The Insolvency Act 2000 extended the moratorium so as to catch a landlord's right of forfeiture by peaceable re-entry.

14 (1987) 3 BCC 492.

15 [2001] Ch 57.

On the other hand, the moratorium does not catch certain types of quasi-judicial or extra-judicial proceedings in the context of regulated industries.[16] For example, in *Re Railtrack plc*[17] it was held that the determination by the Rail Regulator of a statutory application for permission to use the railway network did not fall within the moratorium. It was suggested that the regulator was best placed to weigh up the competing demands by different companies to use the rail network and the fact that a particular company was in administration should not fetter or hinder the regulator in the exercise of its statutory powers. At least some implied gloss was put on the meaning of the phrase 'other proceedings'. Moreover, there was a difference in emphasis in terms of judicial reasoning from *Re Rhondda Waste Disposal Ltd*, where it was suggested that the court concerned with the administration was uniquely positioned to evaluate all the relevant considerations in adjudging whether to permit the institution or continuation of proceedings against a company in administration.

THE CHAPTER 11 STAY

Section 362(a) of the Bankruptcy Code sets out that the effect of the Chapter 11 stay in the US and its operation is broadly similar to that of the statutory moratorium in administration, though there are some differences in detail.[18] For instance, the stay does not cover criminal proceedings, which is a significant difference from the UK.[19] The current version of Chapter 11 also shows the effect of lobbying by special interest groups which has resulted in exemptions from the stay. These exemptions are difficult to justify or rationalise in the abstract and seem perhaps to be the product of political expediency. It should be noted however that s 362 merely establishes a set of presumptions. One can apply to have the stay lifted and the court may stay an action under s 105 even if the action is not automatically stayed under s 362.

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16 *Air Ecosse Ltd v Civil Aviation Authority* (1987) 3 BCC 492.

17 [2002] 1 WLR 3002. It should be noted that this case involved a company subject to a railway administration order under s 59 Railway Act 1993. The 'old' law on administration as set out in Part 11 Insolvency Act 1986 still applies to such companies and also applies to certain other categories of company particularly in the utilities sector – see s 249 Enterprise Act 2002. The effect of the statutory moratorium is still essentially the same however.

18 See generally Charles Jordan Tabb *The Law of Bankruptcy* (New York, Foundation Press, 1997) at pp 174–182.

19 Nevertheless, in *Re Rhondda Waste Disposal Ltd* [2001] Ch 57 leave to institute criminal proceedings was granted.

More generally, s 362(b)(4) exempts from the stay the commencement or continuation of an action or proceeding by a governmental entity to enforce such governmental entity's police or regulatory power. In other words, the corporate reorganisation process should not be permitted to interfere with the operation of essential governmental functions. This means that the public interest in furthering the common good presumptively outweighs the company's interest in being restored to profitable trading or the interests of creditors in enforcing their security promptly. Moreover, the onset of bankruptcy proceedings should not presumptively displace a regulator's rights to have a dispute arising out of the exercise of regulatory functions settled in a nonbankruptcy forum.[20] The exception applies where a governmental entity is suing a company to prevent or stop the violation of fraud, environmental protection, consumer protection, safety or similar police or regulatory laws or attempting to set damages for violation of such a law. The view is that corporate reorganisation proceedings should not, per se, excuse compliance with other laws in the absence of a compelling insolvency-specific justification. The same general idea is reflected in s 959(b) which provides that

> [A] trustee . . . appointed in any cause . . . including a debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

On the other hand, public bodies should not be able to use their special position under s 362 as a cover for obtaining preferential treatment as a creditor.[21] It has been held that the exception in s 362 should be given a narrow construction so as to permit public bodies to pursue actions to protect public health and safety and not to those that were designed to protect a financial interest. 'Congress certainly did not intend for bankruptcy to be either a haven for polluters or a license to pollute. Care must however be taken by the courts not to afford an unintended preference in the bankruptcy distribution to governmental environmental protection agencies acting in their status as a creditor.'[22]

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[20] See Douglas G Baird *Elements of Bankruptcy* (Foundation Press, New York, 4th ed, 2006) at pp 215–216.

[21] See the comment in the US Congress 'Since the assets of the debtor are in the possession and control of the bankruptcy court, and since they constitute a fund out of which all creditors are entitled to share, enforcement by a governmental unit of a money judgment would give it preferential treatment to the detriment of all other creditors' – HR Rep No 595, 95th Congress, Ist Session 343 (1977).

[22] See Tabb *The Law of Bankruptcy* at p 174.

GETTING THE STAY LIFTED – THE UK DISCRETIONARY APPROACH

In the UK, with the leave of the court or with the administrator's consent, security may be enforced, goods may be repossessed, and other legal processes may be instituted or continued notwithstanding the fact that the company is in administration. Under the old, substantially re-enacted provisions of the Insolvency Act 1986, there have been a number of test cases in which the courts have had an opportunity to spell out their approach to the granting of leave. The leading authorities are the decisions of the Court of Appeal in *Bristol Airport plc v Powdrill*[23] and *Re Atlantic Computer Systems plc (No 1).*[24] In the former case it was held that the exercise by an airport authority of its rights under the Civil Aviation Act 1982 to detain an aircraft for non-payment of landing charges constituted a 'step taken to enforce security' and thus came within the statutory moratorium. The court refused leave to enforce the security. Particularly telling factors against the airports were that none of the company's aircraft were on the runways at the commencement of the administration, and had only arrived there subsequently because of the administrator's decision to continue the business; the airports had acquiesced in the administrator's proposal to sell the business as a going concern, which detention of the aircraft would prevent; and the airports had benefited financially from the continuation of the business by the administrator because they had received payment of substantial fees. In other words, having supported the administration when it suited them, the airports could not later seek to enforce a right which was inconsistent with achieving the purpose of the administration.[25]

In *Powdrill*, the Court of Appeal accepted that its reasoning would extend to a case where the holder of an ordinary possessory lien or similar right was requested by an administrator to give up the chattels that were subject to the lien. Refusal to comply with the request would amount to a step taken to enforce security and would fall within the statutory moratorium. The court conceded that it would be practically inconvenient and costly if every lien-holder was forced to apply to court for leave but it was thought that these potential difficulties would be mitigated in practice by the administrator and the lien-holder agreeing the matter between themselves without the intervention of the courts.[26]

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23 [1990] Ch 744.

24 [1992] Ch 505.

25 [1990] Ch 744 at 767 per Browne-Wilkinson V-C.

26 Staughton LJ considered that the effect of the statutory moratorium should be kept carefully under review – [1990] Ch 744 at 772.

Re Atlantic Computer Systems plc (No 1)[27] decided the narrow point that where a company in administration has leased goods and then sub-leased the goods to customers, those goods nevertheless remain in the possession of the company for the purposes of the moratorium. The Court of Appeal, nevertheless, granted leave to the lessors and security holders to recover their property and enforce their security. The court also took the opportunity to state, in general terms, the approach of the court in leave applications.[28] These guidelines could assist administrators in deciding whether to grant consent themselves and this would assist in making applications to the court the exception rather than the rule.

It enunciated an underlying principle that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who have proprietary rights except to the extent that this may be unavoidable. The following factors should also be taken on board:[29]

1. The onus is on the applicant to establish a case for leave.
2. The moratorium is intended to assist in achieving the purposes of administration. If granting leave to the applicant is unlikely to impede those purposes, the leave should normally be given.
3. In other cases, the court should balance the legitimate interests of the applicant and the legitimate interests of the other creditors of the company.[30]
4. In carrying out the balancing exercise great importance is normally to be given to the proprietary interest of the applicant. Administration should not be used to prejudice those who were secured creditors or lessors at the commencement of the administration.[31]
5. It will normally be sufficient ground for the grant of leave if significant loss would be caused to the applicant by the refusal. But if substantially greater loss would be caused to others by the grant of leave, or loss which is out of all proportion to the benefit which leave would confer on the applicant, that may outweigh the loss to the applicant caused by a refusal.

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27 [1992] Ch 505.

28 Nicholls LJ also reflected however, that the range of circumstances in which leave might be sought would vary almost infinitely thus making guidelines inadequate, and noted that first instance judges in the Commercial Court had more practical experience of the procedure than Court of Appeal judges.

29 [1992] Ch 505 at 542–544.

30 For an example of the operation of this balancing process, see *Re Meesan Investments Ltd (Royal Trust Bank v Buchler)* [1989] BCLC 130.

31 Significantly, the airports in the Paramount Airways litigation (*Bristol Airport plc v Powdrill* [1990] Ch 744 were not in that position.

6. In assessing the respective losses, the court will have regard to matters such as: the financial position of the company; its ability to pay rental arrears and continuing rentals (or, in the case of security, to meet its obligations under its loans); the administrator's proposals; the period for which the administration order has been in force and is expected to remain in force; the effect on the administration if leave is given and on the applicant if it is refused; the end result sought to be achieved by the administration; the prospects of that result being achieved; and the history of the administration so far.
7. In considering these suggested consequences it will often be necessary to assess the probability of them occurring.
8. Other factors, such as the conduct of the applicant, may also be relevant.[32]
9. These conditions also apply to a decision to impose terms if leave is granted and to a decision whether to impose terms as a condition for refusing leave.[33] The latter scenario is illustrated by *Re Meesan Investments*,[34] where leave to enforce security was refused but the administrator was ordered to return to court in two months' time if the secured property had not been sold by then. The guidelines envisage refusal on terms becoming a common phenomenon.
10. Where the applicant is fully secured delay in enforcement is likely to be less prejudicial than where the security is insufficient.
11. Unless the issue can be resolved easily, it is not appropriate on a leave application for the court to resolve a dispute about the existence, validity or nature of a security which the applicant seeks leave to enforce. The court needs to be satisfied only that the applicant has a seriously arguable case.
12. Wrongful refusal by an administrator to allow an owner of goods to repossess them could render the administrator liable to pay compensation.[35]

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[32] As in the Paramount Airways litigation.

[33] There is no provision in paras 43 or 44 entitling the court to refuse leave on terms but this result can be achieved by the court giving directions to the administrator or in exercise of its control over the administrator as an officer of the court. It can also be achieved indirectly by ordering that the applicant shall have leave unless the administrator is prepared to do a particular thing or to take a particular step in the conduct of the administration.

[34] [1989] BCLC 130.

[35] *Barclay Mercantile Business Finance Ltd v Sibec Development Ltd* [1992] 1 WLR 1253. The basis of this jurisdiction is the administrator's position as an officer of the court. Whether an administrator could be liable for conversion was left open.

More recent cases have continued to apply the guidelines enunciated in *Atlantic Computers*. A case in point is *London Flight Centre (Stansted) Ltd v Osprey Aviation Ltd*[36] where Hart J refused to permit an aircraft repairer to enforce a lien against an aircraft belonging to a company in administration. It appears that the Enterprise Act 2002 was not intended to change existing law on leave to exercise proprietary rights and that the courts should still carry out this balancing exercise on a case-by-case basis. On the other hand, while the Enterprise Act is respectful of proprietary rights, an argument could be made that, having regard to the overall thrust of the legislation, a slightly different emphasis could be placed on the various factors that make up the *Atlantic Computers* equation. Administrations should be shorter under the new procedure – carried out quickly and efficiently to paraphrase Schedule B1 para 4. In these circumstances it seems less of an injustice that an owner of goods should be shut out from exercising its proprietary rights during the entirety of the administration period.

GETTING THE STAY LIFTED – ADEQUATE PROTECTION FOR HOLDERS OF PROPERTY RIGHTS IN THE US

Instead of the discretionary case-by-case approach that prevails in the UK there are firmer statutory safeguards in the US. Section 362(d) of the Bankruptcy Code provides that a 'party in interest' may apply to have the stay imposed as part of the reorganisation process lifted for cause, including the lack of adequate protection of an 'interest in property'. There are many legislative and judicial statements to the effect that secured creditors should not be deprived of their bargain.[37] The property in question may be necessary for use by the company in the reorganisation process but the interest of secured creditors and other property rights holders should be protected during this period. In particular, holders of proprietary rights should be protected against the risk that their property may depreciate in value during the currency of the reorganisation process. A secured creditor's property interest is not adequately protected if the security is depreciating during the term of the stay.

In *Re Bermec*[38] judicial notice was taken of the deep concern of secured creditors lest their security depreciate beyond adequate salvage. On the other hand, the court said that this had to be balanced with the legislative mandate

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36 [2002] BPIR 1115. See generally David Milman 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue' [2004] Conv 89. See also *AES Barry Ltd v TXU Europe Energy Trading* [2005] 2 BCLC 22.

37 See HR Rep No 595, 95th Congress, Ist Session 339 (1977).

38 (1971) 445 F2d 367.

to encourage attempts at corporate reorganisation where there is a reasonable possibility of success. The objective of the adequate protection requirement is to leave a secured creditor with an alternative means in value of essentially what was bargained for. It appears that the US Congress left the concept deliberately vague so as to facilitate 'case-by-case interpretation and development. It is expected that the courts will apply the concept in light of [the] facts of each case and general equitable principles.'[39]

This point has been picked up in subsequent judicial interpretations. A leading case is *In re Alyucan Interstate Corp*[40] where the court said:

> Congress was aware of the turbulent rivalry of interests in reorganisation. It needed a concept which would mediate polarities. But a carefully calibrated concept, subject to a brittle construction, could not accommodate the indefinite number of variations possible in dealings between creditors and debtors. This problem required, not a formula, but a calculus, open-textured, pliant and versatile.

Section 361 provides three examples of ways in which adequate protection may be given: (1) periodic cash payments; (2) additional or replacement liens; (3) other relief amounting to the indubitable equivalent of the person's interest in the property. It is also specifically stated that administrative expense priority is not an acceptable means of adequate protection. Such a manner of protection was considered too uncertain to be meaningful.[41] Elevating a claim to administrative expense status means that it will rank before the unsecured creditors but after secured creditors at the plan confirmation stage. Section 507(b) in fact confers super-priority administrative expense status as back-up protection to a secured creditor who had been given an approved method of adequate protection that subsequently turned out not to be adequate in fact. There is however some ambiguity about the relationship between this provision and s 503(b) which appears to cap administrative expense claims to the value of any benefits gained by the company undergoing reorganisation.

The uncommon terminology of 'indubitable equivalence' comes from *Re Muriel Holding Corp*[42] where Judge Learned Hand said with reference to a proposed reorganisation plan:

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39 See HR Rep No 595, 95th Congress, Ist Session 339 (1977).

40 (1981) 12 BR 803 at 805.

41 S Rep No 989, 95th Congress, 2d Session 54 (1978) and see generally the discussion in Charles Jordan Tabb *The Law of Bankruptcy* (New York, Foundation Press, 1997) at p 193. Another example of adequate protection would be where a financially very well endowed third party provides a guarantee.

42 (1935) 75 F2d 941 at 942.

> Interest is indeed the common measure of the difference [between payment now and payment 10 years hence], but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.

ADEQUATE PROTECTION AND THE MAINTENANCE OF A SECURITY CUSHION

It has been argued that as part of the 'adequate protection' criterion a secured creditor is entitled to have an equity cushion remain in place.[43] For example, a secured creditor who insisted in the security agreement that the value of the collateral should be 120 per cent of the value of the debt might contend that the reference in s 361(3) to preserving the indubitable equivalent of its interest in such property would mean that the ratio of collateral to debt would be maintained during Chapter 11. The argument for this is that the secured creditor is entitled to the benefit of his bargain and an integral part of that bargain is the equity cushion itself, i.e. the creditor bargained for the value of that collateral to remain a safe percentage above the amount of the debt in the reorganisation period. Initially, the argument received a degree of judicial acceptance, with courts sympathetic to the view that the maintenance of a certain collateral-to-debt ratio as part of the creditor's property interest warranted protection. Ultimately however, this view was rejected in *Re Alyucan*[44] where the court holding that the interest in property entitled to protection was not measured by the amount of the debt but by the value of the secured property. If the value of the creditor's collateral position was not threatened, then adequate protection was not necessary. Moreover, the court also said that the equity cushion could itself be regarded as adequate protection for the secured property. As one commentator acidly observes, a vigilant creditor is forced to devour his own collateral but a prodigal son who had allowed his collateral to shrink to the amount of the debt was entitled to new security as adequate protection.[45]

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43 See James J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139 at 146.

44 (1981) 12 BR 803.

45 See James J White 'Death and Resurrection of Secured Credit' at 146.

PROPERTY NOT NECESSARY FOR AN EFFECTIVE REORGANISATION

According to s 362 where the stay relates to acts against property, relief may be granted where (a) the debtor does not have any equity remaining in the property and (b) the property is not necessary for an effective reorganisation. In the *Inwoods* case[46] the US Supreme Court used this provision to give a very firm judicial push in the direction of a speedier reorganisation process.[47] The Supreme Court said that once the creditor establishes that the debtor has no equity in the collateral, the debtor has the burden of establishing that the collateral is necessary to an effective reorganisation. What this requires is not merely a showing that if there is conceivably to be an effective reorganisation, this property will be needed for it, but that the property is essential for an effective reorganisation that is in prospect. This means that there must be a reasonable possibility of a successful reorganisation within a reasonable time.[48]

Proof that the company lacks an equity of redemption in the property is a necessary but not sufficient condition for obtaining relief from the stay. If the company fails to show either that the property is necessary or that a successful reorganisation is a realistic possibility, then the secured creditor should be given permission to realise the secured property. In almost every Chapter 11 case, the company needs to retain and use its property if it is to have any chance at all of reorganising. While the necessity of the use of the property for this purpose is usually self-evident, the feasibility of a successful reorganisation may be hotly debated. The court will require actual evidence on the

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[46] *United Timbers Association of Texas v Timbers of Inwood Forest Associates Ltd* (1988) 484 US 365.

[47] For criticism of the pre *Inwoods* state of affairs see Douglas G Baird and Thomas H Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi L Rev 97 at 126–127: 'A Chapter 11 proceeding typically buys time for the managers, the shareholders, and other junior owners at the expense of the more senior ones. . . . Bankruptcy judges sometimes seem inclined to do little to remedy this state of affairs. A few seem to show either an inability or unwillingness to comprehend the possibility that secured credit may be something more than a perverse and unfair creature of state law that should be thwarted at every possible turn. Even more remarkable is their wonderful capacity for hope, their unshakeable faith that given time, the firm's ship will come in. Often, bankruptcy judges seem to think that markets systematically undervalue firms that have filed petitions in bankruptcy. A bankruptcy judge may insist that he, not the market, is the best one positioned to set a value on a firm in distress, even though year after year in case after case his valuations prove wildly inflated.'

[48] (1988) 484 US 365 at 375–376.

prospects of reorganisation rather than merely a statement of the company's hopes and dreams for a better future.[49] A secured creditor also might be able to prevail on the feasibility issue if it can prove that legally the company will never be able to confirm a plan of reorganisation since it will not be able to obtain the required consents.

COMPENSATION FOR LOSS OF THE USE OF PROPERTY

In *Re Atlantic Computers*[50] it was made clear that in the context of the 'old' administration procedure, there is no 'expenses of administration' principle similar to an 'expenses of liquidation' principle. In other words, an owner of equipment leased to a company in administration and who is precluded from recovering possession of the equipment by virtue of the statutory moratorium cannot insist on payment of the rental amounts during the currency of the administration as an expense of the administration. Nicholls LJ said that there was no place for comparable hard-and-fast principles. He drew a fundamental distinction between liquidation and administration. In the case of the former, the company had reached the end of its life whereas administration was intended only as an interim and temporary regime. He spoke of flexibility and suggested that rigid principles would 'be inconsistent with the flexibility that, by giving the court a wide discretion, Parliament must have intended should apply'. Nicholls LJ recognised that 'if a lessor or owner of goods is not to have any such automatic priority, this will be a powerful factor in favour of leave being granted to him to enforce his proprietary rights. So be it.'[51]

Given that *Re Atlantic Computers* is a decision on the old administration procedure, its continued application in the new statutory environment may be questioned. Although there is no direct word-for-word correspondence, Schedule B1 paras 99(3) and (4) are broadly speaking the equivalent of ss 19(4) and (5) effectively. In *Centre Reinsurance International Co v Freakley*[52] Lord Hoffmann explained that subs (4) deals with claims against the company by the administrator himself and subs (5) deals with claims against the company by third parties. He went on to say that claims by the administrator may be either for remuneration or for expenses, i.e. for goods and services supplied to the company for which the administrator has paid or chosen to make himself liable but for which he has not yet reimbursed himself out of the company's assets. Subs (5), on the other hand, was concerned with debts and

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49 See *Pegasus Agency Inc v Grammatikakis* (1996) 101 F 3d 882.
50 [2002] Ch 505 at 534. See also *Re Salmet International Ltd* [2001] BCC 796.
51 [2002] Ch 505 at 52.
52 [2007] Bus LR 284.

liabilities incurred by the administrator which have not been discharged and which were incurred under contracts entered into by the administrator in the execution of his functions.

The *Freakley* case does not seem to affect the analysis in *Atlantic Computers* unduly but something of a spanner is thrown in the works by the new Rule 2.67 of the Insolvency Rules, which has no counterpart under the old administration regime. Rule 2.67 defines what constitutes an expense of the administration. The recent decision in *Re Trident: Exeter City Council v Bairstow*[53] seems to imply that if something comes within Rule 2.67 it counts as an expense of administration but not if it falls outside Rule 2.67. The courts have no discretion in the matter. Rule 2.67 in general terms mirrors Rule 4.218 of the Insolvency Rules which sets out what constitutes an expense of liquidation, and Rule 2.67 was given the same interpretation as Rule 4.218 in *Exeter City Council v Bairstow*. In particular, the court specifically approved and applied the leading case *Re Toshoku Finance (UK) plc*.[54] Among the items listed in Rule 4.218 are 'any necessary disbursements' by the liquidator, and it was held by the House of Lords in *Re Toshoku Finance* that the liability to corporation tax constituted a 'necessary disbursement' by the liquidator since it was a sum which, by statute, was payable by a company in respect of profits or gains arising during a winding up. It came within Rule 4.218 and that was the end of the matter. According to Lord Hoffmann, Rule 4.218(1) was intended to be a definitive statement of what counted as an expense of the liquidation. The heads of expense listed in Rule 4.218(1) were not subject to any implied qualification. It had been argued that Rule 4.218(1) created only an outer envelope within which expenses were contained, i.e. it was necessary to come within Rule 4.218(1) to count as a liquidation expense but that was not sufficient. But the House of Lords categorically rejected this proposition. A liability to pay tax counted as a liquidation expense even though it represented no benefit to the company and in fact constituted a drain on the company's resources. By the same process of reasoning, a liability to pay business rates in respect of premises occupied by a company in administration was held to constitute an expense of administration under Rule 2.67 in *Exeter City Council v Bairstow.*[55] The court said that so far as the nature of a company's

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53 [2007] BCC 236. For a critical discussion of the implications of this decision see Gabriel Moss 'Rescue Culture Speared by Trident' (2007) 20 Insolvency Intelligence.

54 [2002] 1 WLR 671.

55 [2007] BCC 236. The court rejected an interpretation that limited the application of Rule 2.67 to situations where the administrator made a distribution to creditors, i.e. to cases where administration served as a 'liquidation substitution'.

liability for corporation tax or rates is concerned, there was no distinction between a company in liquidation and a company in administration.

The question arises whether *Exeter City Council v Bairstow* signifies the end of the discretionary approach towards administration expenses enunciated in *Atlantic Computers*. In other words, rental payments in respect of hired goods in the company's possession are either properly classed as expenses of administration or they are not. It is submitted, however, that there is still room for a discretionary approach. After all, in *Re Toshoku Finance* the House of Lords did not cast any aspersions on the *Re Lundy Granite Co*[56] line of authority. In these cases the courts had expanded the concept of 'liquidation expenses' to include liabilities incurred before the liquidation in respect of property afterwards retained by the liquidator for the benefit of the insolvent estate, including continuing rent or hire purchase charges in respect of land or goods in the possession of the company which the liquidator continues to use for the purposes of the liquidation.[57] This seems to suggest that everything on the expenses front is not open or shut for the purposes of Rule 4.18 and, by analogy, for Rule 2.67.

In the US, there are special statutory rules protecting property owners where a company is the lessee of property and is now undergoing reorganisation.[58] In such a situation, the company may assume or reject the unexpired lease, or indeed an executory contract more generally, at any time before confirmation of a reorganisation plan.[59] The court, however, on the request of any party to such a lease or contract, may order that the determination to

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[56] (1871) LR 6 Ch App 462.

[57] *Re Lundy Granite Co* (1871) LR 6 Ch app 462; *Re International Marine Hydropathic Co* (1884) 28 Ch 470; *Re Oak Pits Colliery Co* (1882) 21 Ch D 322.

[58] This point was noted by Julian Franks and Walter Torous 'Lessons from a Comparison of US and UK Insolvency Codes' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) 450 at p 463: 'in chapter 11 . . . payments on financial leases must continue to be paid in reorganization even though interest and repayments on other debts are stayed. In comparison, in administration such payments can be suspended by the court. As a result, financial leases may be more attractive to lenders in the United States than other types of debt and may be preferred by lenders.'

[59] S 365. Amendments made by the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 have significantly strengthened the position of landlords of nonresidential real property occupied by debtors in possession. For critical comment on the amendments see William D Warren and Daniel J Bussel *Bankruptcy* (New York, Foundation Press, 7th ed, 2006) at p 320: 'Absent striking a deal with their landlords, those debtors may be forced to prematurely assume or reject their leases of nonresidential real property. Premature rejection may result in unnecessary store closures and impair reorganization. Premature assumption may result in potentially catastrophic administrative liabilities in the event the reorganization fails.'

assume or reject should be made within a specified period.[60] The effect of assumption of the lease means that the rental payments become entitled to administrative expense priority.[61] If the 'Chapter 11 company' is in default of its obligations at the time of assumption, it must cure the default or provide adequate assurance of prompt cure; compensate the other contracting party for any actual pecuniary loss resulting from the default, or provide adequate assurance of prompt compensation; and finally, provide adequate assurance of future performance under the contract.[62]

As far as property owners are concerned, the position is less satisfactory with respect to payments due in the limbo period prior to assumption or rejection. A leading authority is *In re Thompson*[63] where the court said:

> When a lease is ultimately rejected but its interim continuance was an actual and necessary cost and expense of the estate, the allowable administrative expense is valued not according to the terms of the lease . . . but under an objective worth standard that measures the fair reasonable value of the lease. . . . The rent reserved in the lease is presumptive evidence of fair and reasonable value . . . but the presumption may be rebutted by demonstrating that the reasonable worth of the lease differs from the contract rate. . . .

The position of lessors was strengthened somewhat by 1984 amendments to the Bankruptcy Code which require companies to make, on a timely basis, rental payments which become due 60 days or more after the company enters Chapter 11.[64] The court however can order otherwise 'based on the equities of the case' and the legislation is silent about the status of rental payments that fall due within the 60-day grace period.

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60 S 365(d)(2).

61 See the comments of US Circuit Judge Calabresi in *Re Klein Sleep Products Inc* (1996) 78 F3d 18. 'Bankruptcy law also aims to avoid liquidation altogether when that is possible. Although the Code offers no magical potion to restore a debtor's financial health, it does provide some useful medicine designed to help a debtor get back on its feet and heading towards convalescence. It does this by allowing a debtor to attempt to reorganise rather than fold and by creating incentives for creditors to continue to do business with the debtor while reorganisation proceeds. The Code does this, at least in part, by assuring these post-bankruptcy creditors that, if the debtor fails to rehabilitate itself and winds up in liquidation, they can move to the front of the distributive line, ahead of the debtor's pre-bankruptcy creditors. Special priority is therefore accorded to expenses incurred under new contracts with the debtor, as "administrative expenses" of the estate. The same priority is given to expenses arising under pre-existing contracts that the debtor "assumes" – contracts whose benefits and burdens the debtor decides, with the bankruptcy court's approval, are worth retaining.'

62 S 365(b)(1)(C).

63 (1986) 788 F2d 560 at 563.

64 S 365(d)(10).

NO INTEREST FOR UNDERSECURED CREDITORS AS PART OF THE ADEQUATE PROTECTION CRITERION

Section 506 of the US Bankruptcy Code allows interest for oversecured creditors out of their security cushion. Such interest payments are entitled to administrative expense status to the extent of the security cushion and must be paid in full at the plan confirmation stage. In *United Savings Association of Texas v Timbers of Inwood Forest Associates Ltd*[65] the Supreme Court addressed the question whether the adequate protection provision entitled an undersecured creditor to compensation for the delay caused by the Chapter 11 stay in enforcing the security. In effect, the undersecured creditor wanted to be paid interest, albeit computed with respect to the value of the collateral, rather than the value of the principal debt. In the past, more than now, Chapter 11 cases were often characterised by lengthy delays and, if time-value compensation is denied, then the company, in effect, has an interest-free loan for the duration of the reorganisation.[66]

It was argued in *Inwoods* that the secured creditor's 'interest in property' was entitled to adequate protection and that the right to enforce the security immediately was one of the bundle of rights that made up the secured creditor's interest. Secured creditors should not be deprived of the benefit of their bargain. The bargain was that, upon the debtor's default, the creditor could immediately take possession of the collateral, sell it and reinvest the proceeds. The Supreme Court however, took the view that, while the phrase 'interest in property' lacked a dispositive plain meaning, statutory interpretation was a holistic endeavour. To grant an undersecured creditor compensation for lost time value would have the same economic effect as allowing interest and this would render the carefully drawn rules in the Bankruptcy Code largely superfluous. It was suggested that if the Bankruptcy Code had meant to give the undersecured creditor interest on the value of his collateral then this would have been set forth clearly and not obscured within the adequate protection provision. It did not comport with commonsense that undersecured creditors should be favoured with interest if they moved for it under s 362(d) at the inception of the reorganisation process – with the possible result of pushing the company into liquidation – but not if they refrained from this step and sought interest only on completion of the reorganisation. The court rejected as

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65 (1988) 484 US 365.

66 See generally Douglas G Baird and Thomas H Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi L Rev 97; Raymond T Nimmer 'Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness' (1983) 68 Minnesota Law Review 1.

implausible the theory that s 506 merely offered duplicate protection to over-secured creditors. Historically, US bankruptcy law took the view that it was inequitable and unfair to allow an undersecured creditor to recover interest from the company's unencumbered assets before unsecured creditors had recovered any principal.[67]

In effect, the Supreme Court was recognising that a rule compensating secured creditors for the interim loss of their collateral might make it more difficult for ailing companies to reorganise and unsecured creditors might find their share of the insolvency estate reduced if liquidation subsequently followed.

A US–UK COMPARISON AND EVALUATION

The consensus view in both the US and UK seems to be that to allow recovery procedures by creditors to operate without restraint could frustrate the overall socially desirable goal of rescue. Since going-concern value may be a lot more than break-up value, reorganisation proceedings are designed to keep a business alive so that this additional value can be captured. These legislative goals will be compromised, however, if creditors are able to seize assets that are essential to the carrying on of the company's business Consequently, we have a stay or moratorium on actions by creditor to collect debts or repossess property that is in the ailing company's possession. The officially sanctioned rescue strategy seems to be founded upon a utilitarian premise that the interests of a few may need to suffer in the service of the needs of the many and that this premise is transformed into a legal mechanism through the moratorium.[68]

Property rights are sacrificed to a degree but, at the same time, protected to a degree. In the US, there is an unambiguous statutory statement that secured creditors are entitled to receive 'adequate protection' of their proprietary rights. Moreover, relief from the stay is available where the property is not needed for a successful reorganisation. The view expressed by Lord Nicholls in *Atlantic Computers*[69] that property that is not needed in the administration should be released to the owner mirrors the US position, though the language in which his statement of principle is cast is somewhat different. Otherwise, Lord Nicholls calls for a balancing exercise between proprietary rights and the socially desirable goals of administration. Strong weight, however, should

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67 See (1988) 464 US 365 at 372–374.

68 See generally David Milman 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue' [2004] Conv 89.

69 [1992] Ch 505.

normally be accorded to proprietary rights and that only where disproportionate loss would be caused to unsecured creditors by the exercise of proprietary rights should such exercise be stayed. There is nothing specific about compensating secured creditors for a decline in the value of the secured property during the administration period though, no doubt, this would be factored into the equation in an appropriate case. Lord Nicholls did say that in other cases, additional factors might be relevant.

Clearly, one's views on the purposes underlying corporate reorganisation law will shape one's views of the statutory moratorium and whether the holders of proprietary rights should be compensated for the delay in enforcing their property rights brought about by the moratorium. A strict supporter of the principle that pre-insolvency entitlement should be upheld absolutely would answer that holders of proprietary rights should undoubtedly be compensated in full.[70] Supporters of more inclusive theories of insolvency law would respond that the question must depend on a complex of different factors including the length of the stay, the immediacy of the prospect of corporate rehabilitation, the necessity for use of the property and the impact on other creditors. This, broadly speaking, is the UK position. US law has a tighter, more clearly defined requirement of 'adequate protection'.

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[70] See Jackson *Logic and Limits of Bankruptcy Law* (Cambridge, MA, Harvard University Press, 1986) at p 189: 'A rule that forces general creditors and shareholders to give secured creditors the full value of their claims (including compensation for the time value of money) imposes the cost of a decision to reorganize the firm entirely on the junior classes, who already stand to benefit if the firm succeeds. As a consequence, they have incentives that approximate those of a sole owner, and their decision about how to deploy the debtor's assets will not be distorted by self-interest.'

6. Financing the debtor

As we have seen in previous chapters, the Enterprise Act 2002 radically redesigned the administration procedure into a more avowedly corporate rescue-oriented process. We have also noted that the Enterprise Act borrows from overseas models, including the US model, but it is not a direct transplant. A major feature of the US system, but not directly replicated in the Enterprise Act, is a mechanism for the financing of companies in financial difficulties.[1] New finance is often critical to the survival of the business of the company. Unless such finance is available from some source, the assets of the company may have to be sold on a piecemeal basis and the company will be forced into liquidation. The DTI review of company rescue and mechanisms that preceded the Enterprise Act suggested that new secured finance is only available to support a rescue procedure in the UK where the existing secured creditors agree, or where there are unsecured assets or sufficient equity in secured assets. During the parliamentary debates, the government resisted an amendment that would have created a statutory framework for super-priority financing after the administration process has commenced.[2] It was wary of creating a situation that would essentially guarantee a return to lenders advancing funds on the basis of such priority irrespective of the commercial viability of the rescue proposals. In its view, the issue of whether to lend to a company in administration was a commercial one that was best left to the commercial judgement of the lending market. A lender might take into account the viability of the rescue proposals and the availability of free assets to serve as collateral, amongst other things. It would also be inappropriate to attempt to replicate the Chapter 11 provisions in the UK where the business culture and economic environment are quite different.

Provision for super-priority new financing is, however, increasingly a feature of model insolvency laws and this paper will ask whether the Enterprise Act was deficient in failing to make explicit provision in this

[1] Referred to as 'DIP' financing or 'debtor-in-possession' financing in the United States.

[2] See House of Lords parliamentary debates for 29 July 2002 and the discussion in Stephen Davies ed *Insolvency and the Enterprise Act 2002* (Bristol, Jordans, 2003) at pp 20–26.

regard.[3] The chapter looks at the perceived merits of super-priority new financing during a corporate restructuring process and at the international consensus pertaining to the same. The relevant US provisions are then examined in detail. Finally, the chapter considers the possible scope for a creative interpretation of the UK legislation that would address financing difficulties. Developments in Canada, as well as in Ireland, are considered in this connection for potential guidance.

MODEL INSOLVENCY LAWS AND SUPER-PRIORITY NEW FINANCING

The underlying principle behind restructuring or reorganisation proceedings is that a business may be worth a lot more if kept alive or even sold as a going-concern than if the parts are sold off piecemeal. Once reorganisation proceedings are commenced, however, the debtor's existing lender or lenders may terminate the company's access to funds so as to limit any further exposure. The company, if it is to avoid liquidation and preserve the going-concern value of the business, will need to find a way of financing its operations until a satisfactory arrangement with creditors can be negotiated and approved.

New lenders however have no great incentive to lend since the company is in difficulties and, by definition, any loan will run the risk of not being repaid in full.[4] Moreover, corporate assets may be secured up to the hilt by existing lenders. These existing lenders may be very reluctant to increase their exposure, or only prepared to do so at an exorbitantly expensive price. As a response to this situation, the law in some countries permits lenders to make new financing available on a super-priority basis. These provisions may allow the company's existing lender, or a new lender, to advance fresh funds that will have to be repaid in priority over all other claims. New priority financing will provide the company with a cash injection, though usually at higher interest rates than would be charged if the company were carrying on business as normal, so as to fund continued operations during the restructuring process.[5]

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[3] See the comment in Stephen Davies ed ibid at p 20: 'Anecdotally, it has been said that, during the preparation of the proposals and the Bill, more time was spent by the Insolvency Service and those whom they consulted considering the vexed question of how administrations would be funded than any other single topic. The assumption is that the topic proved too difficult because neither the White Paper nor the Bill made any provision for funding administrations.'

[4] See generally George G Triantis 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 Vand L Rev 901.

[5] Professor James J White in 'Death and Resurrection of Secured Credit' (2004)

Matters are relatively straightforward where there are unencumbered corporate assets or alternatively, sufficient value in the secured property to serve as security for a new loan. Major difficulties can arise when there is no surplus value that can be 'collateralised' by a fresh provider of funds. Should the legislation permit the priority claims of existing lenders to be overridden or 'primed'? An argument to the contrary points to the risks of creating instability and uncertainty in the credit marketplace. Existing credit lines could dry up/slow down to a trickle or be priced more expensively if lenders found their traditional priorities subverted by a 'new kid on the block' in the shape of a super-priority new financier.[6]

On the other hand, substantial existing indebtedness may militate against a new lender's willingness to extend credit to a company through funding profitable business opportunities and, in this way, enhancing the overall value of the debtor's estate.[7] The most obvious solution is to offer priority treatment to the new lender.[8] 'Old' lenders, however, may be prepared to continue to finance the debtor company possibly to ensure that the secured property retains its value. Unsecured, or undersecured, old creditors may be prepared to lend out of a wish to cross-collateralise the unsecured portion of the debt.

It is not inconceivable that a completely new lender may emerge on the scene during the debtor-reorganisation process. In the main, banks are looking for a low-risk, high-yield venture and debtor-reorganisation financing (DIP financing in the US) is a prime candidate. Chemical Bank led the way in DIP financing by starting a specialist DIP financing unit in 1984 and at one stage, many years into its operations, it suggested that it had 'never lost a penny' on this form of financing.[9] DIP lending can be extremely lucrative because to compensate the bank for the extra risk entailed by the loan, the interest rate may be considerably higher than for ordinary loans. There may also be large transactional fees levied by the bank in connection with the provision of such financing and a bank that helps out a company in trouble may gain a valuable

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12 American Bankruptcy Institute Law Review explains at fn 142 that sometime 'between 1990 and 1995 several lenders came to understand that DIP financing was relatively safe and quite profitable. As the market developed and became more mature, the rates that had been 400 to 600 basis points or more over prime, dropped.'

6 Moreover, it could be argued that an ailing company's inability to obtain new money is not necessarily a shortcoming of the credit markets for if a business is no longer viable then the most sensible solution is to shut it down.

7 See generally Barry E Adler 'A Re-Examination of Near Bankruptcy Investment Incentives' (1995) 62 U Chicago L Rev 575.

8 Bruce A Henoch 'Postpetition Financing: Is There Life After Debt?' (1991) 8 Bankruptcy Developments Journal 575.

9 See generally Darla D Moore 'How to Finance a Debtor in Possession' (1990) 6 Com Lending Rev 3, 8; Joseph U Schorer and David S Curry 'Chapter 11 Lending: An Overview of the Process' (1990) The Secured Lender 10 at 12–13.

relationship when the company emerges from the reorganisation process. As one commentator points out:[10]

> several institutions have developed a reputation and expertise as DIP lenders. . . . Usually, however, if a large bank has extended secured credit to the debtor, it will wind up as the DIP lender as well. There are exceptions to this rule, however, as [some banks] will often go hunting for the opportunity to become the DIP lender.

Many law-and-economics scholars see super-priority new financing as being necessary to resolve 'debt overhang', i.e existing assets being fully secured, and to cure 'underinvestment' problems, i.e. lack of incentives to finance value-generating projects.[11] For instance, in order to gain priority over an existing security interest under s 364(d) of the US Bankruptcy Code the debtor and the new lender must show that the existing security interest is adequately protected.[12] The role of the 'adequate protection' protection requirement is to ensure that the new lending creates new value by implementing what welfare economics calls a Pareto-efficient change.[13] That is an improvement in the pay-off to unsecured creditors while preserving the value of secured creditor rights.[14] The typical debtor has little cash and very few unencumbered assets. Therefore, it cannot easily provide adequate protection unless it demonstrates to the court that its continued operations will create new value. Thus the courts are often called upon to assess the viability of the purpose behind the proposed financing.

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10 See James J White 'Death and Resurrection of Secured Credit' 139 at fn 143.

11 See generally George G Triantis 'A Theory of the Regulation of Debtor-in-Possession Financing' 901 and see the paper prepared by George Triantis for the Corporate Law Policy Directorate of Industry Canada 'Law and Economics of Debtor-in-Possession Financing' – available on the Industry Canada website www.strategis.gc.ca/.

12 The US Bankruptcy Code sets out an adequate protection requirement in several instances when the interests of secured creditors are threatened other than by the grant of senior or equal security interests in existing collateral; for example, by the automatic stay on creditor enforcement proceedings during the bankruptcy process or by the use of collateral by the debtor.

13 See generally on different measures of economic efficiency B Cheffins *Company Law: Theory, Structure and Operation* (Oxford, Oxford University Press, 1997) at pp 14–15; Rizwaan Jameel Mokal *Corporate Insolvency Law: Theory and Application* (Oxford, Oxford University Press, 2005) at pp 20–26.

14 It has been explained that priming security interests are granted most often in two types of cases. The first is where the debtor has a sizeable equity cushion that is sufficient to cover both the priming security interest and the primed security interests. The second is where the debtor persuades the court that the new money will enable the debtor to enhance the value of the collateral so that both security interests will be fully secured – see Charles Jordan Tabb *The Law of Bankruptcy* (New York, Foundation Press, 1997) at pp 794–795.

Professor Triantis argues that the concession of super priority may be less necessary in the case of existing creditors with substantial exposure to the debtor who are called upon to provide new financing:

> borrowing from a lender with existing exposure to the debtor may mitigate to some extent the underinvestment problem even if that lender is given no priority. A couple of other factors reinforce this result. First, given their prior relationship with the borrower, prepetition lenders have lower costs of screening new loan applications than outside lenders. Second, organizational behaviourists have demonstrated that executives often make investment decisions in ways that justify their previous choices, irrespective of expected outcomes. As a result, executives have a tendency to escalate their commitment to a cause or a course of action even if it is not cost-effective.[15]

Professor Triantis suggests that optimal investment incentives are created when the priority of the later creditor is limited to the value that is created by means of its capital contribution.[16] He suggests a trade-off between allowing profitable opportunities to be exploited and deterring investment in unprofitable ventures. A solution is to provide for later-in-time priority that is project based. On this model, the later lender would enjoy priority with respect to the pay-off from the new project and either would have no recourse to, or remain subordinate with respect to, the other corporate assets. Project financing of this sort, with restricted priority, is the functional equivalent of spinning off the profit-making opportunity to a new and separately financed company. The ability of the parties to carve out an 'efficient' later-in-time priority nevertheless, depends on the ease with which the later lender's priority can be linked to the value created by its contribution. This is easiest to accomplish if the later lender funds the purchase or manufacture of a discrete asset and most difficult if the later lender finances expenses such as labour or electricity that enhance the value of existing assets.[17] In the US context, bankruptcy judges are called upon to make frequent valuations of assets and, in this process and where feasible to do so, it is suggested that the courts should carve out the value added to existing assets by new lending and to limit the priority element of the new lending ex post to that portion alone.[18]

The empirical evidence tends to suggest that positive benefits accrue from creating a framework for the financing of companies during the course of reor-

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15 See Triantis 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 Vand L Rev 901 at 924.

16 Triantis ibid at 924–925.

17 See George Triantis 'Law and Economics of Debtor-in-Possession Financing' (1999) at 6.

18 Ibid at 10.

ganisation proceedings. One Business School study examined the reorganisation plans of a sample of large Chapter 11 cases with DIP financing, and other cases without DIP financing, that entered the bankruptcy process in the US in the period 1986–1997.[19] It was found that successful reorganisations benefited from DIP financing despite DIP firms being more 'solvent' prior to filing for Chapter 11.[20] DIP financing did not seem to affect significantly creditor-recovery rates nor deviations at the reorganisation plan confirmation stage from the principle of respecting the priority of pre-insolvency entitlements. Nevertheless, the size of DIP financing did impact positively on recovery rates. DIP financing was associated with the greater probability of a successful reorganisation, thus favouring larger recovery rates. The positive impact was reduced though when the new loans were 'priming' loans, i.e. gained priority over existing security or when new lenders obtain an increase in the seniority of their old debt – basically cross-collateralisation. Somewhat counter-intuitively, speedy judicial court approval of DIP financing seemed to decrease the probability of it having successful effects. There was evidence of larger management turnover in firms with DIP financing and this finding suggested that the DIP lender played an important management and disciplining role in the corporate governance process – a trend that appears to have accelerated in recent times.[21]

Increasingly, provision for super-new priority financing is part of the global consensus on insolvency law reform.[22] For instance it forms part of the European Bank for Reconstruction and Development's (EBRD) 10 Core Principles for an Insolvency Law Regime. Core Principle 8 states that where restructuring is appropriate, the Insolvency Law regime should permit new priority financing during the restructuring process.[23] The EBRD Core Principles do not specifically address the issue of what priority should be vested in the new lender and whether existing security interests should be

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[19] Maria Carapeto 'Does Debtor-in-Possession Financing Add Value?' (London Business School Working Paper No 294-1999, 2004). See also Sandeep Dahiya et al 'Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence' (2003) 69 J Fin Econ 259, 270–276 where it is found that DIP financing increases a firm's chances of emerging successfully from Chapter 11.

[20] Insolvency is not a prerequisite to a US Chapter 11 filing.

[21] It has been suggested that 90 per cent of DIP loans impose explicit restrictions on the debtor's operating activities – see David A Skeel Jr 'Creditors' Ball: The 'New' New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917 at 929.

[22] See generally Mahesh Uttamchandani 'The case for debtor-in-possession financing in early transition countries: Taking a DIP in the distressed debt pool' in Law in Transition online available on www.ebrd.com and see, in particular, text accompanying footnotes 19–22.

[23] These core principles are available on the UNCITRAL website – http://www.ebrd.com/country/sector/law/insolve/core/principle.pdf.

trumped. One of the EBRD lawyers has argued against existing secured creditors having a veto on new lending opportunities:[24]

> Most secured creditors already factor the risk of the borrower becoming insolvent into their assessments. Insolvency legislation must aim at interests broader than merely those of secured creditors. This includes groups not well positioned to assess risk, such as trade suppliers and employees, who can benefit from the debtor obtaining . . . financing.

Moreover, EBRD relies on the proposition that making provision for super-priority new lending is less of a threat to existing secured lenders than would initially appear and may in fact benefit them. This proposition is a variant of the old argument that a rising tide raises all boats. The new lending may enable the debtor's business to thrive and develop and, in this way, old debts owing will be repaid or the further financing may generate additional security for existing lenders in the form of new receivables. Finally, existing lenders are often in the best position to provide the new financing, usually accompanied by very profitable interest rates and so, a new legislative regime may supply new business opportunities.

Likewise, the United Nations Commission on International Trade Law (UNCITRAL) makes the point that the continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganisation, and additional finance is fundamental to this objective. It is stated:[25]

> An insolvency law can recognise the need for such post-commencement finance, provide authorisation for it and create priority or security for repayment of the lender. The central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor to encourage it to lend. To the extent that the solution adopted has an impact on the rights of existing secured creditors or those holding an interest in assets that was established prior in time, it is desirable that provisions addressing post-commencement finance be balanced against a number of factors. These include the general need to uphold commercial bargains; protect the pre-existing rights and priorities of creditors; and minimise any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities.

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[24] See Uttamchandani, above at p 8.

[25] UNCITRAL Legislative Guide on Insolvency Law (2004) and associated commentary at para 97 – available at www.uncitral.org/. The Guide suggests that where an insolvency law promotes the use of insolvency proceedings that permit the insolvent business to continue trading, whether for purposes of reorganisation or to facilitate sale of the business in liquidation as a going concern, it is essential that the issue of new funding is addressed.

UNCITRAL suggests that, as a general rule, pre-existing secured creditors should have the economic value of their rights protected.[26] This objective could be achieved by making periodic payments, or by providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending. More generally, UNCITRAL recommend that the insolvency law should specify that, where the existing secured creditor does not agree, the court may authorise the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:[27]

a. the existing secured creditor was given the opportunity to be heard by the court;
b. the debtor can prove that it cannot obtain the finance in any other way; and
c. the interests of the existing secured creditor will be protected.

FINANCE DURING REORGANISATION PROCEEDINGS IN THE US

The various international model laws have undoubtedly been inspired by the new financing regime in the US under Chapter 11, though they do not necessarily mirror Chapter 11 exactly. In the US, as well as the specific financing mechanism under s 364, there are certain other incentives built into the system to encourage post-petition financing of the debtor.[28] Firstly, while Article 9-205 of the US Commercial Code validates the functional equivalent of the floating charge – a blanket security interest on shifting collateral – a general security interest over all a company's property appears to be much less common in the US context. Secondly, s 552 of the US Bankruptcy Code terminates the effect of a blanket security interest in its application to property acquired after the bankruptcy petition has been filed, though there are

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[26] Ibid at para 105.

[27] Ibid recommendation 67. For a more sceptical perspective on super-priority new financing see International Monetary Fund *Orderly & Effective Insolvency Procedures: Key Issues* (Washington, IMF, 1999) at p 48: 'An extreme approach is one that allows an administrator, when it is unable to otherwise obtain credit, to grant a post-petition creditor a 'super' priority security interest, namely, a priority that is senior to existing liens. However, such an approach risks hampering the extension of secured credit and, therefore, is not recommended.'

[28] But see however s 365(c)(2). While generally speaking a debtor-in-possession may assume or reject executory contracts, the debtor is forbidden from assuming a contract to make a loan, or to extend other debt financing or financial accommodation to the debtor.

exceptions. The curtailment of the blanket security interest may be one of the factors that encourages a pre-petition lender to continue funding the company. The debtor is, however, restricted in the use that it can make of cash collateral by which is meant cash, negotiable instruments, bank accounts, and other cash equivalents. Court permission is necessary to use such collateral even in the ordinary course of business and the secured party must be provided with 'adequate protection'.[29]

But the main provision is s 364 which lays down that any credit extended to the corporate debtor during the reorganisation process has priority over pre-petition unsecured claims. In the absence of any agreement by the lender to the contrary, a company can obtain confirmation of a reorganisation plan only by ensuring payment of the new lender in full at the confirmation stage. Moreover, even if the plan fails, 'new' debts will have priority over unsecured pre-filing debts in the ensuring liquidation. If the extension of credit is in the ordinary course of business, then priority is automatic whereas if the extension of credit is outside the ordinary course, then the priority must be authorised by the court prior to the granting of credit. Two tests have been used by courts to ascertain whether a transaction qualifies as 'in the ordinary course of business' or not. The first test is the so-called 'vertical dimension' test, which focuses on the reasonable expectations of a hypothetical creditor and asks 'whether the transaction is ordinary as compared to the debtor's own pre-petition operations'.[30] The second, 'horizontal dimension', test looks at 'the context of the industry, by comparing the debtor's business to other businesses in the same industry'.[31] It should be stressed however that s 364 looks at the extension of credit and not at the debtor's use of the funds. The extension of credit has to be in the ordinary course of business but not the debtor's use of the funds.

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29 S 363.

30 See Charles Jordan Tabb *The Law of Bankruptcy* (New York, Foundation Press, 1997) at pp 791 and 804. See also *Re James A Phillips Inc* (1983) 29 BR 391 at 394: 'The touchstone of 'ordinariness' is thus the interested parties' reasonable expectations of what transactions the debtor in possession is likely to enter in the course of its business. So long as the transactions conducted are consistent with these expectations, creditors have no right to notice and hearing, because their objections to such transactions are likely to relate to the bankrupt's Chapter 11 status, not the particular transactions themselves. Where the debtor in possession is merely exercising the privileges of its Chapter 11 status, which include the right to operate the bankrupt business, there is no general right to notice and hearing concerning particular transactions.'

31 See Bruce Henoch 'Postpetition Financing: Is There Life After Debt?' (1991) 8 Bankruptcy Developments Journal 575 at 586: 'The following activities are not usually included within the realm of the ordinary course of business: servicing debt, purchasing capital assets, purchasing abnormally large amounts of supplies, or advancing funds to assist in the liquidation of the business. This leaves everyday expenses such as rent, utilities, and just enough pencils to get the job done.'

There may be many cases where a company's assets are secured to such an extent that the granting of priority over simply pre-filing unsecured creditors offers new lenders little chance of recovery in any subsequent liquidation. In these circumstances, meaningful priority means priority over pre-filing secured creditors and s 364(d) expressly allows the court to authorise this, but only in narrowly defined circumstances. There are safeguards for affected secured creditors in that the debtor must prove that it cannot obtain the loan without granting such a security interest and that the pre-filing secured creditor is adequately protected against loss. It seems that the US courts permit the 'priming' of prior secured lending only relatively infrequently and the statutory requirements are strictly applied.[32] In one case, for example, it was held that a debtor company was ineligible for priming financing despite the oversecured status of existing secured creditors when the latter's equity cushion was rapidly eroding due to the company's history of operating losses in an industry that was suffering from a structural and not a cyclical downturn.[33] The equity cushion refers to the excess in the value of the secured property (collateral) over the secured debt. In general terms, a priming loan may not be granted unless the court concludes there is sufficient value in the collateral to protect fully both old and new lenders. The concept of adequate protection is dealt with in s 361 which provides that adequate protection of an interest of an entity in property may be provided by:

1. requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that . . . any grant of a lien under s 364 . . . results in a decrease in the value of such entity's interest in such property;
2. providing to such entity an additional or replacement lien to the extent that such . . . grant results in a decrease in the value of such entity's interest in such property; or
3. granting such other relief, other than entitling such entity compensation allowable under s 503(b)(1) . . . as an administrative expense, as will result in the realisation by such entity of the indubitable equivalent of such entity's interest in such property.

The rationale behind the notion of adequate protection is to provide an ailing business with the flexibility necessary to reorganise in the Chapter 11 process while at the same time protecting the interests of secured creditors. In essence, s 361 permits three types of adequate protection: (1) lump sum payments; (2) periodic cash payments; and (3) the provision of additional

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32 See generally George W Kuney 'Hijacking Chapter 11' (2004) 21 Bankruptcy Developments Journal 19 at 48–49.

33 *In re Shaw Industries Inc* (2003) 300 BR 861.

security though 'indubitable equivalents' are also possible. The US Senate Judiciary Committee, in reflecting upon the adoption of the Bankruptcy Code, reasoned:[34]

> Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the policy of the bankruptcy laws. Thus, this section recognises the availability of alternative means of protecting a secured creditor's interest where such steps are a necessary part of the rehabilitative process. Though the creditor might not be able to retain his lien upon the specific collateral held at the time of filing, the purpose of the section is to insure that the secured creditor receives the value for which he bargained.

It has been judicially stated[35] that a new financing proposal should provide the pre-filing secured creditor with the same level of protection it would have had if there was no super-priority new financing.[36] A company must demonstrate two propositions. Firstly, that existing secured creditors will be adequately protected notwithstanding subordination of their security interests and secondly, that the company cannot obtain credit without the benefit of the subordination order. These requirements are very difficult to satisfy. If the company is unable to convince any prospective lender that it will be guaranteed repayment without being granted a priming security interest, and no prospective lender is willing to lend on the basis of an inferior-ranking security, then it is difficult to see how the priming security interest should, nonetheless, be considered to protect fully the interests of the existing secured creditors. It has been suggested that whenever a company makes a case for a priming loan under s 364(d), that fact alone raises the presumption that there will be no adequate protection and thus the loan should not be permitted.[37]

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[34] S Rep No 989, 95th Cong 2d Sess 53 (1978).

[35] See *Resolution Trust Corp v Swedeland Dev Group Inc* (1994) 16 F 3d 552 at 564. The court also said (at 567)'There, of course, is no doubt that the policy underlying Chapter 11 is important. Nevertheless, Congress did not contemplate that a creditor could find its priority position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects. We trust that in the future bankruptcy judges in this circuit will require that adequate protection be demonstrated more tangibly than was done in this case.'

[36] See also *In re Qualitech Steel Corp* (2001) 276 F 3d 245 where prepetition secured creditors were granted a postpetition replacement lien to the extent that they were harmed by a postpetition loan granting DIP lenders superpriority under 364(d).

[37] See the comment in William D Warren and Daniel J Bussel *Bankruptcy* (New York, Foundation Press, 7th ed, 2006) at p 637: 'Section 364(d) embodies a paradox. It provides that 'priming' liens that subordinate prepetition secured lenders are permitted only when two conditions are satisfied: first, that money necessary to fund reorga-

To establish 'adequate protection', a debtor must generally present the court with evidence about value of the collateral so as to demonstrate that an existing secured creditor is oversecured.[38] In s 506 of the Bankruptcy Code secured creditors are explicitly granted interest to the extent that the value of their collateral exceeded the amount of the debt. It was held by the US Supreme Court in the *Timbers of Inwood*[39] case that by implication, an undersecured creditor is not entitled to recover post-petition interest. Creditors may seek an equity cushion for this reason. The existing creditor, however, will also want a substantial equity cushion, not least because of the risk that valuations presented to the court at the time new credit was sought are flawed or that circumstances change and there is a decline in the value of the collateral after the authorisation of the credit extension.[40]

Section 361(3) talks about preserving the 'indubitable equivalent' of a secured creditor's interest in such property, and it was thought that a secured creditor who was diligent about maintaining a certain collateral/debt ratio would have this ratio maintained during the Chapter 11 reorganisation process. Case law established, nevertheless, that only that part of the collateral that is equal to the debt is entitled to adequate protection.[41] Moreover, an equity cushion of itself has been regarded as adequate protection for the debt.[42] The secured creditor is regarded as having the 'indubitable equivalent' of its security merely because the creditor's equity cushion is so substantial.[43]

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nization is not otherwise available; and, second, that the subordinated prepetition lenders be 'adequately protected.' How can both conditions be simultaneously satisfied? If the protections being offered the prepetition lender are truly adequate, why aren't those same protections sufficient to induce a postpetition lender to provide credit without subordinating the prepetition lender?'

38 See generally on 'adequate protection' DG Baird and TH Jackson 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi L Rev 97 at 126–127.

39 *United Savings Association of Texas v Timbers of Inwood Forest Association Ltd* (1988) 484 US 365 at 371-372.

40 See *In re 5-leaf Clover Corp* (1980) 6 BR 463 at 466–467.

41 *In re Alyucan Interstate Corp* (1981) 12 BR 803.

42 *In re Lee* (1981) 11 BR 84, 85.

43 See James J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139 at 146 'Our vigilant creditor was punished for his vigilance by being forced to devour his own collateral. On the other hand his brother – a prodigal son who had allowed his collateral to shrink to the amount of the debt – was entitled to new security as adequate protection.'

THE DOWNSIDE OF NEW FINANCING – EXCESSIVE CREDITOR CONTROL

In recent years, it appears that new lending ('DIP') lending has become even more central to Chapter 11 reorganisation than ever before.[44] DIP financing universally contains restrictions on the debtor's use of the loan proceeds. It is also necessarily short-term in nature, which means that it is imperative for the debtor to maintain good relations with its DIP lender in the absence of an alternative source of refinancing and, coupled with the basic restrictions built into the loans, this generates a high degree of control over the debtor by the DIP lender. It appears that restrictive clauses and additional lender protections have gathered momentum in recent years.

The loan is invariably set up before the company invokes Chapter 11 and the lender may require a chief restructuring officer be brought in to explore ways of corporate restructuring.[45] The loan covenants may include a schedule under which the company must confirm a reorganisation plan by a particular date to avoid corporate assets being auctioned off to the highest bidder or else they may keep the company on a tight leash. On the one hand, these developments may have speeded up the Chapter 11 process and helped to resolve issues of debt overhang and poorly performing management but, on the other hand, they may have turned Chapter 11 into a quasi-liquidation process.[46]

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[44] See generally David Skeel Jr 'Creditors' Ball: The 'New new Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917; David Skeel Jr 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) Cardozo Law Review 101; DG Baird and Robert Rasmussen 'The End of Bankruptcy' (2003) 55 Stan L Rev 751; DG Baird and Robert Rasmussen 'Chapter 11 at Twilight Reply' (2004) 56 Stan L Rev 673; DG Baird 'The New Face of Chapter 11' (2004) 12 American Bankruptcy Institute Law Review 69.

[45] See Douglas G Baird and Robert K Rasmussen 'Four (or Five) Easy Lessons From Enron' (2002) 55 Vand L Rev 1787 at 1807: 'In the case of a large firm in bankruptcy, we find that, at the moment Chapter 11 is filed, a revolving credit facility is already in place that entrusts decision making authority to a single entity. This entity will often step in and replace management. It will make the necessary operational decisions before Chapter 11 begins.'

[46] For an argument that market failure could induce too much liquidation in the new world of Chapter 11 see Barry E Adler 'Bankruptcy Primitives' (2004) 12 American Bankruptcy Institute Law Review 219 at 222 and see also Douglas G Baird and Robert K Rasmussen 'The End of Bankruptcy' (2002) 55 Stan L Rev 751 at 751–752: 'Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds . . . Even when a large firm uses Chapter 11 as something other than a convenient auction block its principal lenders are usually already in control and

They may also have enriched lenders and corporate insiders at the expense of vulnerable employees.[47]

Initially there were some judicial protests at this train of events, with one proposed lending agreement being castigated in the following stark terms:[48]

> Under the guise of financing a reorganisation, the bank would disarm the debtor of all weapons usable against it for the bankruptcy estate's benefit, place the debtor in bondage working for the bank, seize control of the reins of reorganisation, and steal a march on other creditors in numerous ways. The financing agreement would pervert the reorganisational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit of the Bank and the Debtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code.

But initial judicial disfavour failed to deter the continuing creditor onslaught and eventually the barriers of resistance caved in. The current state of play has been summarised as follows:[49]

> legal developments have combined to metamorphose Chapter 11 in many cases from its original stated purpose of reorganisation to benefit unsecured creditors (and maybe equity too) through confirmation of a reorganisation plan into a federal unified foreclosure mechanism. Debtor and its fate are controlled by secured creditors aided by insiders and insolvency professionals motivated by substantial inducements – personal profit and shelter from liability.

It seems that, from the late 1980s, DIP lenders started using the terms of post-Chapter 11 lending agreements to counteract the formal principle of debtor hegemony during the corporate reorganisation process and to fill a corporate governance vacuum. Through the covenants in the loan agreement DIP lenders can exert influence over managerial personnel – alter existing management structures or no further finance.[50] It should be noted however,

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Chapter 11 merely puts in place a preexisting deal. Rarely is Chapter 11 a forum where the various stakeholders in a publicly held firm negotiate among each other over the firm's destiny.'

[47] See e.g. David J Skeel Jr 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) Cardozo Law Review 101 at 117–125. Skeel suggests that the best solution is simply for courts to restrict the provisions that they will permit in a DIP financing agreement, particularly when the debtor obtains DIP financing from an existing lender.

[48] *In re Tenney Village Co* (1989) 104 Bankr 562 at 568 and see the discussion in Bruce A Henoch 'Postpetition financing: Is there Life after Debt?' (1991) 8 Bankruptcy Developments Journal 575 at 602–604.

[49] George W Kuney 'Hijacking Chapter 11' (2004) 21 Bankruptcy Developments Journal 19 at 110.

[50] See generally on the importance of control during the bankruptcy process Jay

that the expansion of DIP financing and, in particular, its use as a governance and control mechanism, must be seen in the legal, political, social, economic and institutional context of the United States. Unlike administration in the UK, Chapter 11 is based on debtor-in-possession. DIP lending agreements may be trying to achieve through the backdoor an element of 'creditor-in-possession' though without the checks and balances that are a feature of the UK regime.[51] If something equivalent to DIP financing became the norm in the UK it is unlikely, because of the different institutional environment on this side of the Atlantic, to play the same role as it does in the US.

CROSS-COLLATERALISATION AND ROLL-UPS

There are other dangers with new financing mechanisms. New lenders who are promised priority may be happy to finance even a losing venture and, moreover, the lender may use the new loan to buttress the status of its earlier loan either through 'roll-ups' or cross-collateralisation.[52] Companies may often have no choice but to accede to exceedingly unfair terms in the DIP financing agreement. Pre-petition lenders that are only partially secured may want all of the debt owed to them fully secured before lending anew. With a 'roll-up', the DIP lender contends that its existing loan is fully secured but this fact is not entirely clear and the old loan is then rolled up into the new loan which assures that the old loan is paid in full. Cross-collateralisation enhances the lender's priority at the expense of unsecured creditors. The security package supporting the new loan is also used to elevate the status of the lender's earlier unsecured debt. There is the obvious danger of 'bootstrapping' but a lender that can shore up its old loan may be willing to lend to the debtor on better terms than a lender who is starting from scratch. A blanket prohibition on old lenders assuming the mantle of DIP lender is clearly not feasible. A court that excluded old lenders from consideration as a potential source of DIP financing might also be cutting off those lenders that are most likely to be influenced by the possibility of continuing to do business with the debtor, post-reorganisation.[53] Existing lenders may also be in a better position to assess the company's finan-

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Lawrence Westbrook 'The Control of Wealth in Bankruptcy' (2004) 82 Texas Law Review 795.

[51] See Elisabeth Warren and Jay L Westbrook 'Secured Party in Possession' (2003) 11 American Bankruptcy Institute Law Review.

[52] See generally Charles J Tabb 'A Critical Reappraisal of Cross-Collateralization in Bankruptcy' (1986) 60 S Cal L Rev 109.

[53] See generally George G Triantis 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 Vand L Rev 901 at 916.

cial state and the prospects of rehabilitation than other potential lenders. There is no gainsaying the possible informational advantages of existing lenders.

There appears to be a divergence between hostile judicial language and the actual practice of the courts in approving cross-collateralisation applications. Despite the sceptical language most courts, it seems, have approved cross-collateralisation.[54] In other words, the prevalent judicial view recognises substantive objectives to cross-collateralisation but, assuming procedural safeguards are met, approves such a clause after a consideration of various factors. The judicial consensus is reflected in a fourfold test first formulated in *In re Vanguard Diversified Inc*.[55] The four conditions are that in the absence of the proposed financing the debtor's business operations will not survive; secondly, that the debtor is unable to obtain alternative financing on acceptable terms; thirdly, that the proposed lender will not accede to less preferential terms and fourthly, the proposed financing is in the best interests of the general creditor body.

More recently, it has been suggested that the courts should bear in mind the following guidelines when deciding whether or not to accede to financing requests:[56]

i. the extent of the notice provided (to other creditors and parties in interest);
ii. the terms of the DIP financing and a comparison to the terms that would be available absent the Cross-Collateralisation;
iii. the degree of consensus supportive of Cross-Collateralisation;
iv. the extent and value of the pre-petition liens held by the pre-petition lender (and in particular the amount of any 'equity cushion' that the pre-petition lender may have); and
v. whether Cross-Collateralisation will give an undue advantage to some pre-petition debt without a countervailing benefit to the estate.'

The *Vanguard* test has been subjected to critical scrutiny.[57] On close analysis, the first element of the test is simply a 'needs test' and is easily satisfied – all businesses need working capital to survive and few debtors have sufficient

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[54] The seminal case is *In re Texlon Corp* (1979) 596 F 2d 1092. See also *In re Saybrook Manufacturing Co* (1992) 963 F 2d 1490.

[55] (1983) 31 BR 364.

[56] See generally George W Kuney 'Hijacking Chapter 11' (2004) 21 Bankruptcy Developments Journal 19 at fn 200. The guidelines come from the International Insolvency Institute.

[57] See generally Charles J Tabb 'A Critical Reappraisal of Cross-Collateralization in Bankruptcy' (1986) 60 S Cal L Rev 109 at 163.

cash reserves available to fund operations. The second element in effect recognises the near monopoly position of pre-petition lender which is so essential to the lender's ability to extract favourable financing terms. The company is often 'locked into' the old lender, so to speak, in that there is little time to search for other lenders. The evidence adduced in support of the second element may be little more than a recital, or ritual incantation, of the magic words. The third element of the test does not seem very meaningful beyond stating the obvious that courts will not grant extraordinary benefits to someone who does not really insist on them.[58] It also gives rise to somewhat of a chicken-and-egg situation. Cross-collateralisation becomes standard and acceptable if virtually all lenders insist on this preferential term, even though it is very doubtful that all lenders would decide not to finance if cross-collateralisation were never available. The fourth element of the test requires a somewhat speculative judgement, firstly, that liquidation would ensue without DIP financing accompanied by cross-collateralisation and secondly, the liquidation dividend for unsecured creditors would be less than their return in a reorganisation where cross-collateralisation is a feature of the new financing arrangements. According to one commentator, creditors are put to the 'Hobson's choice' of liquidation versus cross-collateralisation only because cross-collateralisation is allowed in the first place. Neither cross-collateralisation nor liquidation may be in the creditors' best interests.[59]

There is a strong argument that cross-collateralisation runs across the distribution scheme of the US Bankruptcy Code, which mandates equal treatment of similarly situated creditors. There is nothing explicit in the language of the DIP financing provision – s 364 – which authorises cross-collateralisation whereas the entire policy and scheme of the Bankruptcy Code furthers the ideal of equal treatment of unsecured claims. Cross-collateralisation seems diametrically opposed to those policies.[60] There is much to be said for a complete prohibition on cross-collateralisation although flat, inflexible rules of this type have an old-fashioned, authoritarian ring to them. Flexible, multipart balancing tests have more of the flavour of the current era but flexible rules may not work to protect basic bankruptcy policies and to prevent lenders from extorting unfair benefits. If there was an outright ban on cross-

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58 Ibid at 167.

59 Ibid at 172. Tabb remarks at 171 'Given the lack of time, the lack of Chapter 11 experience, and the complexity of financing orders, creditors often do not have the information necessary to make informed judgments.'

60 For a general discussion see Charles J Tabb 'A Critical Reappraisal of Cross-Collateralization in Bankruptcy' (1986) 60 S Cal L Rev 109 at 145–147. The US Supreme Court has stated that 'if one claimant is to be preferred over others, the purpose should be clear from the statute' – *Nathanson v NLRB* (1952) 344 US 25 at 29.

collateralisation, lenders would then have to make realistic decisions and given the profitable nature of DIP financing, decisions are likely to be tilted in favour of continued lending except in extremely doubtful cases where the reorganisation attempt is marginal at best.

'Roll-ups' seem as equally objectionable as cross-collateralisation clauses in that certain kinds of old unsecured debt are being given a leg-up over other kinds of unsecured debt.[61] Again, this runs counter to the general philosophy underlying the Bankruptcy Code of equal treatment of similarly situated creditors. There have been judicial statements to the effect that the use of financing to pay a pre-petition unsecured debt is to be used only in extreme cases[62] but, nevertheless, as with cross-collateralisation itself, a laxer attitude may prevail in practice. It seems that courts will examine the same factors used to determine the validity of cross-collateralisation provisions as well as the following additional factors:[63]

a. the nature and amount of new credit to be extended, beyond the amount to be used to repay the pre-petition debt;
b. whether the advantages of the post-petition financing justify the loss to the estate of the opportunity to satisfy the pre-petition secured debt otherwise . . .
c. whether the roll-up can be unwound, if necessary;
d. the extent to which the debtor would have availability in the absence of a roll-up;
e. the extent to which pre-petition and post-petition collateral can, as a practical matter, be identified and/or segregated;
f. the extent to which difficult 'priming' issues would have to be addressed in the absence of a roll-up; and
g. whether the post-petition advances are used to repay a pre-bankruptcy, 'emergency' liquidity facility secured by first priority liens on the same collateral as the post-petition financing, where the pre-petition facility was provided in anticipation of, or in an effort to avoid, a bankruptcy filing.

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61 See David A Skeel Jr 'The Past, Present and Future of Debtor-In-Possession Financing' (2004) 25 Cardozo Law Review 101 at 124 who suggests that the ideal way to separate old and new financing would be to treat them as entirely separate loans; each with its own collateral and bankruptcy treatment. The payments on the new loan would be treated as an administrative expense and secured by whatever security that the court approved. The old loan would be entitled to priority to the extent of any collateral with the remainder being treated as an unsecured claim.

62 *In re Sun Runner Marine Inc* 945 F2d at 1095.

63 See George W. Kuney 'Hijacking Chapter 11' at fn 204.

SUPER-PRIORITY NEW FINANCING UNDER THE ENTERPRISE ACT

During the discussions that preceded the Enterprise Act, it has been suggested that more time was spent considering the vexed question of how administrations should be funded than on any other topic.[64] Ultimately, the topic proved too difficult for the policy makers to put in place a new legislative framework.

In the DTI report on Business Rescue mechanisms it was suggested that the provision of additional finance to ailing businesses could be value enhancing for the business, provided that it was part of a properly considered plan for financial recovery.[65] If the finance was value enhancing for the business, it would also be value enhancing for creditors, or at least not worsen their position. The Report made the point that the outlook of individual creditors was partial in that each creditor tends to look only to its own position. Individual creditors may not perceive this potential for value creation or give it the same value as one would in relation to the business as a whole. The DTI report suggested a radical approach to corporate rescues under which the courts or supporting tribunals would be given a discretion to agree to super-priority finance within tight criteria. Under these conditions, the new finance must reasonably be expected to enhance the value of the enterprise as a whole and thus returns to all creditors. The court would need to be satisfied, on the balance of probabilities, that the financing was likely to result in increased recoveries for all creditors.

In the consultation exercise undertaken by the DTI, these proposals provoked a variety of responses. There was also considerable confusion about how the proposals would work in practice. Some responses considered that bank creditors were sometimes an obstacle to the finance of corporate rescues in that they were unwilling to allow additional finance to be introduced which would rank ahead of their own debt. The Society of Practitioners of Insolvency proposed that super-priority should not be permitted if it overrode existing security rights except to the extent that it would create a priority out of floating charge assets ahead of preferential creditors and the floating charge holder.

The Insolvency Bill as introduced contained no specific provisions for super-priority new financing though the legislation, at variance with the general position,[66] continued to allow the appointment of administrative receivers in large-scale private finance projects. The rationale behind this was that such projects, where they ran into financial difficulties, relied heavily on

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64 Stephen Davies ed *Insolvency and the Enterprise Act 2002* at p 20.

65 See generally pp 38–41 of the Report.

66 Insolvency Act 1986 s 72E; on which see *Feetum v Levy* [2006] Ch 685.

banks' 'step in' rights to allow the completion of the work under the control of the banks.

In the parliamentary passage of the legislation, the government resisted an amendment that would have created a statutory framework for super-priority financing during administration. Under this amendment, 'priming' of existing secured creditors would be possible if the loan funds were to be used to continue the business to meet the administrator's objectives or to protect and preserve business and assets during administration; secured creditors were not prejudiced by the making of the 'priming' order, and it was appropriate to make the order in the overall interests of administration. The proponent of the amendment, Lord Hunt, suggested that a legislative failure to provide for financing would undermine the ability of administration to operate as an effective rescue tool.[67]

The government however, was reluctant to create a situation that, in essence, would guarantee a return to super-priority new lenders, irrespective of whether rescue proposals passed commercial muster.[68] It suggested that whether to lend to a company in administration was a commercial one that was best left to the business judgement of the lending market. In making this decision, a lender was likely to take into account the availability and priority of any security as well as the viability of the rescue plan. Moreover, reference was made to the growth of asset financing, factoring and discounting where financiers may be more oriented towards the rescue environment.

AN ADMINISTRATOR'S EXPENSES – IMPLIED AUTHORISATION FOR NEW PRIORITY FINANCING?

The Enterprise Act does not specifically mention the financing of a company in distress but it is possible to argue that what the Enterprise Act has not done expressly, it has done by implication. Administration entails entrusting

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[67] See House of Lords parliamentary debates for 29 July 2002 and the discussion in Stephen Davies ed *Insolvency and the Enterprise Act 2002* at pp 20–26.

[68] For criticism of this outcome see A McKnight 'The Reform of Corporate Insolvency Law in Great Britain' [2002] JIBL 324 at 327 who notes that the legislation 'fails to address the difficulty that an administrator may face in obtaining funding, especially in a situation where it would be desirable for him to be able to offer security but, at the time of his appointment, the assets of the company were already subject to fixed security or were subject to a negative pledge preventing the company from granting security over the assets. There is no provision which would allow the administrator to proceed in a manner which may be contrary to or affect the rights of such a person and, being an officer of the court, he must act honourably towards such a person.'

responsibility for running a company's affairs to an outside insolvency practitioner – the administrator. The administration may exercise all the management powers formerly possessed by the board of directors, including the power to borrow money and grant security on behalf of the company.[69] In many cases, in order to achieve the purposes of administration, the administrator will need to be able to use or dispose of all the company's property, including that part of it which is subject to an existing security. Schedule B1 Insolvency Act 1986, paras 70 and 71 gives the administrator certain powers to deal with charged property and chattels owned by third parties but in the company's possession, irrespective of the wishes of the charge holders or owners. There is a distinction between, on the one hand, assets subject to a fixed charge (or to hire-purchase agreements),[70] and, on the other, assets subject to a floating charge.

In the case of assets subject to a floating charge, the administrator is given power to 'dispose of or take action' relating to such property as if the assets were not subject to the floating charge. Accordingly, the administrator can deal with such assets and dispose of them as he sees fit without reference to the floating charge holder and without being fettered by any contractual restrictions contained within the floating charge, for example, a negative pledge clause. The reference to a floating charge means a charge which, as created, was a floating charge.[71] Accordingly, the crystallisation of the floating charge prior to, or on the commencement of, an administration order would not prevent the administrator from exercising these wide powers.

Where the administrator disposes of floating charge assets, the holder of the floating charge is given the same priority in respect of any of the company's property directly or indirectly representing the assets disposed of as s/he would have had in respect of the assets subject to the floating charge. As regards assets subject to a fixed charge (as created) or goods which are in the possession of the company under a hire-purchase agreement, the administrator may apply to court for an order authorising the disposal of the property. The court may make such an order if it is satisfied that the disposal (with or without other assets) of the relevant assets or goods acquired on hire purchase would be likely to promote the purpose of administration in respect of the company. It is a condition of any such order that: 1. the net proceeds of the disposal; and 2. a sum equalling the deficit between the net proceeds of disposal and the net amount which would be realised by a sale of the assets at

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69 Schedule 1 Insolvency Act 1986 para 3 'Power to raise or borrow money and grant security therefore over the property of the company.'

70 This term includes conditional sale agreements, chattel leasing agreements and retention of title agreements: Schedule B1, paragraph 111.

71 Schedule B1, para 111.

market value as determined by the court must be applied towards discharging the sums secured by the fixed charge or payable under the hire-purchase agreement.[72]

If a company in administration has a bank account in credit, then the depositary bank will be able to set off the credit balance against other bank accounts that are in deficit. The depositary bank may also have a fixed charge over the credit balance.[73] It may be the case, however, that the company owes nothing to the depositary bank and a charge has been created over the credit balance in favour of another bank. In the normal run of events such a charge is likely to be a floating charge[74] and the administrator would appear to have power, by virtue of para 70, to make unfettered use of the credit balance. In other words, it might be used to fund the operations of the company during the period of administration. But it is likely to be a rare event where an ailing company has a credit balance that is not subject to a right of set-off, or fixed charge, in favour of the depositary bank.

In carrying out his/her functions the administrator wears a couple of hats. Schedule B1 Insolvency Act 1986 para 5 provides that an administrator is an officer of the court whether or not s/he is appointed by the court. Para 69 however states that in exercising his/her functions the administrator acts as the company's agent.[75] Under general principles, an agent is not liable under a contract which s/he makes on behalf of his/her principal. Accordingly, an administrator would not be personally liable on any contract entered into by him/her in the course of acting as administrator, except insofar as the contract otherwise provides. In a suitable case, however, the court may oblige the administrator to comply with a contractual obligation of the company by granting an injunction.[76]

Although the normal rule is that an agent is not personally liable on his principal's contracts, the Insolvency Act makes special provision for the payment of debts and liabilities incurred during the administration under contracts entered into by the administrator.[77] The special provision also applies to debts and liabilities incurred during the administration under contracts of employment adopted by the administrator after the first fourteen days from his/her appointment. The nature of the provision is that a statutory charge, ranking in priority to the administrator's statutory charge for his/her

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72 *Re ARV Aviation Ltd*. [1989] BCLC 664.

73 *Re BCCI (No 8)* [1998] AC 214.

74 See *Re Spectrum Plus Ltd* [2005] 2 AC 680.

75 See also Insolvency Act 1986 s 14(5).

76 See *Astor Chemicals Ltd v Synthetic Technology Ltd* [1990] BCLC 1; [1990] BCC 97.

77 Insolvency Act 1986 Schedule B1 para 99.

own remuneration and expenses, is imposed on the company's property in respect of the said debts and liabilities. Strictly, these statutory charges arise only when the administrator vacates office[78] but the ordinary practice is for administrators to meet obligations as they arise during the continuance of the administration.[79]

These provisions are largely reproduced from s 19 Insolvency Act 1986 in its original version although there is no direct word-for-word correspondence. Discussion of them has largely centred on the position of employees, when an administrator may be said to adopt a contract of employment[80] and what are 'qualifying' liabilities. Nevertheless, the wording of the relevant provisions is much broader with para 99(4) referring to a 'sum payable in respect of a debt or liability arising out of a contract entered into by the former administrator or a predecessor'. In *Centre Reinsurance International Co v Freakley*[81] Lord Hoffmann explained, inter alia, that this provision was concerned with debts and liabilities incurred by the administrator which have not been discharged and which were incurred under contracts entered into by the administrator in the execution of his functions.[82] He said that under the statute the administrator has power to decide what expenditure 'is necessary for the purposes of the administration and should therefore receive priority. But there is no reason to extend that priority to expenditure which neither the administrator nor the court has specifically approved.'[83]

Surely however, in its ordinary meaning, the wording of para 99(3) is sufficiently broad to encompass liabilities under contracts of loan entered into by the administrator on behalf of the company. Interest and capital repayments

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78 Para 99 (3) provides that where a person ceases to be an administrator, his remuneration and expenses shall be charged on and payable out of property of which he had custody or control immediately before cessation and will be payable in priority to any floating charge.

79 In *Powdrill v Watson* [1994] 2 All ER 513 at 522 Dillon LJ said in the Court of Appeal: 'Although strictly sums payable are, under s 19(5), only payable when the administrator vacates office, it is well understood that administrators will, in the ordinary way, pay expenses of the administration including the salaries and other payments to employees as they arise during the continuance of the administration. There is no need to wait until the end, and it would be impossible as a practical matter to do that. What is picked up at the end are those matters which fall within the phrase, but have not been paid.'

80 See *Powdrill v Watson* [1995] 2 AC 394.

81 [2007] Bus LR 284.

82 Rule 2.67 of the Insolvency Rules which defines what counts as an expense of administration really amplifies the meaning of Schedule B1 para 99(3) and does not apply in the present setting. On Rule 2.67 see *Exeter City Council v Bairstow* [2007] BCC 236.

83 [2007] Bus LR 284 at para 16.

under a loan can be classed as liabilities arising out of a contract. Such liabilities are stated to be '(a) charged on and payable out of property of which the former administrator had custody or control immediately before cessation, and (b) payable in priority to any charge arising under sub-paragraph (3)'. Para 99(3) refers to the former administrator's remuneration and expenses which are '(a) charged on and payable out of property of which he had custody or control immediately before cessation, and (b) payable in priority to any security to which paragraph 70 applies'. Para 70 refers to a floating charge.

Working through the relevant provisions one can see contractual liabilities including presumably loan obligations ('A') are payable ahead of the administrator's remuneration and expenses ('B') which in turn are payable ahead of floating charge securities ('C'). All these commitments, it seems, are payable out of the same 'pot' – property of which the administrator had custody or control immediately before cessation of his appointment.[84] A is payable ahead of B which in turn is payable ahead of C and all claims come from the same pot. Although not stated explicitly, perhaps the most sensible interpretation of the legislation is to say that, by implication, A is therefore payable ahead of C. Of course, it would avoid much doubt if this result was stated expressly in the legislation. There are, indeed, statutory parallels very close to hand.

In Ireland, under the 'examinership' procedure, there are also special statutory provisions in place to facilitate the financing of companies in financial difficulties.[85] During the period of examinership, a company enjoys protection from its creditors like a company in administration. The relevant legislation allows the examiner – a court-appointed official, normally an accountant – to certify liabilities incurred during the protection period where such liabilities are essential to ensure the survival of the company as a going-concern.[86] The liabilities so certified then rank with the examiner's own expenses ahead of all other liabilities including pre-examinership secured liabilities. The 'certification of

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[84] On the importance of identifying the relevant fund see *Re Leyland Daf Ltd* [2004] 2 AC 298 (at para 62) where the House of Lords held that in considering the incidence of the costs and expenses of winding up there were two distinct funds: '(i) the proceeds of the free assets which belong to the company and are administered by the liquidator in a winding up and (ii) the proceeds of the assets comprised in the floating charge which belong to the charge holder to the extent of the security and are administered by the receiver. In principle . . . the costs of administering each fund are borne by the fund in question.' Lord Hoffmann commented at para 27 'If A has priority over B in respect of payment out of the proceeds of Blackacre and B has priority over C in respect of payment out of the proceeds of Whiteacre, why does it follow that A has any right to payment out of Whiteacre?' *Leyland Daf* has effectively been reversed by s 1282 Companies Act 2006.

[85] See generally on this procedure T Courtney *The Law of Private Companies* (Dublin, Butterworths, 2002) Chapter 23.

[86] Irish Companies (Amendment) Act 1990, s 10.

liabilities' procedure can be used to cover borrowings made by the company during the period of examinership. In the leading case – *Re Atlantic Magnetics Ltd*[87] – the Irish Supreme Court interpreted the original legislation to mean that assets already secured by fixed charges may be used for the purposes of fresh borrowings. The end result of this and other decisions is that virtually any expenditure, including additional company borrowings, can be deemed 'expenses' if so certified by the examiner. As a result largely of protests by banks, however, the Irish legislation has been amended to provide that liabilities certified by the examiner should rank after the claims of fixed charge-holders although still ahead of floating charges.

If the interpretation suggested of para 99 is adopted then one would have the same position in the UK, though without the administrator having to take the additional step of certifying liabilities as being necessary to ensure the survival of the company as a going concern. One could adopt however a narrower interpretation under which A is only payable ahead of C to the extent of B. In other words, A steps into B's shoes to gain priority over C but only to the extent that B enjoys this priority – a form of subrogation which has been adopted in analogous contexts.[88] In support of this interpretation one might cite the entire legislative history which proceeded on the basis that there was no statutory authorisation for super-priority new financing during the period of administration. If the broader interpretation is correct then this was a total misconception – it is as if the legislature was talking prose without realising it. On the other hand, and in support of the broader interpretation, one could refer to the Canadian experience. The Canadian courts have been prepared to infer the existence of a super-priority new financing jurisdiction on the basis of statutory materials that are far more slender than the English ones.

SUPER-PRIORITY NEW FINANCING IN CANADA

Provision for super-priority new financing for companies undergoing a reorganisation process is essentially a judicial rather than a statutory invention in Canada.[89] Canadian courts have authorised DIP financing under a so-called inherent jurisdiction, though the jurisdiction has recently been placed on a

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87 [1993] 2 IR 561.

88 See *Portbase Clothing Ltd* [1993] Ch 388; *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366.

89 For a general discussion see Janis Sarra 'Debtor in Possession (DIP) Financing: The Jurisdiction of Courts to Grant Super-priority Financing' (2003) 21 Dalhousie Law Journal 337; Michael B Rotsztain 'Debtor-in-Possession Financing: Current Law and a Preferred Approach' (2000) 33 Can Bus LJ 283 at 284.

statutory footing.[90] The authority to subordinate existing security agreements in favour of the new loan agreement was said to derive from an inherent jurisdiction to fill functional gaps in a corporate restructuring statute – the Company Creditors' Arrangement Act (CCAA) – or from the courts' equitable jurisdiction to do so.[91]

Canadian insolvency legislation in the shape of the CCAA is aimed at facilitating a company workout process. The legislation is designed to assist the development of a feasible business plan that allows a company to continue in business where this generates potentially greater value for creditors and the public.[92] It creates a court-supervised process whereby a debtor company attempts to reach a plan of arrangement with creditors. Canadian courts have spoken of the CCAA as a flexible instrument for the restructuring of insolvent companies.[93] It has also been held that, because of the remedial nature of the legislation, the judiciary should exercise its discretion to give effect to the public policy objectives of the statute where the legislative language was incomplete.[94]

DIP financing was not however defined, or even referred to, in the CCAA and, until the mid-1990s, the general consensus was that although the court had the power to permit the debtor to borrow and to charge its assets for this purpose, there was no authority to subordinate pre-existing security interests to new securities, except in quite limited circumstances. Judicial interpretation gradually changed however. Canadian courts frequently cite the potential economic consequences of corporate collapse for employees, local trade suppliers, communities and other unsecured creditors.[95] Sanctioning the grant of DIP super-priority financing was said to be an exercise of equitable jurisdiction; equity coming into play when the statutory framework did not provide a remedy that redresses some risk or harm.[96] Demonstrating beneficial effects was not a sufficient threshold for a favourable exercise of the jurisdiction – the new finance had to be critical to enable the company successfully to restructure

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90 See Canadian government bill the long title of which is 'C 55 An Act to Establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to Make Consequential Amendments to Other Acts'.

91 See generally for background the Report of the Canadian Standing Senate Committee on Banking, Trade and Industry *Debtors and Creditors Sharing the Burden* (November 2003) at pp 100–105.

92 See Sarra (2003) 23 Dalhousie Law Journal 337 at 349.

93 *Re Dylex Ltd* (1995) 31 CBR (3d) 106 at 111.

94 *Re Northland Properties* (1988) 73 CBR (NS) 175 at 182.

95 See generally Keith Yamauchi 'The Courts' Inherent Jurisdiction and the CCAA: A Beneficient or Bad Doctrine' (2004) 40 Canadian Business Law Journal 250.

96 See Sarra (2003) 23 Dalhousie LJ 337 at 357 and cases therein referred to.

its affairs. DIP financing has been authorised in cases where the security was granted on unencumbered assets and thus existing security was not compromised; where an existing secured creditor was not adversely affected by the financing order; where the financing was obtained with the consent of the existing secured creditors; and where the reduction in value of existing security was not significant in terms of the overall value involved, and given the overall economic and financial effects of declining a new financing request.[97]

Landmark judicial decisions include *Re Dylex Ltd*[98] where the court authorised priority lending over existing creditor objections when it found that the collateral sufficed to protect both new and existing lenders. Another landmark case is *Sky Dome*[99] where the court suggested that it may approve super-priority financing on a 'balance of prejudices' test. The losses that the debtor and other groups affected by the reorganisation (such as employees, suppliers and local communities) will sustain if the financing is not approved are weighed against the losses to existing secured creditors if approval is given. Other important cases include *Re United Used Auto & Truck Parts Ltd*,[100] where priority financing was refused for lack of evidence that financing was critical for the debtor's restructuring, and the *Air Canada* case.[101] In the latter case Farley J said that, absent a statutory amendment of the relevant legislation, it is up to the court to strike the appropriate balance between stakeholder interests and grant super-priority charges where the benefit of the charge clearly outweighs the prejudice to the creditors whose security is being subordinated to the charge.

It is appropriate to sound a few cautionary notes about the judicially developed DIP financing regime in Canada. Firstly, on one view,[102] priming orders

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97 Ibid.

98 (1995) 31 CBR (3d) 106.

99 (1998) 16 CBR (4th) 118 where the court said at 123: 'This is not a situation where someone is being compelled to advance further credit. What is happening is that the creditor's security is being weakened to the extent of its reduction in value. It is not the first time in restructuring proceedings where secured creditors – in the exercise of balancing the prejudices between parties which is inherent in these situations – have been asked to make such a sacrifice.'

100 [2000] 5 WWR 178.

101 (2003) 66 OR (3d) 257. The case is discussed in Pamela Huff and Linc Rogers 'Fortune Favours the Bold: Lending in a CCAA Proceedings and Priority Charges to Facilitate Restructurings' (2004) 16 Commercial Insolvency Reporter 57.

102 Another view advanced by Janis Sarra (2000) 23 Dalhousie LJ 337 at 353 cites implicit legislative sanction and points out the CCAA was amended in 1997 to specify that the effect of a stay on creditor enforcement actions during the corporate reorganisation process does not require the further advance of money or credit. The 1997 legislation was silent on the jurisdiction to grant DIP financing even though that jurisdiction was frequently exercised by then. One might conclude that the Canadian

amount to a confiscation of security and, if this is what parliament intended, the governing legislation should have been drafted accordingly.[103] Secondly, DIP financing has not been approved at the highest judicial level in Canada – the Supreme Court of Canada. Thirdly, Canadian courts used a 'balance of prejudices' test which appears wider, less tightly controlled and less respectful of existing securities than that employed in the US under s 364 of the Bankruptcy Code. The US regime in effect requires that existing creditors should not stand to lose under the new lending arrangements. The Canadian approach authorises DIP financing even when the existing creditors might lose if others stand to gain even more. The courts can evaluate the benefit and risks of DIP financing and, based upon that, determine whether the financing is appropriate, without having to ensure any protection for the existing creditors.[104]

The Canadian approach has its academic supporters who suggest that secured creditors should be required to make some sacrifice to achieve reasonably anticipated benefits for other stakeholders.[105] The position of secured creditors is compromised in a relatively small way, whereas giving these lenders an effective veto on new funding opportunities would expropriate the interests of unsecured creditors and others interested in the implementation of a reasonable restructuring plan. Moreover, there are information asymmetries in that secured creditors have the greatest access to the court-supervised process and the resources effectively to argue against the grant of DIP financing. Investing the courts with broad flexibility might alleviate negotiating problems, assist in putting company assets to their best use and address excessive risk aversion on the part of creditors. It was also suggested that the degree of uncer-

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Parliament was not discontent with the current exercise of the courts' jurisdiction to grant such financing.

103 See David Light 'Involuntary Subordination of Security Interests to Charges for DIP Financing under the Companies' Creditors Arrangement Act' (2002) 30 CBR (4th) 245 who concludes by saying that 'for the policy of impairing secured claims under the CCAA to be worthwhile economically, the efficiency gains under restructuring law brought about by the rule change would have to outweigh the losses that can be expected to occur elsewhere in the system. However . . . there is reason to believe that subsidizing the decisions of junior claimants under conditions of insolvency will result in efficiency losses under restructuring law, not gains. Although governments may have demonstrated on other occasions that they are capable of designing economic policies that produce nothing but deadweight losses, where they have not done so, there are good reasons for the courts not to fill the gap.'

104 For criticism see David Light 'Involuntary Subordination of Security Interests to Charges for DIP Financing under the Companies' Creditors Arrangement Act' (2002) 30 CBR (4th) 245.

105 See J Sarra (2000) 23 Dalhousie LJ 337 at 369.

tainty engendered by the discretionary approach had been exaggerated. The courts had engaged in a reasoned effort to further CCAA objectives.[106]

A contrary perspective points to the unfairness of requiring existing creditors (with little economic incentive in restructuring) to bear both the risk and the cost of super-priority funding. [107] Value is redistributed away from existing lenders who, from the outset, are unsure about whether they may be drawn into a situation involving DIP financing. To eliminate this uncertainty, existing lenders may be more likely to step in earlier, when financial difficulties ensue, rather than trying to support a business in troubled times. The added risk factor could cause an increase in the cost of borrowing or a restriction of credit availability.

> By exposing credit contracts to unilateral alteration, doubt is cast on the enforceability of credit contracts, distorts initial lending decisions and reduces credit availability. [C]ourts may also generate inefficiency by attempting to protect the interests of wage earners, suppliers and community through reorganisations when the appropriate solution would be liquidation.[108]

It is also possible to be critical on a micro as well as on a macro level. For instance, in the 'balancing of prejudices' exercise conducted by the courts, the factors to be balanced and the weights assigned to them are seldom discussed.[109] Although subordination is sometimes referred to as being extraordinary relief, or requiring cogent evidence that the benefits outweighs the potential prejudice, in practice, such orders seem to be granted on a fairly routine basis.

Amendments to Canadian Insolvency legislation coming into force in 2006 put the jurisdiction to grant super-priority new financing on a statutory basis. The jurisdiction is also extended to smaller companies subject to the Bankruptcy and Insolvency Act as well as to larger companies governed by the Companies' Creditors Arrangement Act. In deciding whether to authorise new financing:

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106 J Sarra (2000) 23 Dalhousie LJ 337 at 383.

107 See the discussion in J Sarra (2000) 23 Dalhousie LJ 337 at 360 and references accompanying the same.

108 See Canadian Senate Standing Committee on Banking, Trade and Commerce Report 'Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act' (November 2003) at p 43.

109 See David Light 'Involuntary Subordination of Security Interests to Charges for DIP Financing under the Companies' Creditors Arrangement Act' (2002) 30 CBR (4th) 245 at p 19 of the document 'Summary of the CCAA Cases'.

the court must consider, among other things,

a. the period during which the company is expected to be subject to proceedings …;
b. how the company is to be governed during the proceedings;
c. whether the company's management has the confidence of its major creditors;
d. whether the loan will enhance the prospects of a viable compromise or arrangement being made in respect of the company;
e. the nature and value of the company's assets; and
f. whether any creditor will be materially prejudiced as a result of the company's continued operations.'[110]

RELEVANCE OF CANADIAN DEVELOPMENTS FOR THE UK

The Canadian courts have fashioned a jurisdiction to authorise super-priority new financing largely by judicial fiat. In the guise of filling statutory gaps the courts have assumed a quasi-legislative mantle. There may also be scope for judicial innovation in the UK, though on a less audacious scale.

Adopting an expansive interpretation of para 99 Schedule B1 Insolvency Act 1986, as has been suggested, also avoids some of the troublesome issues that have vexed the issue of new financing in North America. Section 364 US Bankruptcy Code has been criticised for its somewhat bureaucratic and court-centred nature. Also under attack has been judicial sanction of cross-collateralisation and 'roll-ups' for their unfair effects on unsecured creditors. The use of cross-collateralisation clauses would appear to be precluded completely by the language of para 99. The 'old' pre-administration debt or liability is not a debt or liability arising out of a contract entered into by the administrator and therefore cannot gain the para 99 priority status. 'Roll ups' under which new advances are conditioned on the basis that they should be used to discharge, in part at least, old unsecured liabilities are not explicitly ruled out by para 99. The courts however might apply a principle used in the context of s 245 Insolvency Act 1986 which invalidates floating charges created within a certain period prior to liquidation or administration to the extent that the floating charges secured past indebtedness. It has been held that if an advance has been made on the basis that it should be used to discharge an existing liability

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[110] See now s 11.2 of the Companies' Creditors Arrangement Act and 50.6 of the Bankruptcy and Insolvency Act. K Yamauchi in 'The Courts' Inherent Jurisdiction and the CCAA: A Beneficient or Bad Doctrine?' (2004) 40 Canadian Business Law Journal 250 at 294 suggests that codification, while potentially helpful, 'is likely to spawn a new period of litigation, with parties seeking to define the scope and limits of how the court is bound by the factors in the exercise of its discretion.'

then it cannot be counted as a fresh advance for the purpose of escaping condemnation under s 245.[111] The same analysis could be applied to para 99, thereby ruling out 'roll-up' which is all about elevating the status of old unsecured debt and not about adding new value to the company.

Also criticised in the US context has been the use of DIP financing agreements as a means of exerting control over management and transferring value to privileged corporate insiders at the expense of ordinary employees. The context of administration in the UK is very different. For a start, general employment law offers greater protection to employees. Secondly, administration is a management-displacement device, with an administrator taking over management functions from the board of directors. While the holder of a general floating charge no longer has a veto on whether or not a company should go into administration, the floating charge holder has an effective veto on the identity of the person appointed as administrator.[112] The holder of a general floating charge can also make an appointment of an administrator himself out of court.[113] There is no need to use a new financing agreement as a 'control' device because the administrator will be somebody in whom the floating charge holder has confidence.

The Canadian approach, with its 'balance of prejudices' test for deciding whether or not to authorise new financing, has been criticised for its vagueness and indeterminacy. In the UK, on a broad para 99 interpretation, there is no need for judicial intervention. Moreover, para 3, in setting out the objectives of the administrator, provides the administrator with a clearly defined frame of reference in deciding whether to seek new financing for the ailing company. While existing security in the shape of the floating charge is indeed overridden, a lender who is concerned about its priority position being eroded during corporate restructuring has the option of taking fixed charges over as many assets as possible. Admittedly, though, the attractiveness of that option has

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111 *Re Fairway Magazines Ltd* [1992] BCC 924 applying *Re Orleans Motor Co Ltd* [1911] 2 Ch 41. The money never became available to the company to be used as it liked.

112 See e.g. Schedule B1 Insolvency Act 1986 para 36 which provides that where an administration application is made by somebody other than a qualified floating charge holder, the latter may intervene in the proceedings and suggest to the court the appointment of a specified person as administrator. The court is obliged to respond positively to this intervention unless it thinks it right to refuse the application 'because of the particular circumstances of the case'.

113 Schedule B1 Insolvency Act 1986 para 14 and see the comment by V Finch 'Re-invigorating Corporate Rescue' [2003] JBL 527 at 535: 'Banks will be able to use the streamlined appointment procedure in all cases, not merely situations of urgency, and they will be able to determine who should be appointed to the office of administrator. This gives the banks the power to insert their chosen administrator with speed and without regard to the other creditors or the courts.'

been diminished by the decisions in *Re Brumark Ltd*[114] and *Re Spectrum Plus Ltd*,[115] holding that to create a fixed charge over receivables such as book debts, the proceeds of the receivables must be paid into a blocked account. Nevertheless, a balance is struck. Fixed security cannot be overridden by new financing and, while the floating charge may be overridden, the holder of that security is in a powerful position during the administration process with the ability to dictate the identity of the person appointed as administrator.

CONCLUSION

New finance is often crucial to corporate turnaround and to enable profitable opportunities to be pursued that will increase returns for all creditors. But an ailing company may not have any unencumbered assets to offer as security. Unless existing lenders are prepared to provide additional finance this may be very difficult to obtain, with new finance providers not willing to lend on an unsecured basis or to accept lower-ranking priority. Some jurisdictions have attempted to resolve these difficulties. The US has led the way by creating a legislative framework for super-priority new financing in s 364 of the Bankruptcy Code, though the mechanism may have undesirable side-features and new financing arrangements often attempt to reach parts that are addressed in other ways in the UK.

Canada has followed suit in making provision for new financing, albeit in a judicially driven vehicle powered by inherent jurisdiction and discretion. International organisations such as EBRD and UNCITRAL have also extolled the virtues of super-priority new financing and suggested explicit provision for the same. In the UK the government has declined the opportunity to create such a mechanism in the Enterprise Act; the official line being that there was insufficient evidence of a market breakdown problem and that a market solution could be found. The Insolvency Act 1986 in s 19 and Schedule B1 para 99 could however, without much difficulty, be read in such a way as to permit new financing arrangements during administration that would take priority over an existing floating charge. It is submitted that there is a great deal going for this solution. It offers the advantages of convenience and flexibility and achieves a necessary reconciliation between the rights of existing security holders and allowing an ailing company to obtain new financing. A creative judicial interpretation that admits the possibility of super-priority new finance would be sensitive to the balancing of interests required by the statutory

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114 [2001] 2 AC 710.
115 [2005] 2 AC 680.

framework and also is firmly in the tradition of incremental change.[116] Moreover, it avoids some undesirable side-effects of the US system such as cross-collateralisation. In addition, it avoids the vagueness and balancing of imponderables required by the Canadian case law and legislation.

[116] See also *Bibby Trade Finance Ltd v McKay* [2006] All ER (D) 2666. While it could be argued that such an interpretation might strengthen the links between secured creditors and the administrator to the detriment of other constituencies, the Enterprise Act already effectively allows the secured creditor a choice over the identity of the person appointed as administrator and any added impact on these links by super-priority new finance is likely to be marginal.

7. The role of employees

Companies experiencing financial difficulties may often blame labour or employment costs for their failure to make a sufficient profit. Of course, in some respects these problems may be easily solved. The company may shed part of its workforce paying the dismissed employees whatever their entitlements are under employment protection legislation. The company may shift its operations overseas where labour costs are lower. This is a phenomenon of an age where manufacturing jobs are often relocated to low-cost, developing countries and administrative backup to companies in the service sector is often performed by means of offshore call centres and 'help' lines. The company, however, may operate in a branch of the economy where relocating a substantial proportion of jobs overseas is not a realistic option. To take a random example, a company may operate a chain of hairdressing salons and finds itself undercut by competitors who have reduced overheads through paying their staff less. How can the company survive the competition? One alternative might be to ask employees to take a wage cut but what if they refuse? Does administration or Chapter 11 open up possibilities that are foreclosed by the general law? This issue will be addressed in this chapter. The important point to note is that general employment protection and also protection during reorganisation proceedings is much stronger in the UK than it is in the US though the devil, as always, is in the detail. After identifying some initial contrasts between the US and UK positions, the chapter will then look at the UK position in more detail, closely followed by a consideration of the US regime. This chapter also considers in broad detail how the pensions of employees are protected during corporate restructuring. The UK, under pressure from the European Union, has recently introduced a statutory guarantee fund for employee pensions in insolvency situations. The legislation, which is clearly modelled on earlier provisions in the US, may have the effect of pushing big companies with large pension deficits into administration instead of the traditional system of informal restructuring. Because the UK provisions are modelled on their US counterparts, it seems to makes sense to examine the US pension provisions first and then the relatively recent UK regime.[1]

[1] On the US position see generally R Ippolito 'Bankruptcy and Workers: Risks, Compensation and Pension Contracts' (2004) 82 Wash U LQ 1251.

UK–US CONTRASTS

In the US, the employment relationship is left largely unregulated and what legislative provisions there are tend to favour the employer. Essentially, a freedom of contract culture prevails. There is no nationwide unfair dismissal legislation in the US and moreover, almost all private sector non-union workers are employed at will. In other words, the contractually required period for giving notice of dismissal is short, if non-existent. Effectively, this means that the employer may dismiss, without notice, as many employees as he wants, at any time, and for whatever reason, as well as freely modifying the terms and conditions of employment agreements. Corporate restructuring may supply a business imperative for such adjustments to the workforce.

There is a general view that restructuring operations could be frustrated or seriously impeded if the company's ability to reduce its workforce is restricted, or if the corporate decision-making process is heavily burdened.[2]

> A rule that prevented or restricted layoffs would have three problematic effects. First, if companies knew they would not be able to lay off employees in the event of financial distress, they would be less likely to hire new workers in the first instance. A no-layoff rule, in other words, would have a chilling effect on hiring. Second, if the no-layoff rule applied only in bankruptcy, companies would try to resolve their problems without filing for bankruptcy, thus forgoing whatever benefits the bankruptcy process offered. Finally, for those companies that did file for bankruptcy, the inability to reduce the company's labor force could cripple the effort to restructure.

In the US, the employment and economic backdrop is fundamentally different from the UK. The trade union movement is significantly weaker with a much higher percentage of non-union workers in the private sector workforce. If the workforce is unionised the hands of the employer are more tied, though still the employer may have more cards to play with than in the UK. In a unionised workplace, the terms and conditions of employment are normally governed by collective bargaining agreements negotiated between the employer and the trade union. The Labor Relations Act 1982 prohibits an employer from unilaterally altering its collective bargaining agreements. The employer is required to bargain in good faith with the certified union over terms and conditions of employment, including wages and hours of employment, and can then modify or terminate a collective bargaining agreement only with union consent. Most collective bargaining agreements contain a successor and assigns clause that purport to make the employer's obligations binding on successors. The transferee of a business may have to bargain with the union

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[2] See D Skeel Jr 'Employees, Pensions, and Governance in Chapter 11' (2004) 82 Wash U LQ 1469 at 1472.

and may be bound for the remaining duration of the predecessor's collective bargaining agreements.

The question arises how these employment law provisions apply if a company experiences financial difficulties and seeks Chapter 11 protection. In Chapter 11, the debtor-in-possession may, with court approval, assume or reject any executory contract at any time before the confirmation of a reorganisation plan.[3] Existing employment contracts are considered to be executory contracts as are collective bargaining agreements. It is somewhat more difficult to reject a collective bargaining agreement than a standard executory contract, though Chapter 11 establishes a special procedure whereby this can be done.[4] In particular sectors of the economy, the suspicion is that some companies enter Chapter 11 with a view to rejecting their collective bargaining agreements. To put the matter more strongly and graphically, such agreements may be, to paraphrase Lenin's view of treaties, like pie crusts made to be broken. In a succession of cases, the bankruptcy courts have favoured the perceived interests of long-term corporate rehabilitation and swept aside wage and benefit concessions that have been won by employees at the bargaining table. The US labour movement, even in former strongholds, like the steel and aircraft industries, seems but a pale shadow of its former self. Its political influence appears to have waned and, moreover, it is divided by intergenerational conflict between retirees and current employees. Given this unpromising backdrop, it is difficult, if not impossible, to sustain victories that have been won in the past through collective bargaining.[5]

The landscape is different in Britain for at least two reasons: the power of the trade union movement and the influence of Europe. In the UK, the trade union movement has traditionally been far stronger than in the US and so too

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3 S 365 of the Bankruptcy Code.

4 S 1113 of the Bankruptcy Code.

5 See generally Michael D Sousa 'Of Prologue and Present: Selected Recent Developments in the Rejection of Collective Bargaining Agreements in Bankruptcy' (2007) 16 Journal of Bankruptcy Law and Practice 3 text accompanying footnote 3: 'Prior to the mid-1970s, the issue of rejecting collective bargaining agreements as part of a Chapter 11 reorganization proceeding received little attention. For most of this period of time, the labor movement in the United States was strong and well-organized. Consequently, attempts to reject collective bargaining agreements in bankruptcy proceedings invariably would have been exercises in futility. The businesses involved could not obtain substitute labor and could not sustain themselves during the course of a strike; thus, while the statutory power existed, in practical terms it was illusory. Since the mid-1970s however, the strength of unions across the country has waned, especially due to the sharp decline in membership. As a result, more companies involved in Chapter 11 reorganization proceedings have attempted, either successfully or unsuccessfully, to reject collective bargaining agreements that prove burdensome to the bankruptcy estate.'

has been its political influence.[6] Following the pattern in the US, the strength of the unions and their political influence may also have waned but, starting from a stronger base, they still carry far greater clout than their transatlantic counterparts. The employment relationship in the UK is heavily regulated and the regulation, increasingly influenced and shaped by European social policy, tends to favour the employee. Britain is of course a member of the European Union and obliged to follow the fundamental tenets of European Union law. European law contains strong elements of a social partnership approach towards employment regulation and measures of protection for employees as historically the weaker party in the employment setting.[7] Although not legally binding in the strictest sense, the Charter of Fundamental Rights signed in Nice in 2000 establishes a set of fundamental principles that underpin the European Union.[8] Chapter IV of the Charter on labour and employment rights is headed 'Solidarity'. This includes protection against unjustified dismissals and information and consultation rights for employees.

As a result, the UK and US have broadly contrasting approaches towards the enforceability of employment contracts in the event of corporate reorganisation. Partly, through implementation of relevant EU directives, the UK labour law system offers more extensive protection to existing employees.[9]

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[6] See generally I Lynch-Fannon *Working Within Two Kinds of Capitalism: Corporate Governance and Employee Stakeholding: US and EC Perspectives* (Oxford, Hart Publishing, 2003) and see also I Lynch-Fannon 'Employees as Corporate Stakeholders: Theory and Reality in a Transatlantic Context' (2004) 4 Journal of Corporate Law Studies 155.

[7] For more details see generally the European Union website www.eurunion.org and more specifically Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions: *Promoting Core Labour Standards and Improving Social Governance in the Context of Globalisation* Com (2001) 416; *European Social Policy: A Way Forward for the Union Commission of the European Communities* COM (94) 333 final/1 and COM (94) final/2.

[8] Article 51(2) provides that the Charter does not establish any new power or task for the European project, or modify powers and tasks defined by the Treaties. Nevertheless the Charter might be used as a guide for the interpretation of more detailed regulations.

[9] See B Carruthers and T Halliday *Rescuing Business – The Making of Corporate Bankruptcy Law in England and the United States*, (Oxford, Clarendon Press, 1998) at p 360: 'British labor has historically been a stronger political actor than American organized labor in part because of the power of the Trades Union Congress (TUC) within the Labour Party. The combination of similar interests and greater political power implies that British organized labor would have played a more active role in legislative reform. Yet, in this case, non-insolvency laws and policies served Labour's interests in a variety of ways, and had the effect of diminishing the importance of insolvency law for British employees.'

The US system aims at keeping the operations of the business alive and generally refraining from interfering with the corporate restructuring process but, at the same time, it facilitates restructuring by relieving the company of 'burdensome' collectively bargained employee commitments. It might be argued that the US approach only gives indirect consideration to the interests of employees and provides them with inadequate protection in a restructuring or bankruptcy scenario. The UK system aims more directly at saving more jobs and offers more benefits to existing employees. It might be argued that this approach provides less incentive for employers to engage employees in the first place and also leaves less flexibility for restructuring. A fear is that, in the long run, this approach may lead to more business liquidation. In the final analysis, one may question whether employees, or potential employees, really benefit from the UK approach. Sensitive to this point however, the trend of recent legislation in the UK, particularly the revised Transfer of Undertakings (Protection of Employment) 2006 regulations,[10] has been to introduce greater flexibility into the system, though this goal may not have been adequately accomplished.

There are also differences of approach between the UK and US in terms of payments to employees in a liquidation or reorganisation context, though the differences are less fundamental. The countries are at one in giving employee claims a certain preferential status up to certain, relatively ungenerous, monetary limits though the consequences of preferential status are slightly different in the two countries. In the UK, preferential status means priority over general unsecured creditors as well as over a particular kind of secured creditor, namely the floating charge holder.[11] In the US, it merely means priority over unsecured creditors.[12] Secured creditors of whatever ilk will get paid first. The major difference between the two countries, however, lies in the fact that in the UK there is effectively a state guarantee system for unpaid employees in the shape of the National Insurance Fund.[13] In insolvency proceedings, employees will normally make a claim against this Fund which, upon satisfying the claim, is then subrogated to the employee's status, whether it be preferential or unsecured creditor, in the proceedings.[14] The UK therefore adopts a mixture of approaches towards protecting employee claims combining the device of preferential status under insolvency law with that of a specific statutorily guaranteed fund as an

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10 Generally referred to as TUPE.

11 See generally A Keay and P Walton 'The Preferential Debts Regime in Liquidation Law: In the Public Interest' [1999] Company, Financial and Insolvency Law Review 84.

12 S 507(a)(4) and (5) of the US Bankruptcy Code.

13 See Part XII Employment Rights Act 1996, ss 182–190.

14 S 189 Employment Rights Act 1996.

adjunct to the bankruptcy system.[15] Under this approach, the State, to a large extent, rather than the employee, runs the risk of non-payment by the insolvent employer.[16] Employees are in a different position from other creditors in that they do not have to compete for payment, at least for the statutorily guaranteed sums.[17] There is no state guarantee in the US and employees of an insolvent enterprise have merely their preferential status to rely upon.

Employees who are kept on during administration or Chapter 11 will normally have their current wages or salary paid in full as this falls due by the administrator or debtor-in-possession. In the UK, basically a claim for post-administration wages or salary is given a form of super-priority status and ranks ahead of the administrator's own claim for remuneration and expenses.[18] One can be confident, therefore, that the administrator will make provision for payment. The pattern is broadly similar in the US with post-petition Chapter 11 wage claims given administrative expense status, which means that they must be paid in full as a condition of the court approving the reorganisation plan.[19] In the UK, the statutory priority has been specifically limited to exclude pre-administration claims for arrears of wages but in the US there is some modest scope for such claims to be allowed as part of the expenses of preserving the bankruptcy estate.[20]

EMPLOYMENT PROTECTION IN THE UK

Information and Consultation Rights

Chapter IV of the European Charter of Fundamental Rights deals with labour and employment rights and is headed 'Solidarity'. Article 27 states that workers or their representatives must be guaranteed information and consultation in

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15 See S Cantlie (1994) 'Preferred Priority in Bankruptcy' in JS Ziegel ed *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford, Clarendon Press, 1994) at p 443: 'Note that a preferred priority does not guarantee complete protection since it is effectual only where the debtor's estate contains sufficient assets to pay out prior claims as well as the particular preferred claim. By contrast, an insurance fund would provide greater protection.'

16 Some employees may prefer the preferential debt regime, for example employees outside the UK who are not covered by the National Insurance Fund – see D Pollard and I Carruthers 'Pensions as a Preferential Debt' (2004) 17 Insolvency Intelligence 65 fn 21.

17 D Skeel, Jr 'Employees, Pensions, and Governance in Chapter 11' at 1483.

18 Schedule B1 para 99 Insolvency Act 1986.

19 S 1129(a)(9) of the Bankruptcy Code.

20 S 503 of the Bankruptcy Code.

good time in the cases, and under the conditions, provided for by Community law and national laws and practices. This statement of general principle can be justified on grounds of social justice: protecting the weaker party to the employment relationship. It can also be viewed through instrumental lens. An advance consultation procedure can serve to legitimate, or at least take some of the sting out of, controversial management decisions. It might also improve the actual decision reached in that employee input may remove some of the blinkers on management decision making. While management are in no sense obliged to obtain the consent of employees to particular decisions, opening up the decision making to employee perspectives may bring a new sense of pointers into the equation and liberate management from the constraints of existing hierarchical thinking.[21] That is the theory at least. Other more critical voices would see the articulated philosophy as political window-dressing at best and, at worst, as a burden on business that hampers the efficient use of resources and draws jobs and businesses away from Europe and into Asia and America.[22]

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[21] See Hugh Collins, KD Ewing and Aileen McColgan *Labour Law: Text and Materials* (Oxford, Hart Publishing, 2005) at p 1072 'Although the pressures from global capital movement may discourage legal interventions to control employers' decisions with respect to changes in the business, it is surely possible to justify some regulation even on narrow grounds of promoting allocative efficiency or the reduction of social cost. Severance payments, if modest, can legitimise workforce reductions, encourage employers to check that reductions will improve the efficient use of capital, and help to reduce social cost by compelling the employer to internalise some of the social costs of economic support for the workforce. The requirement to consult with the workforce may produce better proposals for the efficient use of capital that also serve to enhance employment security. These justifications fit into the policy of promoting the efficient use of capital. In addition, it is important to remember that economic analysis of the effects of regulation indicates that predictions about the inefficient use of capital caused by restrictions have been exaggerated.'

[22] For a statement of the government's general philosophy in this area see the following from the Department of Work and Pensions website – www.dwp.gov.uk: 'The government's approach to employment law combines social justice with economic prosperity. Building on the foundation of economic stability, effective and focused regulation can play a vital role in correcting market failures, promoting fairness and increasing competition. We have therefore introduced a range of important new rights for employees and unions – e.g. a decent minimum wage, prohibition of a variety of unjust discriminatory practices, and new rights in support of family life. These have been widely welcomed, and we will not dilute them.'

However we recognise that many businesses say they do not understand what is required of them, and that the administrative burdens of complying with employment law can seem high. This in turn can discourage employers from employing people, and lead to employees missing out on their rights. We therefore want to reduce the costs to business of applying these regulations, increase their confidence in doing so, and raise the level of compliance.

Be that as it may, the general principles enunciated in the Charter of Fundamental Rights reinforce more detailed information and consultation provisions in the area of collective redundancies and business transfers. In the latter area, the Acquired Rights Directive[23] makes provision. Under Regulations 13 and 14 of the implementing provisions in English law, TUPE, the employer is required to inform and consult with appropriate employee representatives in cases of business transfers.[24] The sanction for non-compliance consists of financial compensation paid by the employer to the employee – the 'protective award'. If there is an independent trade union recognised by the employer, then consultation must take place with that trade union. If no such union is recognised, the employer must consult with elected employee representatives.[25] The consultation must take place long before the relevant transfer and must disclose when the transfer is to take place, the reasons for it, and its legal, economic and social implications for the affected employees. The consultation is also required to reveal what measures are envisaged in relation to the affected employees.[26]

There are no statutory provisions that automatically disapply the information and consultation obligations where the employer is potentially or actually insolvent. The employer must begin the information and consultation process in a timely fashion. The importance of this point is illustrated by *Susie Radin Ltd v GMB*[27] where the Court of Appeal held that where an employer had not

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To this end Success at Work – a March 2006 document setting out the government's approach to employment law for the remainder of this Parliament – announced the Employment Law Simplification Review. This seeks to reduce the compliance costs and complexity of employment law without diluting employee or union rights.'

[23] EEC Council Directive 187 of 1977 on the Approximation of the Laws of the Member States relating to the Safeguarding of Employee's Rights in the Event of Transfers of Undertakings, Businesses or Parts of Businesses (77/187/EEC). The 1977 Directive was amended by Directive 98/59/EC with the relevant provisions now all consolidated in Directive 2001/23/EC.

[24] Under ss 188, 189 of the Trade Union and Labour Relations (Consolidation) Act (TULRCA) 1992 as amended by the Collective Redundancies and Transfer of Undertakings (Protection of Employment) (Amendment) Regulations 1999, the same basic information and consultation obligations apply in situations of mass redundancies. If an employer is proposing to make 20 or more redundancies at a single establishment the consultation must begin in good time and at least 30 days before the first of the dismissals takes effect. If the employer is proposing to make 100 or more dismissals within a 90-day period, the consultation must begin at least 90 days before the first of the dismissals takes effect.

[25] In circumstances where there is no recognised independent trade union, TUPE regulation 14 makes provision for the election of employee representatives.

[26] TUPE regulation 14(4) requires the transferee to notify the transferor of any information that should appropriately be given to the employee representatives.

[27] [2004] 2 All ER 279. In *Sweetin v Coral Racing* [2006] IRLR 252 it was held

engaged in any meaningful consultation before making redundancies, an industrial tribunal could make a protective award for the maximum amount, irrespective of whether the consultation process would have had any material effect on the outcome. The focus is on the severity of the employer's default and therefore the tribunal is entitled to start with the maximum protected period and see if there are any mitigating factors justifying a reduction. Since the protective award should be regarded as punitive or dissuasive rather than retributive, it was an irrelevant consideration that the employer was insolvent and therefore unlikely to be able to meet any protective award.

It is provided in the regulations that if there are special circumstances which render it not reasonably practicable for the employer to comply with the relevant requirements, the employer shall take all such steps towards compliance as are reasonably practicable in those circumstances. The onus is on the employer to demonstrate the existence of special circumstances and it has been held that insolvency can, but does not necessarily, constitute a special circumstance. The fact that a company is insolvent does not make it inherently impracticable to become involved in collective consultation.[28]

In *Baker's Union v Clarks of Hove*[29] Geoffrey Lane LJ held:

> what they said, in effect, was this, that insolvency is, on its own, neither here nor there. It may be a special circumstance, it may not be a special circumstance. It will depend entirely on the cause of the insolvency whether the circumstances can be described as special or not. If, for example, sudden disaster strikes a company, making it necessary to close the concern, then plainly that would be a matter which is capable of being a special circumstance; and that is so whether the disaster is physical or financial. If the insolvency, however, was merely due to a gradual run-down of the company, as it was in this case, then those are facts on which the tribunal can come to the conclusion that the circumstances were not special. In other words, to be special the event must be something out of the ordinary, something uncommon; and that is the meaning of the word 'special' in the context of this Act.

In the past, some administrators may have ignored the information and consultation obligations in view of the fact that there was a small maximum liability and only a small part ranked as a preferential debt. Moreover, the liability might not have passed to the transferee on a TUPE transfer, though

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that Parliament could not have intended any different approach to the assessment of compensation under TUPE compared with the collective redundancy provisions of TULRCA. This meant that the *Susie Radin* guidelines should be applied in assessing the award to be made for failure to inform and consult under TUPE.

28 See *Smith and Moore v Cherry Lewis (In Receivership)* [2004] ICR 893 which applies the *Susie Radin* principles in an insolvency context. Claims for protective awards and for pay in lieu of notice are generally partly guaranteed by the taxpayer under the National Insurance Fund.

29 [1978] 1 WLR 1207.

the issue generated conflicting case law. On the one hand, there was the view that if the transferor did not retain liability, there would be no incentive for the transferor to inform, or consult, at all.[30] On the other hand, it was held in *Alamo Group v Tucker*[31] that the liability to consult transferred and accordingly, the transferee became liable to pay compensation for the transferor's lack of activity. The court said that transferees could protect themselves by making provision for warranties and indemnities in the contract of transfer. This position has now changed not least because the maximum liability is now significantly greater; it takes the form of 13 weeks' pay under TUPE and the new TUPE Regulations expressly provide that liability for failure to consult is joint and several on the transferor and transferee.[32] The information and consultation process can be carried through relatively quickly and straightforwardly, though especially if standard form notification documentation is used.

A common criticism of the information and consultation process is that it is left far too late to have any meaningful effect on the outcome. It needs to be earlier for this purpose. Management thinking has effectively crystallised and is extremely unlikely to change by the time that consultation takes place. This matter has now been addressed by the Information and Consultation directive[33] implemented in the UK by the Information and Consultation of Employees Regulations 2004.[34] These regulations provide employees with the right, subject to certain conditions, to request that their employer should establish arrangements to inform and consult them about major issues affecting the employer. The Regulations came into force for organisations with 150 or more employees in 2005, with more than 100 employees from 6 April 2007 and with more than 50 employees from 6 April 2008.

The Regulations do not prescribe one particular information and consultation procedure. The procedure is triggered either when an employer chooses to start negotiations or by a formal, written request for an information and consultation agreement from at least 10 per cent of employees, subject to a minimum threshold of 15 employees and a maximum of 2500. In either case, the employer will need to make arrangements to allow the employees to elect representatives to negotiate the agreement. The information and consultation agreement should cover major matters affecting the organisation's future. This would include the employer's current and future activities and economic situation, as well as the structure and probable development of employment within

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30 See M Sargeant 'TUPE – The Final Round' [2006] JBL 549 at 563.

31 [2003] ICR 829.

32 Reg 15(9) of the 2006 TUPE regulations.

33 Directive 2002/14/EC.

34 SI No 2004/3426. It seems however that the take-up of the regulations has not been very great.

the organisation and, in particular, on any anticipatory measures envisaged where there is a threat to employment. Information and consultation should also extend to likely future changes of a substantial nature to patterns of work organisation or employment contracts.

STATUTORY NOVATION OF EMPLOYMENT CONTRACTS AS A CONSEQUENCE OF BUSINESS TRANSFERS – ARD AND TUPE

In the UK, employment contracts are transferred as part of a business transfer with existing employment rights remaining good against the transferor. This basic idea comes from the Acquired Rights Directive (ARD) implemented in UK law in the form of the TUPE regulations. The principal premise of the ARD is that it is necessary to provide for employee protection in the event of a change of employer, in particular to ensure that existing employment rights are safeguarded. The European Court of Justice (ECJ) in the *Daddy's Dance Hall* case[35] stated that the objective of the directive was to:

> ensure as far as possible the safeguarding of employees' rights in the event of a change of proprietor of the undertaking and to allow them to remain in the service of the new proprietor on the same condition as those agreed with the vendor. The Directive therefore applies as soon as there is a change, resulting from a conventional sale or a merger, of the natural or legal person responsible for operating the undertaking who, consequently, enters into obligations as an employer towards employees working in the undertaking, and it is of no importance to know whether the ownership of the undertaking has been transferred.

The ARD stipulates that the transferor's rights and obligations arising from a contract of employment or from an employment relationship existing on the date of the transfer shall, by reason of such a transfer, be transferred to the transferee. The transfer does not, by itself, constitute grounds for dismissal by either employer, unless there are economic, technical or organisational reasons ('ETO' reasons) entailing changes in the workforce. The ARD and related aspects of employment law recognise that employees have a property-like claim in relation to the enterprise which is independent of the structure of its ownership.[36] Granting employees rights of this kind is seen as an efficient

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[35] *Foreningen of Arbejdsledere i Danmark v Daddy's Dance Hall A/S C-324/86* [1988] ECR 739.

[36] J Armour and S Deakin 'Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive' (2003) 22 International Review of Law and Economics 443 at 445.

means of recognising their firm-specific human capital. Employees may have spent time and effort in building up skills and expertise that are specific to a particular enterprise and it is worthwhile to preserve this investment when the enterprise restructures. The employees acquire important 'voice' rights which enable their interests to be factored into the decision-making process. The directive also allows for individual claims to be collectivised – subsumed under a collective procedure which allows for the difficulties associated with hold-outs by individual claimants to be overcome.

The broad effect of Regulation 4 of TUPE is to transfer practically all the rights and obligations relating to employees from the seller/transferor to the purchaser/transferee. TUPE allocates responsibilities as a matter of law between the seller and purchaser of a business, but seller and purchaser are free to agree how they will bear the economic cost. For example, a purchaser may seek indemnities from the seller for liabilities that arose before the transfer date. When the original TUPE Regulations were introduced in 1981 the then Conservative Government made it clear that their enactment was only as a result of European constraints. The relevant Minister spoke of a 'remarkable lack of enthusiasm' on the Government's part[37] and, in Parliament, an official spokesperson said:[38] 'It is a major change in principle; but in practice it will not be anything like as far reaching as some have assumed. In reality, it will matter little where responsibility lies, since any shift in that responsibility will be reflected in the purchase price paid for the business.'

The TUPE regulations have however, generated a number of difficulties. Some of these difficulties stem from the original Acquired Rights directive but others from the manner of its implementation in the UK. Firstly, what counts as a relevant transfer for the purpose of the Regulations? Secondly, exactly what rights and obligations are transferred? The general principle does not occasion any particular issues where the rights and obligations are easily capable of being continued by the transferee for example an obligation to pay wages, but, in other cases, the situation may be more problematic. Thirdly, how does TUPE affect existing pension arrangements? Fourthly, what is meant by an ETO reason justifying dismissal? Fifthly, what if employees do not wish to be transferred? Can they opt-out of a transfer? Finally, how does TUPE apply in the context of 'insolvency' transfers?

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37 David Waddington MP 14 HC 680.

38 Lord Lyell 425 HL 1484, 10 December 1981. See generally the discussion in M Sargeant 'TUPE – The Final Round' [2006] JBL 549 who points out that the 2006 version is the fifth in a series of amendments and alterations to the TUPE regulations.

WHAT CONSTITUTES A RELEVANT TRANSFER

On the first point, a new definition provides that a relevant transfer involves the transfer of an economic entity that retains its identity.[39] The phrase 'economic entity' reflects the language found in the ARD 'being an organised grouping of resources which has the objective of pursuing an economic activity, whether or not that activity is central or ancillary'.[40] On whether or not there has been a transfer, the ECJ supplied useful, though non-exhaustive, guidance in *Spijkers v Gebroeders Benedik Abbatoir*[41] stating that it:

> it is necessary to take account of all the factual circumstances of the transaction in question, including the type of undertaking or business in question, the transfer or otherwise of tangible assets such as buildings and stocks, the value of intangible assets at the date of transfer, whether the majority of the staff are taken over by the new employer, the transfer or otherwise of the circle of customers and the degree of similarity between activities before and after the transfer and the duration of any interruption in those activities. It should be made clear, however, that each of these factors is only a part of the overall assessment which is required and therefore they cannot be examined independently of each other.

More generally, the House of Lords held in *Lister v Forth Dry Dock and Engineering Co Ltd*[42] that employment liabilities transferred to the purchaser even if those employees were dismissed by the transferor before the TUPE transfer. The words in the regulations 'immediately before the transfer' were read as if they contained the following additional words 'or would have been so employed if he had not been unfairly dismissed in the circumstances described' by what is now Regulation 7(1). Employees who have been dismissed on account of the later TUPE transfer will still have responsibility for any claims transferred to the purchaser. The dismissal is regarded as automatically unfair unless the purchaser can show that the reason for the dismissal was an economic, technical or organisational reason entailing changes in the workforce. If the 'ETO' defence applies, this is regarded as a substantial reason justifying dismissal under s 98 of the Employment Rights Act 1996 and the tribunal then has to consider whether dismissal comes within the range of reasonable responses by the transferor.

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39 Regulation 3(1)(a) of the 2006 TUPE regulations. There is also specific reference to 'service provision changes'.

40 Article 1 of Directive 2001/23/EC. This is essentially the test employed by the European Court of Justice in *Suzen v Zehnacker Gebdudereingung GmbH C-13/95* [1997] ECR 1-1259.

41 C-24/85 [1986] ECR 1119 at para 13 of the judgment.

42 [1990] 1 AC 546.

There is a significant body of case law as to when dismissals by an insolvent company should be regarded as being by reason of a subsequent transfer. Dismissals made at the request of the proposed purchaser should satisfy this criterion, but it is less clear in the case of dismissals by an administrator where it is economically impossible to retain the entire workforce but, nevertheless, where the administrator has the ultimate sale of the business in mind.[43] If the principal reason for dismissals was to make the business more attractive to a purchaser, then TUPE will come into play, but not if the dismissals were for genuine operational reasons. This is a difficult question of fact that requires an analysis of the administrator's state of mind at the relevant time. While the state of a person's mind at a particular point in time may be as much a fact as the state of his or her indigestion, discerning the precise state of mind is a much more exacting task. Moreover, it is entirely conceivable that the administrator will have more than one reason in mind. Because the issue is not clearcut, purchasers in borderline cases may seek indemnities or reduce the price paid. The desire to reduce the risk of a connection with any subsequent transfer might mean that administrators make dismissals at an earlier stage than would otherwise be the case. If this occurs, then the paradoxical effect of the TUPE regulations has been to reduce job security.[44]

WHAT RIGHTS AND OBLIGATIONS ARE TRANSFERRED

On the second point, which relates to the subject matter of the relevant transfer, Regulation 4(2) provides that all the transferor's rights, powers, duties and liabilities under or in connection with the employee's contract of employment are transferred. Moreover, 'any act or omission before the transfer is completed, of or in relation to the transferor in respect of that contract or a person assigned to that organised grouping of resources or employees' is

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[43] See the *Lister* case [1990] 1 AC 546 and see generally D Pollard 'TUPE and Insolvency' (2006) Insolvency Intelligence 81 and 102 at 84–86 and 102–104.

[44] See D Pollard 'TUPE and Insolvency: Part 1' (2006) 19 Insolvency Intelligence 81 at 85. For the conclusions of a survey conducted by the law firm DLA see S Hardy 'TUPE in Action in Insolvency Proceedings' [2003] Insolvency Lawyer 24 at 26: 'Clearly the DLA (2001) survey evidence suggests that the current legal framework governing business transfers sends out confusing and contradictory guidance to insolvency practitioners. Furthermore, that insolvency practitioners consider TUPE to be unhelpful. As one respondent put it, "[t]he biggest hindrance to saving jobs out of insolvencies is TUPE". Another suggested that "TUPE is the single most important reason why going concern sales are not achieved and businesses are lost". Moreover, another respondent observed that "[i]f TUPE liabilities are too large, it is better to break up the business and sell the assets rather than preserve the business".'

treated as an act or omission of, or in relation to, the transferee. Effectively, the transferor drops out of the picture and there is a statutory novation of the contract of employment in favour of the transferee. It has been held that the statutory novation is sufficiently broad to encompass a sex discrimination complaint that an employee had against the transferor as well as the right to enforce a restrictive covenant in the contract of employment.[45] In general, however, pension obligations do not transfer.

PENSION RIGHTS AND BUSINESS TRANSFERS

On the third point, the Acquired Rights Directive in Article 3(4)(a) excludes from its scope 'employees' rights to old age, invalidity or survivors' benefits under supplementary company or inter-company pension schemes outside the statutory social security schemes in Member States'.[46] The Court of Appeal has rejected an interpretation that would confine the exclusion to accrued pension rights from previous employment.[47] It had been argued that future pension benefits represented a form of deferred pay and were therefore payable after the transfer but the court did not accept this proposition. The ECJ, has however, narrowed the scope of the exclusion by holding that it only operates in respect of benefits payable to a person on reaching the end of his normal working life. It did not cover early retirement benefits that a person might draw upon in the event of dismissal. The ECJ said in *Beckmann v Dynamco Whicheloe MacFarlane Ltd*:[48]

> only benefits paid from the time that an employee reaches the end of his normal working life as laid down by the general structure of the pension scheme in question . . . can be classified as old age benefits, even if they are calculated by reference to the rules for calculating normal pension benefits.

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[45] *DJM International v Nicholas* [1996] ICR 219.

[46] Member States are free to extend the provisions of the directive so as to include pension benefits. See generally B Hepple and K Mumgaard 'Pension Rights in Business Transfers' (1998) 27 ILJ 309.

[47] *Adams v Lancashire County Council* [1997] IRLR 436. See the comments of Morritt LJ at para 11: 'This view of the meaning of the Directive does leave a gap. An employee who has had the opportunity to earn both immediate and deferred pay with his old employer may find that he is deprived of that opportunity, so far as deferred pay is concerned, with his new employer. But the language of the Directive compels me to the conclusion that the Council must, for sufficient reasons, have recognised and accepted that gap.'

[48] *Beckmann v Dynamco Whicheloe MacFarlane Ltd* Case C-164/00 [2002] ECR I-4893 at para 31 of the judgment. See also *Martin v South Bank University* Case C-4/01 [2003] ECR I-12859.

Essentially, what the ECJ seems to have decided is that benefits payable under a pension scheme after the age of 50 following the redundancy of an employee should not be classed as old-age benefits for ARD purposes. The right to receive such benefits transfers and thus the new employer becomes liable to pay them. As one commentator points out:[49]

> Employers of transferred employees will need to replicate benefits provided by the previous employer in respect of early retirement or intended to enhance the conditions of early retirement paid in the event of dismissal. It will be difficult to offer employees terms on a less beneficial basis as any changes are likely to be seen as connected with the transfer.

The ECJ decisions appear to give rise to a number of anomalies. They seem to say that the right to receive redundancy-type benefits in an early retirement scenario will transfer and also perhaps early retirement benefits more generally. The *Beckmann* case concerned early retirement benefits in respect of dismissal by reason of redundancy. The same reasoning was applied in *Martin v South Bank University*[50] in the context of early retirement agreed between the employer and the employee. According to the ECJ there was no reason to treat the two kinds of benefits differently. Such early retirement benefits were not old-age, invalidity or survivors' benefits under company pension schemes, etc. within the ARD.

If these decisions are given their fullest interpretation, then one has the paradoxical situation that an employee who retires early may require the new employer to pay pension benefits on the old pre-transfer basis.[51] If however, the employee chooses to wait until the normal retirement age before retiring then there is no obligation on the new employer. This is anomalous to say the least, and the same comment applies when it comes to the variation of pension benefits. Case law suggests that employees are not permitted to consent to variations in the terms and conditions of employment that has been novated under TUPE if the variation is connected with the transfer.[52] Many, if not

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49 See D Pollard 'Pensions and TUPE' (2005) 34 ILJ 127 at 139.

50 [2003] ECR I-12859.

51 But see *Cross v British Airways plc* [2006] ICR 1239. This interpretation would only apply however where the pension scheme with the transferor has early retirement benefits which give the right to retire early without abatement of pension. Such schemes in practice are confined to the public service and the context of redundancy or early retirement through ill-health. Early retirement on grounds of ill-health would be caught by the exclusion in Regulation 10 relating to 'invalidity' and so *Beckmann* and *Martin* would not be triggered.

52 See the *Daddy's Dance Hall* case C- 324/86 [1988] ECR 739 which holds firmly that the protection afforded by the Acquired Rights directive was a matter of public policy and independent of the will of the parties to the contract of employment.

most, occupational pension schemes permit employers through unilateral acts to vary the terms and conditions of pension entitlement. It seems strange that unilateral variation by the employer is allowed but not variations that are consented to by the employee.

Under UK law, pension fund assets are not held personally by an employer but are legally vested in a separate entity. Assets cannot be transferred out of this fund without the consent of the trustees and under pensions law, employees with two or more years of qualifying service are given preserved rights on leaving the scheme. In other words, they can claim a pension when they reach pensionable age and satisfy the other conditions under the scheme. In a final salary scheme, however, pension benefits are normally calculated by reference to length of qualifying service and final salary. In the course of his working life, an employee might expect to receive salary enhancements through increased seniority and perhaps by regular promotions. An employee who receives a number of separate pensions from different employers is likely to receive far less in the aggregate than an employee who receives a single pension based on his total overall number of years in pensionable employment and his salary at the end of his working life. It may be that in some cases an employer may be willing to accept transferring employees into its existing pension scheme and arrange with the trustees of the transferring employees' pension scheme to take over accrued benefits and liabilities. The new employer, however, may not operate a pension scheme or instead provide one with much less generous benefits than the existing employer. Notwithstanding TUPE, transferred employees may find their income security during retirement greatly affected as a result. The case of *Adams v Lancashire County Council*[53] has been highlighted in this connection. This is a case where the council outsourced its school dinners' service but all the former employees did not qualify for membership of the pension scheme offered by the new contractor. Lower-paid employees, in particular, found themselves without a pension scheme to contribute to for future income security.

The UK government has now grappled with the pensions issue and provided a degree of security for occupational pension rights in the context of TUPE transfers. The relevant provisions are contained in ss 257 and 258 Pensions Act 2004 and the Transfer of Employment (Pension Protection) Regulations 2005 which came into force from 6 April 2005. The provisions are complex but, from that date onwards, transferee employers must provide

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Therefore, the provisions of the directive were mandatory and it was not possible to derogate from them in a manner unfavourable to employees. Consequently, employees were not entitled to waive the rights conferred on them by the directive. Those rights could not be restricted even with their consent. .

53 [1997] IRLR 436 and see the discussion in M Sargeant 'TUPE – The Final Round' [2006] JBL 549 at 566.

transferred employees with a minimum level of pension provision going forward if the employees had access to an occupational pension scheme with employer contributions immediately before the transfer. Basically the employer must match employee contributions up to 6 per cent of pensionable pay. As an exception to the general principle under TUPE, employer and employee are free to contract out of this obligation and instead make provision for alternative pension arrangements. Even with the new legislation however, and the 6 per cent matching contributions, pension benefits from the transferor may not be as valuable as those from the transferee. The legislation though does provide a relatively clear test and one must remember that it applies to all transfers both large and small.[54] As the Department of Work and Pensions has stated:[55] 'Some employers could face significant costs if they were obliged to set up and fund an equivalent scheme from scratch. This provision ensures that these employers have a flexible alternative while still ensuring that employees benefit from employer pension contributions.'

WHAT IS MEANT BY 'ECONOMIC, TECHNICAL OR ORGANISATIONAL' REASONS ENTAILING CHANGES IN THE WORKFORCE

On the fourth point, the reference to ETO reasons justifying dismissals poses another set of conundrums. In the case of an ailing company in administration, pre-transfer dismissals are likely to occur because the business will be shrinking. The administrator may be considering a sale of the business, where possible, but pre-transfer redundancies related to the running of the business should often be found to be for an ETO reason so long as the employees concerned are not subsequently rehired by the purchaser/transferee. In these circumstances, liability does not pass to the purchaser leaving it with the insolvent transferor and the National Insurance fund. It has been argued that a pre-transfer dismissal may be for an ETO reason if it is carried out at the request of (or with the consent of) the purchaser. But at the very least this seems very difficult to establish, especially where the purchaser subsequently rehires the

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[54] See generally D Pollard 'Pensions and TUPE' (2005) 34 ILJ 127 at 139. It should be noted that there is a more generous regime applicable to public sector employees who transfer from the public sector to the private sector. This regime requires the transferee to put in place broadly comparable pension rights and therefore overshadows the rights that other workers have under the 2005 Regulations.

[55] See generally the Department of Work and Pensions website – www.dwp.gov.uk and more specifically www.dwp.gov.uk/lifeevent/penret/penreform/8_trans.asp.

dismissed employees in the same job as before, or hires new employees or redirects its existing employees into the business.[56] Moreover, the Scottish Court of Session in *Hynd v Armstrong*[57] has recently denied the possibility that a pre-transfer dismissal could be for an ETO reason if carried out at the request of the transferee. The court said that a transferor could not take advantage of a transferee's ETO as the ETO must relate to the future conduct of the business. A transferor, if selling the business, had no interest in the future conduct of the business.

More generally, the 'ETO' expression does not yield up a simple meaning. What are economic, technical or organisational reasons justifying changes in the workforce or in the terms and conditions of employment? These words have been referred to as 'gobbledegook'[58] and the requirement that the ETO reasons should entail changes in the workforce adds another element of obfuscation. There was no attempt to define the terms in the TUPE regulations thus leaving a clear invitation to the courts to provide clarification. Although the words have been considered in a number of cases, it is not possible to say precisely what they mean with any confidence. For instance, transferred employees may often have different terms and conditions of employment than existing employees who are carrying out essentially the same tasks for the transferee. The question arises whether harmonisation of terms and conditions constitutes an acceptable ETO reason for varying the contract of employment. Arguably it does not, since an ETO reason for varying the employment contract must also entail a change in the workforce. This suggests a change in the actual numbers of the workforce and not simply the terms and conditions on which they work.[59]

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[56] See D Pollard 'TUPE and Insolvency: Part 11' (2006) 19 Insolvency Intelligence 102 and 103. See the comments of Kerr J in the Northern Ireland case *Willis v McLaughlin & Harvey Plc* [1998] Eu LR 22 that a dismissal at the request of a purchaser could be for an economic reason 'if it can be shown that the prospective purchaser would not proceed unless the employee was dismissed. In those circumstances, it may be said that the employee is dismissed to enhance the prospects of the sale of the undertaking, but since this is necessary for the sale to proceed and the business could not otherwise survive, it is an economic reason which entails (i.e. requires) a change in the workforce.' But for the view that economic reasons should be read more narrowly so as to relate exclusively to the conduct of the underlying business see *Wheeler v Patel* [1987] IRLR 211 and see now *Hynd v Armstrong* 2007 SLT 299; [2007] IRLR 338.

[57] 2007 SLT 299; [2007] IRLR 338.

[58] See M Sargeant 'Proposed Transfer Regulations and Insolvency' [2002] JBL 108 at 111.

[59] See also *Martin v South Bank University* Case C-4/01 [2003] ECR I-12859.

CONTRACTING OUT OF RIGHTS UNDER TUPE

On the fifth point, Regulation 4 of the TUPE regulations stipulates that an employee is not transferred if he objects to being so transferred, but the employee is then in something of a no man's land. The employee has not been transferred but the transferor cannot be treated as having dismissed the employee. It seems however that an employee, to avoid being disadvantaged, is allowed to mount a common law claim for wrongful dismissal or a statutory claim for unfair dismissal or redundancy provided that s/he has good cause to object to the transfer.[60]

It is clear from *Wilson v St Helens BC*[61] that where a company transfers all or part of its business assets, the transferee is not bound to take the employees of the transferor into its employment. In such a situation, however, the transferee will have to pay compensation in respect of unfair dismissal and/or redundancy and this may be substantial, particularly if it is coupled with liability under the protective award for failure to consult on proposed redundancies.[62]

Moreover, the ability of an employer to vary employment terms before or after a TUPE transfer is heavily circumscribed even where the employee consents to such a change. Under Community Law an employee may not waive rights granted to him under the Acquired Rights Directive. This was made clear in the *Daddy's Dance Hall* case.[63] It was held by the House of Lords in *Wilson v St Helens BC*[64] that if employees are the subject of a

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60 See *Humphreys v University of Oxford* [2002] ICR 405 where Humphreys objected to transfer. If this were simply an election on his part to transfer without good cause he would have been left with no claim. He objected however because his employment terms were not going to be continued in all respects by the transferee. This gave him a right to claim constructive dismissal. As he had objected to the transfer of his contract under the Regulations, he was able to pursue this claim against the transferor instead of the transferee.

61 [1999] 2 AC 52.

62 The House of Lords suggested that questions concerning the termination, or otherwise, of contracts of employment was a matter for national law. Neither the TUPE regulations nor the Acquired Rights Directive nor the jurisprudence of the European Court created a community law right to continue in employment which did not exist under national law.

63 [1988] ECR 739.

64 [1999] 2 AC 52. See also reg 4(5) of the 2006 TUPE regulations. Lord Slynn said that variations could be made for reasons that were unconnected with the transfer though in particular cases it might be difficult to decide whether the variation was due to the transfer or was attributable to some separate cause. The new TUPE regulation makes it clear that variations can be agreed for reasons that are unconnected with the transfer or for ETO reasons entailing changes in the workforce. See also on 'contracting-out' etc. *North Wales Training and Enterprise Council Ltd v Astley* [2006] 1 WLR 2420.

'TUPE' transfer, their terms and conditions cannot lawfully be varied for a reason connected to the transfer, regardless of whether they consent to the variations and regardless of how long after the transfer such variations are made. Accordingly, the only reliable way in which an insolvent business could have brought about a change in terms and conditions of employment had been to dismiss the employees and then offer them re-employment on revised terms – a high-risk strategy. Under the new TUPE regime, variations are permissible if the sole or principal reason for the variation is (1) a reason connected with the transfer that is an ETO reason entailing changes in the workforce or (2) a reason unconnected with the transfer. The *Daddy's Dance Hall* case[65] does not expressly allow for variations which are for an ETO reason though the government takes the view that it is illogical to permit dismissals for an ETO reason but not variations of the contract of employment.

BUSINESS TRANSFERS BY INSOLVENT ENTITIES

Perhaps the most controversial aspect of the Acquired Rights Directive has been in relation to business transfers by insolvent entities. It is obviously of concern to employees to ensure that rights and obligations are transferred to an acquirer of all or part of the relevant business of the insolvent entity. The acquirer is likely to be solvent and in a position to ensure that all obligations, including those which relate to service before any transfer, are met in full. On the other hand, it might be argued that recognising employment rights of this kind may obstruct desirable reorganisations. The fact that an acquirer has to bear to burden of employee transfers may both reduce the price paid for corporate assets and the chances of selling the assets. Moreover, the TUPE regulations do not dovetail very well with the general law on insolvency. The effect of the regulations is to give employees a form of super-priority. Employee claims are transferred from an insolvent employer to a solvent acquirer. Other creditors, including secured creditors, are left with claims against the insolvent employer and moreover, the pot that would otherwise be used to pay their claims is reduced because the acquirer has paid less for the assets because of the responsibility of having to meet employee claims.

In the original version of the Acquired Rights Directive, there was no insolvency exception but, in the *Abels* case,[66] the ECJ read in a limited insolvency exception and distinguished between different types of insolvency proceedings in considering the potential application of the Directive. Where the

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65 [1998] ECR 739.

66 *Abels v Administrative Board* [1985] ECR 469 Case 135/83.

proceedings were of the liquidation variety, the directive did not apply. In the subsequent *D'Urso* case,[67] the ECJ held that the directive did apply to the transfer of an insolvent business where the purpose of the insolvency procedure was to enable the undertaking to continue trading.

In the UK, however, it was held in *Bellhaven Brewery v Berekis*[68] that TUPE 1981 should not be interpreted in the light of the implied liquidation exclusion from the Acquired Rights Directive. Regulation 4 of the 1981 TUPE regulations attempted to deal with the insolvency issue by introducing the concept of 'hiving down'. A hive down removes the assets, business and goodwill from an insolvent company or business and transfers these to a new company or business. Only those employees who are not deemed surplus to requirements would have their contracts transferred to the new business. This new business could then be sold, leaving behind the old company or business, with its debts and surplus employees, to face the prospect of going into liquidation.

The decision of the House in *Lister v Forth Dry Dock*[69] appear to deprive the 'hive down' notion of much of its practical utility and this view was confirmed in the *Maxwell Fleet* case.[70] In this case, the administrators entered into a number of transactions with the clear intention of using the hiving down provisions to avoid the consequences of TUPE. Administrators transferred a business a number of times with the employees being dismissed at an early stage and then re-employed by the ultimate acquirer of the business. The court held that these transactions constituted a single transaction for TUPE purposes with the business, and consequently also the employees, being transferred to a new employer.

The Acquired Rights Directive was amended in 1998 to make special provision for insolvency-related transfers. Firstly, Member States were given an option to disapply the transfer provisions in liquidation. Secondly, if the transfer provisions did apply in a particular case, then pre-transfer debts did not have to transfer and, moreover, employee representatives could agree changes in the terms of employment. The UK government has taken advantage of these possibilities and under Regulation 8(7) of the 2006 TUPE regulations, the transfer provisions do not apply where the transferor is the subject of bankruptcy proceedings or any analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and the

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67 *D'Urso v Ercole Marelli* [1991] ECR 1-4105 Case 362/89.

68 (1993) IDS brief 494 and see generally D Pollard 'TUPE and Insolvency: Part 1' (2006) 19 Insolvency Intelligence 81 at 82–83.

69 [1990] 1 AC 546.

70 *Re Maxwell Fleet and Facilities Management Ltd* [2000] 2 All ER 860; [2000] ICR 717.

proceedings are under the supervision of an insolvency practitioner. This provision has been copied directly from Art 5.1 of the Acquired Rights directive. It has been drafted in this way to 'future proof' the provisions against future changes in insolvency rules and to ensure 'that the UK has not extended the coverage of this provision more widely than the Directive allows'.[71] But what the provision may gain in breadth of coverage it loses in clarity. The provision applies to liquidations and conceivably, it could also apply to those administrations where liquidation of assets is the reason for the administration but it is unclear how this will be shown. The provision is unclear about whom should have the relevant 'view'.[72]

Furthermore, in 'non-liquidation' insolvency proceedings, any liability which is covered by the National Insurance Fund under the provisions in the Employment Rights Act 1996 does not pass to the purchaser. In practice, the type of claims caught by this provision will be arrears of pay.[73] Effectively, there is a government subsidy for business transfers in insolvency situations. If the transferor had gone into liquidation, the government would have been liable for those guarantee payments anyway and it might be argued there is no extra expenditure. Nevertheless, the assets that have been transferred would be available to meet any payments and so there is at least a theoretical extra cost incurred by the government whose purpose is to preserve jobs. The transferee has been relieved of debts owed to employees which might otherwise have passed with the business. This should make it easier for an insolvency practitioner to sell on the business as a going-concern.

In addition to the government subsidy, changes in employment terms can be agreed with appropriate employee representatives. Under Regulation 9,

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[71] See p 28 of the 2005 Government consultation on the draft TUPE regulations and see generally M Sargeant 'TUPE – The Final Round' [2006] JBL 549 at 562: 'This seems a very defensive approach for a government to take in relation to the transposition of an EU directive and perhaps reflects a wider concern to remove controversy from the proposals.'

[72] See S Hardy 'Some TUPE implications for Insolvency Lawyers' [2001] Insolvency Lawyer 147 at 'As the TUC has pointed out, " the reality is that it will not always be clear at the outset of the procedure whether it will lead to a continuation of the business or its termination" . . . In Jules *Dethier* [1998] ICR 541 Case 319/94 the ECJ held that the correct criterion to apply for the application of the Directive was not the purpose of the liquidation proceedings (i.e. the realisation of the assets of the company) but whether the company continued to trade after the liquidation process was initiated. This is a far superior test for determining the applicability of the Directive but it is questionable whether it can outlive the formula adopted by the Amending Directive.'

[73] This view depends on a purposive rather than a literal interpretation of the Regulations and it may be that there is still room for argument about what liabilities can be paid from the National Insurance Fund.

variations are permitted to the contract of employment of an assigned employee where the sole or principal reason for it is the transfer itself or a reason connected with the transfer that is not an ETO reason entailing changes in the workforce. The variation must be designed to safeguard employment opportunities by ensuring the survival of the undertaking, business or part of the undertaking or business that is the subject of the relevant transfer. The relevant phrase is 'employment opportunities' rather than merely 'employment' and the justification for any variations can be argued widely on the basis that the business is rescued or safeguarded and this will safeguard employment opportunities in the future.

Employee representatives must be capable, in practice, of mediating between the potentially conflicting claims of different groups of employees as well as having the legitimacy necessary to make credible commitments to management and to creditors. In many workplaces, independent employee representation of the kind needed is lacking, and even the capacity of a recognised trade union to carry out restructuring negotiations on behalf of a group of workers with widely divergent interests cannot be taken for granted. Nowadays in the UK, only a minority of private-sector workers are represented by recognised trade unions and this means that consultation and information rights often vest in ad hoc employee representatives whose independence in practice is open to question. There are considerable difficulties in the process of ensuring effective representation in workplaces where no union is present and where employee representatives have to be elected or selected in an ad hoc way. Moreover, it is difficult to see what employee representatives might use during the negotiation process as a basis for resisting changes to terms and conditions.

More generally, before or after a TUPE transfer, an employer can ask an employee to accept a variation in the terms of employment including a wage cut, though the employee is under no obligation to accede to the request. But if the employee refuses to accept a wage cut and is dismissed for that reason then the dismissal will probably be regarded as unfair for the purpose of the Employment Rights Act, thus entitling the employee to compensation provided that s/he has the requisite amount of service.[74] Of course an employee, having weighed up his/her options, may consider that keeping his/her existing job at a lower wage is a better alternative than the risk of dismissal and the costs, uncertainty, and inconvenience of instituting unfair dismissal proceedings.

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[74] S 94(1) confers on an employee the right not to be unfairly dismissed by his or her employer.

PROTECTION FOR EMPLOYEE CLAIMS AS AN EXPENSE OF ADMINISTRATION

In the UK, certain employee-related claims may be treated as an expense of the administration and are given a form of priority status by what is now para 99 Schedule B1 Insolvency Act 1986.[75] Such claims are given priority over the administrator's own claim for remuneration and over liabilities that are secured by a floating charge. The legislation deems an administrator to be an agent for the company.[76] Under normal principles of agency law an agent is under no liability for the debts and contracts of his principal. Applying this general principle to the present context would mean that employees would have a claim for arrears of wages, etc. against the insolvent employer but none against the administrator personally.[77] This position was considered to offer insufficient protection to employees.[78] Therefore certain employee claims were given priority status by treating them as an expense of the administration. At the same time, however, the legislature was concerned not to privilege the position of employees unduly. Many businesses are labour-intensive with large, existing employee liabilities that might include bonus payments, overdue pension contributions, and if employment ended, redundancy pay and pay in lieu of notice as well as wages and salary strictly so-called. Administrators considered that investing such claims with priority status might hamper the goal of business rescue as well as advantaging employees at the expense of other potential creditors.[79] Some administrators therefore adopted the practice of dismissing all employees on the commencement of administration but then offering re-engagement on the basis they would pay only wages, etc. earned during the period of administration.

Dismissal and re-engagement received some judicial support in the unreported decision in *Re Specialised Mouldings Ltd*.[80] The practice of firing and

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[75] Paras 99(5) and (3) and see also s 19(6) and (4) Insolvency Act [2005] Insolvency Intelligence 156 R Parr and N Bennett.

[76] See Schedule B1 Insolvency Act 1986 para 69: 'In exercising his functions . . . the administrator of a company acts as its agent.'

[77] See *Nicoll v Cutts* [1985] BCC 427 applying this reasoning in the context of receivership.

[78] Essentially it meant that an employee might be unable to recover wages for the services that he had rendered during receivership.

[79] See also the comments of Dillon LJ in at 522: 'Although strictly sums payable are . . . only payable when the administrator vacates office, it is well understood that administrators will, in the ordinary way, pay expenses of the administration including the salaries and other payments to employees as they arise during the continuance of the administration. There is no need to wait until the end, and it would be impossible as a practical matter to do that.'

[80] High Court, unreported, 12 February 1987.

rehiring continued until 1994 when the Court of Appeal ruled in the *Paramount Airways*[81] litigation that administrators could not cherry-pick from employment contracts those provisions which they wanted and ignore those they did not. The House of Lords narrowed the impact of the decision by excluding liabilities that accrued prior to adoption of a contract.[82] Nevertheless, administrators were still left with the prospect of paying as an expense of the administration (in priority even to their own remuneration) not only wages accruing during the adoption period but also pay in lieu of notice, and expensive pension contributions.[83]

The *Paramount* case was statutorily overruled by the introduction of the concept of a qualifying liability – a liability to pay wages or salary, or a contribution to an occupational pension scheme, but only for services rendered wholly or partly after the adoption of a contract. To provide administrators with a breathing space to decide whether or not to adopt contracts of employment it was enacted that no liability should accrue for anything done, or omitted to be done, within 14 days after the commencement of administration. These reform measures – potential liabilities being circumscribed and the administrator given a 14-day grace period for deciding if existing contracts of employment should be adopted – were carried over into para 99 Schedule B1.[84]

In some respects, the provisions in para 99 were unhappily drafted and gave rise to conflicting interpretations.[85] In the *Huddersfield Fine Worsteds* case Peter Smith J, however, concluded that para 99 was nothing more than a sensible attempt at marrying the differing definitions of wages or salary contained in insolvency and social security legislation.[86] He gave para 99 its broadest

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81 *Powdrill v Watson; Re Paramount Airways Ltd (No 3)* [1994] 2 All ER 513. In this case, administrators were held to have impliedly adopted the contracts of employment of two airline pilots when they continued to pay them in accordance with their previous contracts after the 14-day period had expired.

82 [1995] 2 AC 394.

83 See generally P Davies 'Employee Claims in Insolvency: Corporate Rescues and Preferential Claims' (1994) 23 ILJ 141; D Pollard 'Adopted Employees in Insolvency – Orphans No More' (1995) 24 ILJ 141; C Villiers 'Employees as Creditors: a Challenge for Justice in Insolvency Law' (1999) 20 Company Lawyer 222.

84 Insolvency Act 1986, Schedule B1, para 99.There is no statutory definition of what constitutes the adoption of a contract but according to *Powdrill v Watson* [1995] 2 AC 394 the contract of employment was inevitably adopted if the administrator caused the company to continue the contract of employment for more than 14 days after appointment; F Toube and G Todd 'The Proper Treatment of Employees' Claims in Administration' (2005) 18 Insolvency Intelligence 108 at 109.

85 *Re Allders Department Stores Ltd (In Administration)* [2005] EWHC 172 (Ch). The scope of 'wages or salary' refers to Schedule B1, para 99(6) of IA 1986.

86 Para 99(6) provides that 'wages or salary' includes:

possible interpretation so as to include a protective award and pay in lieu of notice. A more limited interpretation was adopted though in *Allders Department Stores Ltd*[87] where it was held that statutory liabilities for redundancy or unfair dismissal payments are not wages or salary and thus do not have priority under para 99. The only liabilities that were payable by virtue of para 99 in priority to the administrator's expenses are those liabilities which had been adopted after 14 days from the administrator's appointment and which constituted wages or salary.

The latter interpretation was preferred by the Court of Appeal in *Re Huddersfield Fine Worsteds Ltd* who held most payments in lieu of notice and protective award payments are not wages or salary for the purposes of para 99. Consequently, they are not payable as administration expenses. The Court of Appeal was anxious to avoid an interpretation that elevated redundancy and unfair dismissal claims to super-preferential status for fear that this might adversely affect the ability of administrators to rescue businesses and save jobs.

If an administrator makes an employee redundant the employee becomes entitled to a statutory redundancy payment but this payment does not count as wages or salary for the purposes of para 99 and is therefore not payable as an expense of the administration. Normally, in such a situation, the employee would make a claim from the National Insurance Fund and the Fund is then subrogated to the employee's claims against the company in administration. An employee's claim for a redundancy payment is entitled to preferential status under Schedule 6 of the Insolvency Act, subject to certain limits, and the National Insurance Fund is entitled to step into the shoes of the employee insofar as claiming this preferential status is concerned. Pursuant to para 65, an administrator may make distributions to creditors but, in doing so, preferential entitlements must be respected. The expenses of administration have to be met first, followed by preferential claims, then amounts secured by a floating charge and finally, general unsecured debts.

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a. a sum payable in respect of a period of holiday (for which purpose the sum shall be treated as relating to the period by reference to which the entitlement to holiday accrued),
b. a sum payable in respect of a period of absence through illness or other good cause,
c. a sum payable in lieu of holiday,
d. in respect of a period, a sum which would be treated as earnings for that period for the purposes of an enactment about social security, and
e. a contribution to an occupational pension scheme.

87 [2005] 2 All ER 122.

THE UNITED STATES – RELATIVE LACK OF EMPLOYMENT PROTECTION

Rejection of Collective Bargaining Agreements

In the US, one of the advantages of entering Chapter 11 is that a company is given a relatively free hand in dealing with executory contracts. A company is free to assume or reject executory contracts notwithstanding the provisions of the contract. Therefore, a so-called 'ipso facto' clause stating that the contract comes to an end upon the company's bankruptcy is of no effect in the Chapter 11 context. While there may be some controversy as to what constitutes an executory contract,[88] contracts of employment undoubtedly come within the category as do collective bargaining agreements. In the UK, in general, terms and conditions of employment are governed by individual contracts of employment whereas collective agreements are not regarded as legally binding.[89] While employees may be asked to accept a wage cut where companies are in financial difficulties, collective bargaining agreements per se cannot serve as the appropriate target for cost cutting like in the US.[90] There are no

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[88] A standard definition is that proferred by Professor Vern Countryman who calls an executory contract a contract under which the obligations of the debtor and the other party are so far unperformed that the failure of either to perform would constitute a material breach excusing the performance of the other – see 'Executory Contracts in Bankruptcy Part 1' (1973) 57 Minn L Rev 439. More recently a functional test suggested by Professor Jay L Westbrook has found favour with the courts. This test looks at what performance remains for the debtor and decides whether it makes economic sense for the debtor in possession to assume or reject or, in simpler terms, to perform or not to perform. The focus is on whether it benefits the bankruptcy estate to perform whatever remains for the debtor to do under the contract. 'The trustee may, indeed must, assume or reject every pre-bankruptcy contract of the debtor that is not completely performed or satisfied on the date of bankruptcy' – see JL Westbrook 'A Functional Analysis of Executory Contracts' (1989) 74 Minn L Rev 227 at 235.

[89] S 179 Trade Union and Labour Relations (Consolidation) Act 1992 provides that a 'collective agreement shall be conclusively presumed not to have been intended by the parties to be a legally enforceable contract unless the agreement – (a) is in writing, and (b) contains a provision which (however expressed) states that the parties intend that the agreement shall be a legally enforceable contract.'

[90] See B Carruthers and T Halliday *Rescuing Business – The Making of Corporate Bankruptcy Law in England and the United States*, (Oxford, Clarendon Press, 1998) at p 362: 'There is, in other words, no equivalent to the labor contract as an executory contract. Elements of collective bargaining agreements did not apply in the English case because there was no legal relationship to redefine or overturn. . . . Whatever opportunities insolvency offers for restructuring the firm and reducing costs, British managers will be reluctant to seize them unless forced to do so, for their own jobs will also be threatened. The upshot is that there is no English equivalent to "strategic bankruptcy".'

special provisions applicable to collective bargaining agreements in the context of an administration or company voluntary arrangement.

In the US, in the unionised sectors of the economy, terms and conditions of employment are governed by collective bargaining agreements. The collective bargaining agreement may however commit the employer to wage levels and to other employment benefits that it now considers to be unsustainable in the context of the company's survival. Chapter 11 provides the company with the opportunity to reject the collective bargaining agreement and reduce these wages and benefits to levels that it considers economically viable.

It appears, however, that in the debates on the 1978 Bankruptcy Code organised labour was largely oblivious to the dangers to it posed by the provisions on executory contracts. The labour movement concentrated on improving the preferential status of employee claims and largely ignored the executory contract provisions.[91] Insofar as it addressed the issue at all, organised labour considered that the provisions of labour law upholding collective bargaining agreements would prevail. This complacent attitude was rudely shattered by the 1984 Supreme Court ruling in *National Labor Relations Board v Bildisco*,[92] which highlighted the potential conflict between bankruptcy law and labour law and allowed bankruptcy law to prevail. In *Bildisco*, the Supreme Court held that a bankruptcy judge may approve rejection of a collective bargaining agreement if the company demonstrates that the agreement is a burden on the company and the relevant equities, when balanced, favour rejection.[93] It was feared that the decision in *Bildisco* would encourage companies to use Chapter 11 in a very strategic way to reduce costs through altering their collective bargaining commitments.[94] At the time that the decision was handed, the labour movement

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[91] B Carruthers and T Halliday ibid at pp 334, 336: 'Labor witnesses focused upon the priority rank accorded wages and benefits. One reason for labor's prior neglect was that management groups also showed little interest…. Yet labor did not see collective bargaining as a prime issue for the same reason that neither management nor staffers gave it close attention: the probability of its occurrence seemed sufficiently remote that it should not clutter the legislative agenda. The 1978 Act was scarcely mentioned in union publications, and no mention was made of executory contracts.'

[92] 465 US 513 (1984).

[93] By a five to four majority, the Supreme Court also ruled that the debtor had not committed an unfair labor practice by unilaterally modifying its labor contract before securing the permission of a bankruptcy judge, pending the court's decision on the rejection motion.

[94] Some companies may tend to file Chapter 11 even though they are having no trouble meeting their current obligations and are, from a balance sheet perspective, solvent. The primary reason for such a filing might not be for reorganisation but for costs cutting. 'The most publicized examples were Continental Airlines and Wilson Foods, both of which in 1983 used Chapter 11 reorganizations to cut their unionized labor costs by a substantial amount.' See B Carruthers and T Halliday *Rescuing Business* at p 337.

occupied a position of influence in the US Congress and it managed to achieve a speedy, but partial, reversal of *Bildisco*. Section 1113 of the Bankruptcy Code was enacted to govern the rejection or modification of collective bargaining agreements.[95] Section 1113 attempts to balance the reorganisational objectives of Chapter 11 with the protections given to collective bargaining agreements under labour law. The section is designed to encourage collective bargaining and aims to ensure that the Chapter 11 process cannot be used solely by employers to rid themselves of commitments entered into previously with unions.[96] Section 1113 prohibits unilateral termination or modification of collective bargaining agreements before obtaining the permission of the bankruptcy court. It does set out a procedure however, that permits the debtor company to implement interim changes in the terms, conditions, wages benefits, or work rules provided by such an agreement. The implementation of interim changes, nevertheless, does not relieve the company of its obligation to obtain court approval for rejection or modification of the agreement. Interim relief is available if it is essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the bankruptcy estate.

Section 1113 specifies both a series of steps and a new standard that a debtor in Chapter 11 must meet before it can reject a collective bargaining agreement.[97] Before authorising rejection, the bankruptcy court must be satis-

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[95] For more details of the enactment process see B Carruthers and T Halliday ibid at pp 337–339; L Levitt and RJ Mason 'Rejection of Labor Contracts Under Chapter 11' (1984) 89 Com LJ 177; M. Pulliam 'The Rejection of Collective Bargaining Agreements Under Section 365 of the Bankruptcy Code' (1984) 58 Am Bankr LJ 1 and D Hermann and D Neff 'Rush to Judgement: Congressional Response to Judicial Recognition of Rejection of Collective Bargaining Agreements under Chapter 11 of the Bankruptcy Code' (1985) 27 Arizona Law Review 617.

[96] See Keith A Simon 'Liquidating Chapter 11 Debtors and Rejection of Collective Bargaining Agreements under Section 113 of the Bankruptcy Code' (2005) 14 Journal of Bankruptcy Law and Practice 5 at fn 12.

[97] The debtor may act without prior bankruptcy court approval only if the court fails to act on the debtor's application for rejection within 30 days after the date of the commencement of the hearing – s 1113(d)(2). For ordinary executory contracts, the traditional test for court approval was the 'business judgment' test: if rejection would benefit the estate financially, it was approved. In collective bargaining cases, there was a general view some stricter standard must be applied, but disagreement about how stricter it should be. In *Shopmen's Local Union No. 455 v Kevin Steel Products Inc* (1975) 519 F 2d 689 it was held that a collective bargaining agreement could be rejected pursuant to a balancing of the equities standard. In *Brotherhood of Railway, Airline & Steamship Clerks v REA Express Inc* (1975) 523 F 2d 164 a tougher standard for rejection was announced – a 'business failure' standard which required proof that rejection was necessary to save the debtor's business from failing. Subsequent decisions, including that in *Bildisco* favoured the *Kevin Steel* 'balancing of the equities'

fied that, after considering the debtor's proposal, the union has refused to accept the proposal 'without good cause' and the 'balance of the equities' also clearly favours rejection of the agreement. Extrapolating from the statutory language, the courts have set out a nine-step test that should be used in determining whether a company can reject:[98]

1. The company must make a proposal to the union to reject or modify the collective bargaining agreement.
2. The proposal must be based on the most complete and reliable information that is available to the company at the time of the proposal.
3. The proposed changes must be necessary to permit the company's reorganisation.
4. The proposed changes must assure that the creditors as a whole and all affected parties including the company are treated fairly and equitably.
5. The company must provide the union with the information necessary to evaluate the proposal.
6. Between the time of making the proposal and the relevant court hearing, the company must meet with the union at reasonable times.
7. At the meetings the company must confer in good faith in an attempt to reach a mutually satisfactory modification of the collective bargaining agreement.
8. The union must have refused to accept the proposal without good cause.
9. The balance of the equities must clearly favour rejection of the collective bargaining agreement.

The statutory language is almost unusually opaque.[99] Many of the terms in s 1113, including balancing the equities, lack specific statutory definition and the courts usually have to resort to the legislative history of the provisions or their pre-existing meaning in relevant legislation.

The employer must demonstrate a willingness to confer in good faith and in one case this requirement was held not to be satisfied where the employer presented a proposal to the union on a non-negotiable basis.[100] In other words,

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standard over the *REA Express* 'business failure' standard. Mainly codifying the *Bildisco* standard, s 1113(c)(3) requires that the court must find that both the union has refused to accept the debtor's proposal 'without good cause' and the 'balance of the equities clearly favours rejection' of the agreement.

98 See *Re American Provision Co* (1984) 44 BR 907 at 909.

99 In *Re Family Snacks* Inc (2001) 257 BR 884 at 893 it was suggested that the section was not a masterpiece of craftsmanship and was in fact quite poorly drafted.

100 See *Re Lady H Coal Co Inc* (1996) 193 BR 233 at 242: 'A debtor has a duty under section 1113 to not obligate itself prior to negotiations with its union employees, which would likely preclude reaching a compromise. In this case the debtors could not

it was unprepared to revisit its initial modification proposals in the light of union objections. The union is required to refuse to accept the debtor's proposal without good cause. It has held that this test does not require the court to examine whether the debtor's proposal is the only one that could reasonably be advanced. It does not matter that the union has put forward a plausible counterproposal:

> [I]t bears repeating that Section 1113 focuses on the debtor-employer's proposal, not the union's. It is [the employer's] proposal which must pass muster under the several requirements of the statute, and Congress has not authorized the Court to decide a Section 1113 motion by acting as a sort of super-arbiter choosing between competing proposals. The Court is required to focus on the debtor's proposal and to grant or deny the motion based upon its conclusions as to whether the debtor's proposal meets the statutory criteria.[101]

In balancing the equities, courts usually weigh up various factors, including the number of employees not subject to the collective bargaining agreement who run the risk of losing their jobs if the reorganisation fails, the timing of the rejection or modification request and the risk of the company's total shutdown during the reorganisation process.[102] The court is enjoined to consider whether rejection of modification of the agreement is necessary to permit the debtor's reorganisation. The predominant judicial interpretation takes a flexible approach towards the 'necessity' requirement and asks whether rejection, etc. would increase the likelihood of a successful reorganisation. The courts have talked about an equitable balancing test and[103]

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have bargained in good faith as the debtors were, prior to any negotiations with the union, locked into an agreement where the purchaser was not assuming the collective bargaining agreement. Further, there is evidence in this case that the officers did not pursue a possible sale to another buyer who was willing to assume the collective bargaining agreement.

[101] *Re Delta Air Lines Inc (No 2)* 2006 WL 3771049 at 17 and see generally Michael D Sousa 'Of Prologue and Present: Selected Recent Developments in the Rejection of Collective Bargaining Agreements in Bankruptcy' (2007) 16 Journal of Bankruptcy Law and Practice 3.

[102] S Becker 'The Bankruptcy Law's Effect on Collective Bargaining Agreements' (1981) 81 Columbia Law Review 391 at 402–403. 'Once the court is satisfied that the bankruptcy is not a sham, it is self-evident that "the payment of benefits . . . would drastically prejudice the position of the unsecured creditors," so the contract should be rejected.' If the debtor lays off employees in the process of shutting down part of its plant, the equities will generally favour the debtor.

[103] *Truck Drivers Local 807 v Carey Transport Inc* (1987) 816 F 2d 82 at 92. In *Carey* the court also suggested that necessary modifications need not be restricted to those that are absolutely essential or minimal and that reorganisation refers to the long-term financial viability of the company rather than the short-term goal of preventing

at least six permissible equitable considerations, many of which also factor into the other substantive requirements imposed by section 1113. Those are (1) the likelihood and consequences of liquidation if rejection is not permitted; (2) the likely reduction in the value of creditors' claims if the bargaining agreement remains in force; (3) the likelihood and consequences of a strike if the bargaining agreement is voided; (4) the possibility and likely effect of any employee claims for breach of contract if rejection is approved; (5) the cost-spreading abilities of the various parties, taking into account the number of employees covered by the bargaining agreement and how various employees' wages and benefits compare to those of others in the industry, and (6) the good or bad faith of the parties in dealing with the debtor's financial dilemma.

RETIREE BENEFITS

Section 1114 deals with retiree benefits under a health care plan and provides a procedure for modification similar to that laid down in s 1113 for collective bargaining agreements. According to s 1129, unless the benefits are modified pursuant to s 1114, they must continue to be paid as a condition of the reorganisation plan being confirmed. The employer must bargain with the union or a separate committee that is representative of retirees over a proposed modification of the benefits. If these negotiations are unsuccessful, the employer can then turn to the court to sanction a modification of the benefits provided that other procedural steps are met. It should be noted however that, after modification, retiree representatives can apply to the court for a subsequent increase in benefits.[104]

EMPLOYEE CLAIMS WITH PRIORITY STATUS

Pre-Chapter 11 debts owed to employees are sometimes paid in full in a so-called 'first day order' whereby the Bankruptcy Court authorises payment of existing company debts particularly those owed to 'critical vendors'. The critical vendor doctrine came, however, under stringent judicial scrutiny in the

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the company's liquidation. Other courts have taken a more restrictive view of the scope to sanction modification. In *Wheeling-Pittsburgh Steel Corp v United Steelworkers* (1986) 791 F 2d 1074 it was said that the court should only permit essential minimum modifications to the collective bargaining agreement and the term 'necessary' was construed to mean 'essential'. It was also said that the objective of the modifications should be the short-term goal of preventing the company's liquidation rather than the long-term goal of restoring the company to financial health.

[104] S 1114(g)(3). The court is obliged to accede to such a request if it 'assures that all creditors, the debtor, and all of the affected parties, are treated fairly and equitably, and is clearly favored by the balance of the equities'.

Kmart litigation where the bankruptcy court authorised payment of no less than $300m in existing unsecured debts, deeming the creditors to be critical vendors whose payment in full and goodwill was critical to the survival of the company's business. On appeal, a more sceptical approach was evidenced with the court suggesting that such payments are impermissible unless the company can show that they will 'enable a successful reorganization and make even the disfavoured creditors better off'.[105] But as Professor Skeel remarks,[106] the *Kmart* ruling

> is unlikely to discourage corporate debtors from paying their pre-petition obligations to employees they wish to retain. This is as it should be. Not only are the retained employees essential to the reorganization process, but attempting to stop the company from paying them in full would be a fool's errand; firms would simply find other ways to make up for the lost wages.

Any payment for retiree benefits required to be made prior to plan confirmation under s 1129 has administrative expense status under s 503 of the Bankruptcy Code.

PENSION PROTECTION IN INSOLVENCY

The US Position

There are broad similarities between the treatment of defined benefit occupational pension schemes in the Chapter 11 context and in the UK administration context though substantial differences in detail. In general terms, a sponsoring employer is allowed to terminate a defined benefit pension plan that is in deficit and such termination triggers a statutory guarantee liability. In Chapter 11, an employer is permitted to terminate a pension plan if it meets certain notice requirements and establishes to the satisfaction of the Bankruptcy Court

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105 *Re Kmart Corp* (2004) 359 F 3d 866 at 872. Other courts have adopted a more sympathetic approach towards critical vendor payments authorising them on a looser, value maximising test. In *Re CoServ LLC* (2002) 273 Bankr Rep 487 at 498–499 it was said that the corporate debtor must demonstrate the existence of three elements: 'First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.'

106 David A Skeel 'Employees, Pensions and Governance in Chapter 11' (2004) 82 Washington LQ 1468 at 1474.

that it will be unable to pay its debts and continue in business outside Chapter 11 unless the pension plan is terminated.

More generally under the Employee Retirement Income Security Act 1974 (ERISA), a pension plan may be terminated voluntarily by the plan sponsor or involuntarily by the Pension Benefits Guaranty Corporation (PBGC).[107] Voluntary termination is possible in one of two ways. The first is 'standard termination' where the plan sponsor has sufficient assets to meet all benefit commitments and the second is 'distress termination' where the assets are insufficient to satisfy all pension liabilities. The 'reorganisation' criterion is one of four possibilities that a plan sponsor can point to as allowing distress termination.[108] As explained in *Re Kaiser Aluminium*[109] the reorganisation test contains in itself four ingredients. Firstly, the plan sponsor must have filed a Chapter 11 reorganisation petition; secondly, as of the proposed termination date, the petition has not been dismissed; thirdly, the sponsor has provided the PBGC with a copy of the request for bankruptcy court approval of the termination and finally, the court is required to approve the termination having found that unless the plan is terminated, the company will be unable to pay all its debts pursuant to the reorganisation plan and continue in business outside Chapter 11. The latter element may be referred to as a financial necessity determination.

There is little case law on the interpretation and application of the distress termination provisions of ERISA and, in particular, the financial necessity determination. It seems however that it should be construed as meaning that, but for the termination of the pension plan, the company will not be able to pay its debts when due and will not be able to continue in business.[110] The court will ask whether a company will be unable to pay its debts and continue in business under any reorganisation plan and not just under the proposal on the table. Obtaining bankruptcy court approval is not a shoo-in. As certain commentators remark:[111]

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107 See generally on the role of the PBGC and bankruptcy Daniel Keating 'Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy' (1993) 77 Minnesota Law Review 803.

108 The other possibilities are when the company is in liquidation proceedings, or the PBGC determines that the company will go out of business unless its plan is terminated or that providing pension coverage has become unduly burdensome solely by reason of a declining work force – see s 1341 of ERISA.

109 (2006) 456 F 3d 328.

110 See *Re Resol Manufacturing Co Inc* (1990) 110 BR 858 at 862.

111 See generally Tom A Jerman and Aparna B Joshi 'Termination of Defined Benefit Pension Plans and Other Retiree Benefits' (2004) 13 Journal of Bankruptcy Law and Practice 2.

> An employer seeking approval should be prepared to demonstrate all of the actions it has taken to avoid the necessity of terminating the plan . . . [In one case] the bankruptcy court held that to obtain a distress termination, the debtor must show that 'it has taken every means within its power to fund the plan according to the current terms embodied in the agreement between the company and the union'. This includes 'a showing of efforts made by management to reduce their own compensation, to take any and all steps to improve their efficiency of operation, and to demonstrate what those steps are and what efficient procedures have been introduced and the effect of their implementation.'

One might argue that, notwithstanding the sensitivity of the operation, bankruptcy judges are well positioned to balance pension rights against the survival of the company or at least that this task is not fundamentally different from that which they are called upon to perform in every Chapter 11 case. In Chapter 11, bankruptcy judges are required to judge the likelihood of a successful reorganisation.[112] Moreover, bankruptcy judges are also:[113]

> familiar with potential conflicts such as the tension between older and retired workers, whose principal concern is their pension, and younger workers who may be comparatively more concerned to see a reorganization that preserves their jobs. These are not easy issues, but Chapter 11 is the most sensible place to resolve the question of when a company should be permitted to terminate its pension plan without also going out of business.

When a distress termination of a pension plan has been approved, the PBGC takes over the management of the plan and makes guaranteed payments to retirees first from the plan's remaining assets and then from its own assets.[114] The effect of plan termination, however, may be a sharp reduction in

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[112] For a discussion of the practicalities of judges considering the feasibility of a reorganization plan see Lynn M LoPucki *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* (Ann Arbor, University of Michigan Press, 2005) at pp 103–107.

[113] David A Skeel 'Employees, Pensions and Governance in Chapter 11' (2004) 82 Washington LQ 1468 at 1480.

[114] The statutory guarantee only covers defined benefit plans and not defined contribution plans. This makes sense as in a defined contribution plan employers fulfil their funding obligations as soon as they make contributions. With a defined benefit plan the employer promises employees a certain level of benefit on retirement. If the scheme is wound up, one can calculate actuarially whether or not there is going to be a surplus. With a defined benefit plan the employer's liabilities are much more open handed and uncertain than with a defined contribution plan. With a defined contribution plan the risk of poor investment returns etc. is shifted from the employer onto the shoulders of the employee. In both the UK and US there has been a shift from defined benefit to defined contribution pension plans. On the US see generally Margaret M Blair 'Comments on Richard Ippolito, Bankruptcy and Workers: Risks, Compensation

pension payments to retirees. The PBGC guarantee only covers benefits up to a statutory limit and provided that the benefits have already vested before the plan termination and have not been increased by an amendment of the plan that was made less than five years before termination. Benefits become payable in excess of the statutorily guaranteed amounts if the plan assets, plus any recoveries by the PBGC in claims against the plan sponsor, enable this to be done. This is an unlikely scenario, however, and it will only become clear some time after termination. Consequently, retirees will have their pensions reduced to the guaranteed levels immediately on plan termination with the small possibility of an increase in the distant future.

Essentially, the PBGC is a statutory insurer of defined benefit pension schemes and its most importance source of income is the premiums that it charges companies which receive the benefits of its insurance cover. Other sources of funding are investment income and recoveries in bankruptcy, with the PBGC having the status of an unsecured creditor in respect of any liabilities arising out of the company's failure to meet its defined benefit pension commitments. The Deficit Reduction Act 2006 introduced a termination premium for companies whose pension plans are terminated in a Chapter 11 reorganisation context. The legislation significantly discourages companies from using Chapter 11 as a vehicle for shedding pension commitments.[115] A company is now required to pay the PBGC $1250 in respect of each enrolled pension plan participant for three consecutive years following the company's Chapter 11 discharge.

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and Pension Contracts' (2004) 82 Washington U LQ 1305: 'In 1998 only 16% of working people in the United States were covered by traditional defined-benefit pension plans. This was down from 38% in 1980. The overall percentage of working people who are covered by some form of pension plan has also declined. It was 54% in 1980 and it was down to 52% in 1998. Although small, that decline happened despite the fact that we had substantial ageing of the population during that period, as well as an increase in the share of the workforce in full-time employment. So the fact that the proportion of people that are covered by any kind of pension benefits declined at all is surprising when you think about it in the context of demographic changes that have been underway.'

[115] For an argument against further restrictions see Adam E Cearley 'The PBGC: Why the Retiree's Traditional Life Raft is Sinking and how to Bail it Out' (2006) 23 Emory Bankruptcy Developments Journal 181 at 206–207: 'A rule requiring liquidation during voluntary distressed terminations would be under-inclusive because plans that terminate under this scheme would likely leave a larger burden on the PBGC. As companies become unable to keep up with their pension obligations, they often begin to take greater risks with funding levels. With liquidation as the only alternative, companies would take this behaviour to the statutorily allowed extreme. This could result in substantially increased plan asset insufficiency for the PBGC. Without any accompanying evidence that the PBGC would recover more through Chapter 7 than it does under Chapter 11 this solution could exacerbate the PBGC's insolvency problem.'

> The newly created termination premium creates a poison pill that companies must consider if they choose to shirk unfunded liabilities through bankruptcy. . . . In every Chapter 11 case, the costly obligations created by the termination premium would arise only after a company receives a discharge, meaning the premiums cannot be discharged or settled in connection with the Chapter 11 proceeding. This creates a Chapter 11 poison pill and forces the Chapter 11 debtor to allocate resources to pay this 'poison pill' penalty.[116]

The UK Position

Following the US PBGC model, the UK has now introduced a statutory insurance fund to meet pension deficits in certain circumstances where the relevant employer has entered insolvency proceedings. A new statutory creation, the Pension Protection Fund steps in and will pay pension benefits up to certain limits. The Pension Protection Fund was introduced by the Pensions Act 2004 and applies in respect of defined 'insolvency events' (including administration) that arise after the fund came into force in April 2005.[117]

The lack of comprehensive statutory protection before April 2005 has occasioned condemnation for the UK at the EU level. In *Robins v Secretary of State for Work and Pensions*[118] adversely affected pension scheme members (supported by their union) contended before the ECJ that this constituted a breach of Art 8 of EC Directive 80/987 (the Employment Insolvency Directive). This Directive provides for 'the approximation of the laws of Member States relating to the protection of employees in the event of the insolvency of their employer'. Article 8 contains an obligation on Member States to 'ensure that the necessary measures are taken to protect the interests of employees' and ex-employees, under occupational pension schemes following insolvency of the employer. The article (unlike Art 4 dealing with wage claims, etc.) does not expressly allow a Member State to impose any monetary limits on the 'necessary measures', whereas the protections afforded by the National Insurance Fund under the Pension Schemes Act 1993 contained tight and specific limits. The ECJ basically ruled in the members' favour though subject to certain caveats. The court said that the directive did not make it

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116 Adam E Cearley 'The PBGC: Why the Retiree's Traditional Life Raft is Sinking and How to Bail it Out' at 191.

117 Where the relevant 'insolvency event' occurred before that date, there is limited non-statutory protection under the Financial Assistance scheme (for details see the Pensions Regulator website – www.pensionsregulator.gov.uk/ and similarly limited statutory protection comes in the shape of the National Insurance Fund – s 184 of the Employment Rights Act 1986 and ss 123–125 of the Pension Schemes Act 1993.

118 [2007] 2 CMLR 13 (Case C 278/05).

possible to establish with any precision the minimum level required in order to protect pension entitlements. Nevertheless, provisions of domestic law that could, in certain cases, lead to a guarantee of benefits of less than half the entitlement, could not be considered as adequate protection.

But the court did not hold out much hope for pension scheme members recovering compensation for the UK's breach of the Directive. It held that for a Member State to incur liability for damage caused to individuals by a breach of Community Law, the breach should be sufficiently serious, which implied manifest and grave disregard by the Member States of the limits set on its discretion. Relevant factors included the clarity and precision of the rule infringed and the measure of discretion left by the rule to the national authorities. Article 8 conferred considerable discretion and lacked precision. Moreover, the UK, in a sense, had been lulled into a false sense of security by an EC Commission Report[119] on the transposition of the Directive which implied UK compliance.

In brief terms, the main function of the Pension Protection Fund is to provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the Pension Protection Fund level of compensation.[120] To provide funding, compulsory annual levies are charged on all eligible pension schemes and the levies are based on a combination of scheme- and risk-based factors. The scheme-based element must take account of the level of a scheme's liabilities relating to members. If the Pension Protection Fund considers it appropriate, it may also take account of the number of members within a scheme, the total amount of pensionable earnings of active members within a scheme and/or any other scheme factor as set out in regulations. The risk-based element must take account of the funding level of a scheme and, in some cases, the risk of the sponsoring employer becoming insolvent. If the Fund considers it appropriate, it may also take account of a scheme's asset allocation and/or any other risk factor as set out in regulations.

The Pensions Act 2004 sets out in detail the conditions that must be met for the Pension Protection Fund to assume responsibility for a scheme. Amongst other criteria, a qualifying insolvency event (including administration) must have occurred in relation to the scheme's employer; there must be no chance that the scheme can be rescued; and there must be insufficient assets in the scheme to secure benefits that are at least equal to the compensation that the

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119 COM (95) 164 Final.

120 See generally Ken Baird 'Pensions and Insolvencies: The New Law and the Shape of Things to Come' (2005) 18 Insolvency Intelligence 139 and for detailed information see the Pensions Regulator website – www.pensionsregulator.gov.uk/.

Pension Protection Fund would pay if it assumed responsibility for the scheme. Where a qualifying insolvency event occurs, an assessment period automatically begins when the Pension Protection Fund will assess whether or not it must assume responsibility for the scheme. It will ask whether the scheme can be rescued. Examples of rescue are when the original employer can continue as a going-concern or when somebody is going to take over the employer and assume responsibility for the scheme. It will also ask whether the scheme can afford to secure benefits that are at least equal to the compensation that the Fund would pay if it assumed responsibility for the scheme.

The Fund replaces the pension trustees as creditor of the employer during the assessment period and assumes the trustees' rights and powers in relation to debts (including any contingent debt) due from the employer. This includes any debt under s 75 of the Pensions Act 1995, which imposes a statutory obligation on sponsoring employers to meet any shortfall in relation to defined benefit pension schemes.[121] In practice, this means the Pension Protection Fund will be responsible for negotiations with the company and/or the administrator, including discussions on possible compromises and representing the pension scheme on creditors' committees and at creditors' meetings.[122] After paying the relevant guaranteed amounts, the Fund then takes over the claim of the employee or pension trustee, including the preferential status of that claim.[123]

The Pension Protection Fund is clearly modelled on the PBGC in the US, but the events which cause the statutory liability to come into effect are more directly and uniquely linked to employer insolvency than they are in the US. If insofar as a desire on the part of companies to shed their pension commitments was a motivation for seeking Chapter 11 protection, then a large part of the incentive has been removed by the termination premium introduced by the

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[121] Changes made to s 75 by the Pensions Act 2004 mean that where a defined benefit scheme is in deficit and the sponsoring company becomes insolvent or the scheme is wound up, the statutory debt is the full cost of buying an annuity from an insurer to secure the promised benefits. Previously, the amount of the deficit was calculated by reference to the minimum funding requirement (MFR) for defined benefit schemes which was likely to be significantly lower than the full buy-out cost. Ken Baird 'Pensions and Insolvencies: The New Law and the Shape of Things to Come' at 139 points to one pension scheme where the MFR based deficit was estimated to be £97m and the full buy-out cost based deficit estimated to be £917m.

[122] Ss 173 and 127 of the Pensions Act 2004. Schemes with a Crown guarantee will be exempt from the Pension Protection Fund. Schemes with a partial Crown guarantee will only be liable to pay the Pension Protection Fund levies for that part of the scheme that does not have a Crown guarantee.

[123] S 127(2) of the Pension Schemes Act 1993 and s 189(2) of the Employment Rights Act 1996.

Deficit Reduction Act for companies emerging from Chapter 11 with a confirmed plan of reorganisation. If companies are using Chapter 11 to reduce pension obligations, this now comes at the price of having to swallow a large poison pill in the shape of the termination premium. There is no equivalent in the UK but one might argue that there is no need for an equivalent as companies very seldom emerge from administration as a viable business entity. Administration generally serves as a gateway to liquidation or to dissolution without an intermediate liquidation, though, of course, administration may facilitate the sale of viable parts of the company's business and, in this way, the process helps to save jobs and rescue businesses.

Rescue of larger companies as going-concerns has traditionally been done in the UK through informal procedures without recourse to administration. It may be however that the fact that administration serves as a trigger for Pension Protection Fund liability will push larger companies with big pension scheme deficits to use administration, perhaps on a pre-packaged basis, whereas before they might have attempted to resolve their difficulties informally. The trade union movement has been alert to this fact and the GMB union in particular has tried to highlight perceived abuse of the statutory guarantee. A telling example is singled out:[124]

> The existence of Turner & Newell involving GMB members provides one relevant case. US private equity took a controlling share of the parent company in the US and withheld proper levels of funding for the UK pension scheme. After failing to agree with the scheme's Trustees sufficient employer contributions to make up the deficit, the UK section of T & N went into Administration (following the commencement of Chapter 11 proceedings in the US). The pension scheme was wound up with insufficient funds resulting in its entry to the Pension Protection Fund. Following the insolvency of the UK employer the company's assets were brought back (at a reduced price) by the same US private equity. The result is the company essentially continues as it did before private equity involvement but without the pension scheme. This can be the pattern of some private equity asset stripping and asset dumping activities.

CONCLUSION

There are clear differences in the level of statutory support for employees in the context of corporate restructuring in the UK and US, though the differences are less marked in the pensions arena. The UK provides much higher levels of employment protection. Arguably, this stems from two factors,

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124 'Private Equity's Broken Pension Promises' (2007) which highlights the links of the private equity industry to insolvent pension funds and can be found on the GMB website – www.gmb.org.uk.

namely, the historically greater political and economic clout of the British labour movement and secondly, the influence from Europe of a social partnership approach towards employment relations. In defence of the status quo in the US, it might be said that business works best, and the level of economic prosperity is raised the most, when management has a free hand. The UK approach however, can be rationalised on two grounds. The first is social justice – protecting the party with weaker bargaining power. The second is its possible contribution to efficient and sensitive decision making. Factoring more employee inputs into management decisions may open up newer and more dynamic perspectives as well as producing greater industrial harmony and acceptance of decisions.

Turning from the general to the specific, one might argue that the statutory support for employment rights in the context of TUPE and the Acquired Rights directive limits the scope for destructive reorganisations that generate financial gains for shareholders and managers at the expense of employees. On the other hand, it has been suggested that the legislation is an impediment to the rescue of businesses and therefore does not achieve the intended effect of preserving employment and employees' rights but rather the opposite effect. The White Paper leading up to the new TUPE regulations seems to recognise this by speaking of the need to modernise the legislation and to safeguard employment opportunities. The method adopted under the new TUPE regime of dealing with the perceived problem of insolvency transfers is to provide a potential subsidy to transferees and to lessen the statutory protection made available to employees. Changes to terms and conditions of employment can now be agreed with employee representatives in a business-rescue context. Employee interests are factored into a bargaining process that is intended to enhance the survival prospects of enterprises undergoing restructuring. One might argue that the law functions best when effective mechanisms of employee representation are in place and when the conditions under which employees' acquired rights can be waived in the interests of preserving employment are clearly specified.[125] Whether the new TUPE regime achieves this goal is questionable.[126]

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[125] See generally J Armour and S Deakin 'Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive' (2003) 22 International Review of Law and Economics 443.

[126] See D Pollard 'TUPE and Insolvency: Part 1' [2006] Insolvency Intelligence 81.

8. The restructuring plan

There are major differences between US and UK law when it comes to the formulation and acceptance of a restructuring or reorganisation plan for an ailing company. The main differences are threefold and could be summarised as follows. Firstly, in the US, the debtor has an exclusive right to formulate a reorganisation plan for a certain period of time whereas there is no such opportunity in the UK. Secondly, US law is much more prescriptive when it comes to division of creditors into classes. UK law is much less prescriptive in this regard. Thirdly, a class of creditors, including secured creditors in exceptional circumstances can be crammed down in the US, i.e. forced to accept a reorganisation plan against its wishes provided that at least one other class of impaired creditors has accepted the plan. In the UK, there is no facility for cramdown. The point has been made in previous chapters that 'corporate' rescue in the UK tends to take the form of business rescue through sale of all or part of the business as a going concern. In the US, more emphasis has traditionally been paid on getting the corporate vehicle back into proper working order, though going concern or asset sales have taken on a greater prominence in recent years. But perhaps because corporate revival is such a significant part of the traditional Chapter 11 landscape, the US reorganisation confirmation provisions appear to have been the subject of much greater debate and discussion than their UK counterparts. Partly for this reason the US provisions will be considered first in this chapter.

A GENERAL DESCRIPTION OF THE US SYSTEM – REQUIREMENTS FOR APPROVING A REORGANISATION PLAN

Stevens J commented in *Bank of America v 203 North LaSalle Street Partnership*:[1] 'Confirmation of a plan of reorganization is the statutory goal of every Chapter 11 case. Section 1129 provides the requirements for such confirmation, containing Congress' minimum requirements for allowing an

[1] (1999) 526 US 434 at fn 4 of his judgment.

entity to discharge its unpaid debts and continue its operations.' The confirmation of a reorganisation plan by the court discharges a company from carrying out those legal obligations that have not been set out in the plan.[2]

Although the company, speaking through its normal governance organs, will usually propose the reorganisation plan, creditors as a group are given the task of determining whether the plan lies in their best interests. Creditors are seen as best being able to evaluate both the company's future prospects and the merits of the plan.[3] The legislative framework ensures that creditors will have a voice in the plan negotiation process. Since creditors can oppose the plan, the proponent of the plan has an incentive to engage constructively with creditors with a view to securing their approval. The company, however, has the exclusive right to propose a reorganisation plan for the first 120 days of the Chapter 11 process. The reasons for this exclusivity period will now be considered.

DEBTOR EXCLUSIVITY IN FORMULATING REORGANISATION PLANS

The legislative record reveals the reasons for the exclusivity period.[4] It seems that the US Congress thought that, without being afforded the exclusive opportunity to fashion a plan, management and shareholders would keep the company out of Chapter 11 until it was too late to save the business. The

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[2] S 1141.

[3] See *Bank of America v 203 North LaSalle Street Partnership* (1999) 526 US 434 at fn 28 'Congress adopted the view that creditors and equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees or the SEC…. Consistent with this new approach, the Chapter 11 process relies on creditors and equity holders to engage in negotiations towards resolution of their interests' referring to G. Eric Brunstad, Mike Sigal and William Schorling 'Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One' (1998) 53 Business Lawyer 1381, 1406 n 136.

[4] See the discussion in *Re Public Service Company of New Hampshire* (1988) 88 BR 521 referring to reports from the US Senate and House of Representatives (HR Rep No 95-595 at 231–232): 'Proposed Chapter 11 recognizes the need for the debtor to remain in control to some degree, or else debtors will avoid the reorganization provisions in the bill until it would be too late for them to be an effective remedy. At the same time, the bill recognizes the legitimate interests of creditors, whose money is in the enterprise as much as the debtor's, to have a say in the future of the company. The bill gives the debtor an exclusive right to propose a plan for 120 days. In most cases, 120 days will give the debtor adequate time to negotiate a settlement, without unduly delaying creditors.'

exclusive right is significant because of the opportunity to coordinate the process of negotiation and to stake out the reorganisation parameters.[5] On the other hand, however, there is the opportunity for mischief-making and opportunistic behaviour in that management may frame a plan that treats existing shareholders more favourably than they deserve, or at least more favourably than some other plan proponent might treat them. This could have the effect of delaying the reorganisation process until the creditors give in to the company's demands.[6] Shareholders who have little to lose from a prolonged process may use this procedural leverage in negotiations with creditors, and lenders may be forced to succumb to plans that compromise their pre-insolvency entitlements.[7] The exclusivity period could enable shareholders to appropriate nearly all of the 'going concern surplus' that reorganisation rather than liquidation is designed to achieve. Critics of the present US position refer to it as a win-win situation for junior stakeholders. If the court errs, and crams down a plan that favours shareholders and junior creditors at the expense of secured creditors, junior interests receive a windfall. If court correctly rejects the proposal, secured creditor triumph may be short-lived since the shareholders can simply propose another plan that is beneficial to them in a different manner. They can continue to propose self-preferential plans until one slips through.[8]

It has been argued that the highest and best offers for the company's business will materialise not only where there is a competitive bidding process but

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[5] See Karen Gross and Patricia Redmond 'In Defense of Debtor Exclusivity: Assessing Four of the 1994 Amendments to the Bankruptcy Code' (1995) 69 American Bankruptcy Law Journal 287 at 291: 'exclusivity is perceived to encourage rehabilitation by empowering the debtor to control its own destiny, an observation confirmed by practitioners. In a sense, the exclusive right to file a plan can be seen as the debtor's chip in the reorganization game.'

[6] See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in Bank of America v 203 North LaSalle Street Partnership' (1989) 54 Business Lawyer 1475 text accompanying footnotes 53–57.

[7] See generally L Bebchuk 'A New Approach to Corporate Reorganizations' (1988) 101 Harvard Law Review 775 at 780; L Bebchuk and H Chang 'Bargaining and the Division of Value in Corporate Reorganization' (1992) 8 Journal of Law, Economics and Organisations 253 at 255.

[8] See Merton Miller 'The Wealth Transfers of Bankruptcy: Some Illustrative Examples' (1977) 41 Law & Contemporary Problems 39 at 40–41: 'court protection that permits stockholders to work their way out of difficulties and repay their obligations in full . . . gives the stockholders a valuable call option at the expense of creditors, who in effect are permitted to put the [funds] on terms they would otherwise never accept'.

also where there are competing plans on the table.[9] A plan proposed by the company itself might meet the threshold requirements of Chapter 11 but a creditor plan might be better for the company's future success or at least provide a better return to creditors. It has been suggested that to 'normalise' the decision-making process, one should encourage competition over the terms of the reorganisation plan.[10] If more than one plan is proposed and meets the statutory confirmation requirements, the court can consider the preferences of creditors and shareholders in deciding which plan to give its blessing.

The 120-day period may be extended for a cause but it has been stressed that time extensions should not be employed as a tactical device to put pressure on parties to accept a plan that they consider to be unsatisfactory.[11] The period may also be shortened but applications for premature termination are rarely granted.[12] Partly, this is because of the possibility of chaos if too many competing plans emerge,[13] but this does not seem a very realistic prospect. It is unlikely, in most cases, that creditors would go to the trouble and expense of formulating multiple competing plans. The process is an expensive and time-consuming one and, even in large cases, there are unlikely to be more than one or two creditor groups with the necessary time and resources. The court also has the power to streamline the process.

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9 Bruce A Markell 'Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations' (1991) 44 Stanford Law Review 69 at 123–124.

10 See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory' 1475 text accompanying footnotes 297–305 and Bruce A Markell 'Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations' (1991) 44 Stanford Law Review 69 at 123–124.

11 See the Congressional Record on the Bankruptcy code – Senate Rep No 95-989 at 118 (1978).

12 In *Re Public Service Company of New Hampshire* (1988) 88 BR 521 the US Bankruptcy Court concluded that an appropriate interpretation of the 'for cause' language of s 1121(d) would 'provide that size and complexity must be accompanied by other factors pertinent to the particular debtor and its reorganization to justify extension of plan exclusivity, except perhaps in the very early, initial stages of the Chapter 11 proceedings. Such factors include . . . the likelihood of an imminent consensual plan if the debtor retains control, no alternate substantial plan being held off by debtor exclusivity, and the general balancing analysis to avoid allowing the debtor to hold the creditors and other parties in interest 'hostage' so that the debtor can force its view of an appropriate plan upon the other parties.'

13 It should be noted that the 2005 Act prohibits further extensions of the exclusive filing period beyond 18 months from the company's entry into Chapter 11.

THE FEASIBILITY REQUIREMENT

Section 1129(a)(11) says that for a plan to be confirmed it must be feasible. This involves the court in finding that plan confirmation is not likely to be followed by liquidation or the need for further financial reorganisation of the company or any successor to the company under the plan, unless the plan itself proposes liquidation. To see whether the feasibility standard has been achieved, the courts may look at a number of matters of factors affecting a company including (1) adequacy of the capital structure (2) earning power (3) general economic conditions and the identity and abilities of the firm's management.[14] The feasibility standard helps to ensure that companies come out of Chapter 11 with adequate capital structures.[15]

The statutory standard looks to the likelihood of success of the reorganisation and asks whether the debt forgiveness or injection of capital is sufficient to bring about a successful reorganisation. The question is whether the company will now have sufficient financial strength to carry out the promises it made in the plan and whether there is an adequate capital cushion to absorb any future losses that can reasonably be foreseen. The feasibility requirement cannot be satisfied if the company is so thinly capitalised that it is unable to withstand some future losses. An all-equity capital structure would provide the largest possible cushion but most companies operate satisfactorily with substantial levels of debt. Debt increases risk, but the company may obtain offsetting benefits from the tax advantages and leverage that debt financing provides. There is no precise formula for determining an ideal capital structure but a company should not be allowed to emerge from the reorganisation process with inadequate shareholder equity.[16] The court might also require the plan to include contractual restrictions to prevent the company from diluting the capital base through making 'excessive' dividend payments after the plan has been confirmed.

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[14] See *Consolidated Rock Products Co v Du Bois* (1941) 312 US 510 at 525: 'Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sina qua non to a determination of the integrity and practicality of the new capital structure.'

[15] See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory' 1475 text accompanying footnotes 261–265.

[16] See Douglas G Baird *Elements of Bankruptcy* (New York, Foundation Press New York, 4th ed, 2006) at p 256 who describes the feasibility test as 'subjective but the court can give it some hard edges by comparing the capital structure of the reorganized corporation with other corporations in the same industry. A reorganization plan that leaves a corporation too highly leveraged relative to other corporations in the same industry may not be feasible within the meaning of the Bankruptcy Code.'

The 'feasibility' standard can be satisfied by evidence from investment banks about the company's projected earnings and cash flow. The court may need expert testimony from informed outside sources; for example, from a financial analyst about appropriate capitalisation levels and from a lender about the company's ability to borrow the amount of debt specified in the plan. It must be remembered, however, that bankruptcy courts lack substantial financial expertise. They are judges, not investment bankers. Moreover, small changes in assumptions about interest rates and income streams produce spectacular differences in estimates of value and a judge has little means of evaluating the wisdom of these economic assumptions.[17]

The 'feasibility' requirement is a strongly entrenched part of the Bankruptcy Code but one cannot help thinking that it asks too much of judges. As one leading bankruptcy judge once remarked:[18]

> A judge is bound by the record that is presented. If you have good lawyers, they will present a record that establishes feasibility. If the judge reviews the disclosure statement and things leap out, I think the judge will ask questions. But if you have good lawyers and they're doing their job right, the likelihood of things jumping out is pretty slim. Lawyers may disclose assumption, but in the absence of discovery or something being flagrant on its face, it's hard for a judge to know what's wild assumption and what's not.

THE CONCEPT OF 'IMPAIRMENT'

The notion of 'impairment' is fundamental to Chapter 11 because only the holders of 'impaired' claims or interests are entitled to vote on the reorganisa-

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[17] In *R Orfa Corp* (1991) 129 BR 404 it was suggested that the standards for determining plan feasibility are not rigorous and reference was made to the following factors enunciated in *Re Temple Zion* (1991) 125 BR 910 at 914–915: '(1) the adequacy of the debtor's capital structure; (2) the earning power of its business; (3) economic conditions; (4) the ability of the debtor's management; (5) the probability of the continuation of the same management; and (6) any other related matters which determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan. . . .'

[18] See Lynn M LoPucki *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* (Ann Arbor, University of Michigan Press, 2005) at p 105. The quote comes from Barbara Houser. Another bankruptcy judge, Bruce McCullough is also cited: 'You must have seen some of these plans. Some of them are as big as the New York telephone book. How is a judge who is foreclosed from participating in the reorganization ever going to read that plan and find anything wrong with it? . . . I don't care how smart you are, you wind up talking to yourself, challenging your own assumptions and driving yourself crazy. The judge isn't going to be allowed to call in and examine a bunch of expert witnesses. That's not a typical judge's role. It may be the judges' responsibility, but as a practical matter they can't do it.'

tion plan. Under s 1124, a claim or interest is impaired unless the plan leaves unaltered the rights outside bankruptcy associated with that claim or interest. The plan must divide claims (indebtedness) and interests (equity shares) into separate and distinct classes, not only for voting purposes but also for purposes of treatment and payment. Each class of claims or interests should be designated as either impaired or not impaired. Pursuant to s 1126(f), the holders of claims or interests that are not impaired are deemed to have voted to accept the plan since their rights against the debtor outside bankruptcy will be preserved and protected in full.[19]

Chapter 11 centres around the idea of structured bargaining between classes of creditors and shareholders and the composition of the relevant classes is fundamental to the process. If members of a class vote collectively to accept a plan, then a dissenting member of that class cannot insist on application of the absolute priority rule. The members of the class collectively can agree to give up value to junior stakeholders. Each impaired class must accept a reorganisation plan before the court can confirm the plan unless the conditions necessary for 'cramdown' are present. Moreover, one of the conditions of cramdown is that there should be at least one impaired class who have assented to the plan.[20]

CLASSIFICATION OF CLAIMS

The role of classification is to facilitate the ongoing negotiation over the division of the 'going concern surplus'.[21] Different creditors may have different

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[19] By virtue of s 1124(a) a plan may effectively reinstate pre-petition obligations on pre-petition terms in which case a class of creditors whose claims are reinstated are deemed not to have been impaired.

[20] 'The general rule from earliest practice is that each secured claim is almost always placed in its own separate class because each has different rights regarding collateral and priority' – see J Friedman 'What courts do to secured creditors in Chapter 11 cram down' (1993) 14 Cardozo Law Review 1495 at 1500. Where however, there has been a single issue of secured bonds, all the bond holders may be placed in the same class.

[21] See *Re Public Service Company of New Hampshire* (1988) 88 BR 521 referring to the Congressional record: 'The bill does not impose a rigid financial rule for the plan. The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer. It is unrealistic to assume that the bill could or even should attempt to answer that question. Instead, negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders.'

views on the value of the reorganised company and the risks presented by extended repayment schedules. The ability to mould creditors into separate classes is a powerful one.[22] For example, a company whose assets comprise largely real estate often will attempt to classify its small amount of trade debt separately from a mortgagee's large unsecured deficiency claim in the knowledge that its trade creditors are likely to vote in favour of the plan. This creates an opportunity for 'cramming down' the plan over the objection of the company's largest and most impaired creditor.

In consensual cases, the ability to put claims held by general creditors into a number of different classes rarely presents significant difficulties however. For instance, tort claimants could be paid out of a newly established trust fund while trade claimants are paid off directly in cash and unsecured lenders in short-term commercial paper.[23] It is sometimes acceptable to treat creditors, the legal status of whose claims to the assets of the debtor are alike, in unlike fashion. A plan could classify unsecured institutional debt separately from unsecured trade debt providing the former with a pay-out after a longer term or indeed an equity stake in the company while the trade creditors receive cash. Section 1122 requires that all members of a class should hold substantially similar claims and interests but there is no explicit requirement that all similar claims should be placed in the same class.

There are several practical justifications for differential classification of creditors. Creditors with alternate forms of payment such as third-party guarantees have different incentives vis-à-vis the debtor. Creditors who view the ailing company as a valuable vendor or customer have more of an interest in its survival than do the company's one-off tort victims.[24] Moreover, certain creditors may have separate interests that run contrary to the goal of corporate rescue. Trade unions, for example, may wish to preserve a reputation for toughness at a price that exceeds their private stakes in the particular case.[25] These types of creditors have been described as irritants in the sense that their individual interests are at odds with the general goals of Chapter 11.[26]

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[22] See Bruce A Markell 'Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification' (1994) 11 Bankruptcy Developments Journal 1 at 16.

[23] See National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 568.

[24] See the comment made by the Bankruptcy Court in *Re Greystone 111 Joint Venture* (1991) 995 F 2d 1274: '[I]f the expectation of trade creditors is frustrated … [they] have little recourse but to refrain from doing business with the enterprise. The resulting negative reputation quickly spreads in the trade community, making it difficult to obtain services in the future on any but the most onerous terms.'

[25] See *Re US Truck Co* (1986) 800 F 2d 581.

[26] See Bruce A Markell 'Clueless on Classification' at 44.

If one applied an undiluted creditor democracy perspective, the validity of a particular classification scheme should be secondary to the general preferences of the creditor body but Chapter 11 adopts a more legalistic perspective. While classes must be internally homogenous, s 1122 does not require that all substantially similar claims must be classified together and judicial interpretations have varied as to what degree of separate treatment is justified. Nevertheless, there is almost uniform agreement that it is improper to classify claims with the sole aim of separating assenting creditors from dissenting creditors.[27] In *Re Greystone 111 Joint Venture*[28] the court spoke of the 'one clear rule that emerges from otherwise muddled case law on section 1122 claims classification: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.'[29]

On one strand of authority, this is the only real prohibition in s 1122.[30] After all, Chapter 11 contains other safeguards and if the plan unfairly discriminates against an objecting impaired class, then the plan can not be confirmed over the dissent of that class. Under Chapter X of the Chandler Act, the court classified claims according to the nature of their respective claims. Chapter XI did not impose the same limitations and permitted the division of unsecured debts into classes and the treatment thereof in different ways or upon different terms. It is argued that Chapter 11 should be interpreted in the same vein thereby sanctioning a broad latitude as regards classification schemes.[31] After all, courts do not always agree on whether

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[27] But see the comment in Douglas G Baird, Thomas H Jackson and Barry E Adler *Bankruptcy: Cases, Problems and Materials* (New York, Foundation Press, Revised 3rd ed, 2001) at p 577: 'Courts routinely strike down crude gerrymandering, but, especially outside the single-asset real estate setting, it is sometimes hard to distinguish a gerrymandered class from a legitimate one.'

[28] (1991) 995 F 2d 1274.

[29] See also the statement of the US Court of Appeals, 6th Circuit, in *Re US Truck Co* (1986) 800 F 2d 581 at 586: '[T]here must be some limit on a debtor's power to classify creditors in such a manner . . . Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.'

[30] See *Re Woodbrook Associates* US Court of Appeals, 7th Circuit (1994) 19 F 3d 312: '*Greystone* condones separate classification "for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims".'

[31] See the US Court of Appeals, 6th Circuit decision in *Re US Truck Co* (1986) 800 F 2d 581 at 586: 'Congress' switch to less restrictive language in section 1122 of the Code seems to warrant a conclusion that Congress no longer intended to impose the now-omitted requirement that similar claims be classified together . . . However, the legislative history indicates that Congress may not have intended to change the prior rule.'

particular types of claims are substantially similar[32] and prohibiting the separate classification of substantially similar claims possibly could create more, rather than less, litigation.[33]

Most courts have accepted that the separate classification of similar claims is permissible but, nevertheless, imposed some limits to ensure that classification is reasonable and meets with a basic fairness standard. Reasonableness itself may be a problematic concept. In determining reasonableness, some courts have focused on the business purpose in having separate classification whereas others have based their determinations on the nature of the claims and the extent to which these claims warrant separate representation.[34] With the 'nature of claim' approach, the focus of classification historically has been on the nature or legal character of the claim as it relates to the assets of the debtor.[35] The approach does not filter out classification schemes that are designed only to create a class that will vote favourably on the plan. Moreover, it requires litigation on a question that may be unrelated to the debtor's business plan, and thus wastes time and resources.[36]

If one applied the test of whether there was a 'business justification' for separate classification of substantially similar claims, this should screen out impermissible gerrymandering of classes for voting purposes. The courts ought to be able to distinguish cases in which legitimate business reasons exist from those in which separate classification is merely a thinly veiled attempt to create an accepting class of creditors.[37] Application of the 'business justification' test should minimise litigation over the threshold 'substantial similarity' question and, in this way, reduce costs and delay. It also focuses the inquiry on the business needs of the company rather than concentrating on the legal attributes of certain creditors.[38] Moreover, because 'substantial similarity is

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[32] See *Re Woodbrook Associates* US Court of Appeals, 7th Circuit (1994) 19 F 3d 312: 'Similarity is not a precise relationship, and the elements by which we judge similarity or resemblance shifts from time to time in bankruptcy.'

[33] See National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 575.

[34] Ibid at p 572.

[35] See the legislative record – HR Rep No 595, 95th Congress, 1st Session 406 (1977).

[36] National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 578.

[37] See the comment in Charles Jordan Tabb *The Law of Bankruptcy* (New York, Foundation Press, 1997) at p 818: '[The] motivation for creating separate classes might pass muster, if a good business reason supported the distinction. For example, some institutional creditors may have restrictions on how much stock they are permitted to hold in other companies, and thus will not want to receive stock under the plan.'

[38] National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at pp 580–582. The Report endorsed the 'rational business justifi-

inherently a fact-intensive issue, a more specific definition of legal or substantial similarity would be inappropriate and inadequate due to the almost infinite number of factual distinctions that may arise'.[39] Courts have been cautioned against substituting their own judgment for those who voted in favour of the plan, or getting involved in speculation on alternative methods of corporate restructuring that would leave unimpaired various classes of creditors.[40] Creditors are provided with procedural and substantive protection that ensures fair treatment of dissenters and also safeguards individual creditor interests. Each individual creditor, even in an assenting class, is entitled to insist on receiving under the plan at least as much as they would do in a Chapter 7 liquidation. There is also the good faith criterion which governs the relationship between the result achieved and the motive used in achieving that result.[41] If dissenting creditors believe that the vote of the impaired class was improperly obtained, they can seek to disallow it on the good faith grounds explicitly provided for in s 1126(e).[42]

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cation approach. It protects creditors' interests while it preserves reasonable flexibility to structure a plan of reorganization to meet the business needs of the parties in interest and facilitate the reorganization efforts of all parties in the vast majority of cases. The test requires business justification, not business necessity.'

[39] National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 589.

[40] See *Re Hotel Association of Tuscon* (1994) 165 BR 470 at 475: 'We do not believe it is the bankruptcy court's role to ask whether alternative payment structures could produce a different scenario in regard to impairment of classes. Denying confirmation on the basis that another type of plan would produce different results would impede desired flexibility for plan proponents and create additional complications in the already complex process of plan confirmation' and see National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 586.

[41] On good faith see *Re Figter Ltd* (1997) 118 F 3d 635 where the US Court of Appeals said:

> In short, the concept of good faith is a fluid one, and no one single factor can be said to inexorably demand an ultimate result, nor must a single set of factors be considered. It is always necessary to keep in mind the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest. Prior cases can offer guidance, but, when all is said and done, the bankruptcy court must simply approach each good faith determination with a perspicacity derived from the state of its informed practical experience in dealing with bankrupts and their creditors.

[42] See *Re Figter Ltd* (1997) 118 F 3d 635:

> If a person seeks to secure some untoward advantage over other creditors for some ulterior motive, that will indicate bad faith . . . But that does not mean that creditors are expected to approach reorganization plans voted with a high degree of altruism

There is an argument that allowing freer rein on classification would, for example, validate the creation of a class having only one sympathetic creditor whose claim is only trivially altered and that then the plan proponent could use this one creditor class to cram down a plan over the dissent of more substantial creditors. The good faith limitations on plans, however, should cater for this objection adequately. Moreover, the statutory prohibition on unfair discrimination is there as a legal long stop to disallow significant disparities in the treatment of assenting and dissenting classes of creditors. This prohibition, and not rules about classification, serves as the more appropriate vehicle to challenge the inherent unfairness of a reorganisation plan.[43]

CRAMMING DOWN AN OBJECTING CLASS OF CREDITORS

Before an objecting class of creditors can be crammed down, an onerous list of requirements must be met.[44] To cram down a secured class, the requirements of ss 1129(b)(1) and 1129(b)(2)(A) must be satisfied.[45] Under (b)(1) the plan must not discriminate unfairly and must be fair and equitable. This

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> and with the desire to help the debtor and their fellow creditors. Far from it . . . That is to say, we do not condemn mere enlightened self interest, even if it appears selfish to those who do not benefit from it.

Reference was made to *Re Pine Hill Collieries Co* (1942) 46 F.Supp 669 at 671:

> If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster. On the other hand, pure malice, 'strikes' and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.

[43] National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 583.

[44] See J Friedman 'What Courts do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 Cardozo Law Review 1495.

[45] See J Friedman ibid at 1496: 'In Chapter 11, judges have extraordinary power to approve plans of reorganization that impose significant concessions on dissenting creditors, shareholders, and others. Colloquially, this power is called "cram down." It is the common parlance used by judges and practitioners when referring to the forcing of modifications down the throat of an unwilling party. The modifications imposed on secured creditors may, among other things, do the following: modify lien covenants, reinstate mortgages on the verge of foreclosure, change interest rates, stretch out principal payments twenty years or more, and substitute new collateral for existing collateral.'

requires that creditors who are similarly situated should be treated in a comparable fashion. A fortiori, it would for example be unfair discrimination for a junior creditor to receive a higher interest rate than that imposed on a senior creditor on the same property. The fair and equitable standard means that an unreasonable risk of the plan's failure should not be imposed on the secured creditor. It also includes the s 1129(b)(2)(A) requirement such that a secured creditor must receive one of three alternatives:

a. retention of its secured interest plus sufficient deferred payments to equal the present value of the collateral;
b. sale of the collateral with the creditor's security interest attaching to the proceeds of sale;
c. the creditor's receipt of the 'indubitable equivalent' of its security interest.

The first alternative is the most common method for non-consensually restructuring a secured claim, but determining the present value of a stream of payments is no easy task since it involves working out an appropriate interest, or discount, rate. In *Till v SCS Credit Corporation*[46] the Supreme Court noted that a

> debtor's promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is some risk of non-payment. The challenge for bankruptcy courts reviewing such repayment schemes, therefore, is to choose an interest rate sufficient to compensate the creditor for these concerns.

In *Till* the court rejected the 'coerced loan', 'presumptive contract' and 'cost of funds' approaches towards determining the appropriate interest rate. According to the Supreme Court, each of these approaches was complicated and imposed significant evidentiary costs.

Instead, the court commended a formula approach which began by looking at the prime rate which 'reflects the financial market's estimate of the amount a commercial bank should charge a credit worthy, commercial borrower to

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[46] (2004) 541 US 465. It should be noted however that this case arose under Chapter 13 and not Chapter 11 but there are strong suggestions from the court that the same approach should follow in Chapter 11. The court noted that in many Bankruptcy Code provisions it was called upon to determine the present value of a stream of payments and added that we 'think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of those provisions. Moreover, we think Congress would favour an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings.'

compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default.' The court acknowledged that bankrupt debtors typically would pose a greater risk of non-payment than standard solvent commercial debtors and therefore the prime rate would have to be adjusted upwards. In determining the appropriate uplift, court would have regard to such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganisation plan. The court considered that this approach reduced the need for potentially costly, evidentiary proceedings. The resulting 'prime-plus' rate turned on the state of the financial markets, the characteristics of the loan, and the circumstances of the bankruptcy estate; not on such things as the creditor's circumstances and its prior relationship with the debtor.[47]

While sometimes the courts are generous to debtors when asked to stretch out repayments of principal, creditors have also successfully attacked long stretch-outs as being unreasonable. The argument is that such plans are not feasible (the longer the pay-out, the more speculative it is) or do not satisfy the implicit requirements of being fair and equitable – too much risk is put on the creditor. Generally the courts have also ruled against 'negative amortisation' plans under which part or all of the interest on a secured claim is not paid currently but instead is deferred and allowed to accrue, with the accrued interest being added to the capital and paid when income is greater. The concern is about the future value of the collateral required to compensate for the increasingly large amount of unpaid accrued interest.

In *Great Western Bank v Sierra Woods Group*[48] the US Court of Appeals for the 9th Circuit ruled, however, that negative amortisation was not per se impermissible. The court said that the fairness of a reorganisation plan that includes negative amortisation should be determined on a case-by-case basis and listed some of the factors that were relevant to this determination.

1. Does the plan offer a market rate of interest and present value of the deferred payments;
2. Is the amount and length of the proposed deferral reasonable;
3. Is the ratio of debt to value satisfactory throughout the plan;

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[47] There was a strong dissent in the case from four judges including the Chief Justice and led by Scalia J which favoured presumptively, the contract rate of interest. Scalia J suggested that the contract rate was generally a good indicator of actual risk providing a quick and reasonably accurate standard and therefore disputes should be infrequent. In his view, the contract rate approach made the reasonable assumption that subprime lending markets were competitive and consequently largely efficient. 'If so, the high interest rates lenders charge reflect not extortionate profits or excessive costs, but the actual risks of default that subprime borrowers present.'

[48] (1992) 953 F 2d 1174.

4. Are the debtor's financial projections reasonable and sufficiently proven, or is the plan feasible;
5. What is the nature of the collateral, and is the value of the collateral appreciating, depreciating, or stable;
6. Are the risks unduly shifted to the creditor;
7. Are the risks borne by one secured creditor or class of secured creditors;
8. Does the plan preclude the secured creditor's foreclosure;
9. Did the original loan terms provide for negative amortization; and
10. Are there adequate safeguards to protect the secured creditor against plan failure?

The second cramdown alternative allows the sale of collateral, free and clear of a security interest. The corporate debtor may pay the proceeds of a sale of collateral to the creditor or else retain the proceeds subject to a security interest. If it chooses the latter, it must make deferred cash payments or the indubitable equivalent of the same.

More generally, the indubitable equivalent alternative includes the possibility of collateral substitution. The courts however have been restrained in substituting new collateral that would increase the creditor's financial risk. Debtors often propose to abandon collateral to secured creditors in return for the satisfaction of the claim up to the value of the collateral at the time of confirmation. The creditor will then have an unsecured claim for the amount of the deficiency. There is no indubitable equivalence, on the other hand, if the secured creditor is merely offered shares in the reorganised company. According to the legislative record:[49] 'Abandonment of the collateral to the creditor would clearly satisfy indubitable equivalence, as would a lien on similar collateral. . . . Unsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent . . .'.

It has been suggested that the cramdown power is more often used as a threat to coerce a settlement rather than as an actual club.[50] Timing is often more important than the ideal result and so the delay caused by use of the cramdown power is likely to result in harm to all. On the other hand, while conceding that significant uncertainties remain as to 'delay, cost, and court valuation of assets in a cram down', one comprehensive study concludes that 'the traditional mystique concerning cram down which instills fear among secured creditors is exaggerated. Cram down is applied in a remarkably homogenous and predictable manner regarding secured claims.'[51]

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[49] 1978 USCCAN. 6544 – statement of Senator Dennis DeConcini who was the Senate manager of the 1978 Bankruptcy statute.

[50] Richard F Broude 'Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative' (1984) 39 Business Lawyer 441.

[51] See J Friedman 'What Courts Do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 Cardozo Law Review 1495 at 1499.

If shareholders receive nothing under the plan, then they are deemed to have voted against and a valuation of the reorganised company is required, with all the attendant risks. This factor provides a reason to give the 'old' shareholders a sufficient stake to gain their consent and to avoid cramdown. The valuation process is something that sophisticated Chapter 11 participants avidly desire to avoid. By compromise and settlement, secured creditors can avoid the risks inherent in a valuation of the collateral and a court-imposed interest or discount rate while unsecured creditors and shareholders can avoid the risk presented to them by a valuation of the 'new' company. As Professors Blum and Kaplan remark:[52]

> The valuation procedure always produces a dollars and cents figure. Although that figure looks mathematically exact, it actually reflects in a single number a whole series of highly conjectural and even speculative judgments concerning long-range business expectations and hazards as well as future social and general economic conditions. To exclude a class of creditors or investors from participation in a reorganization plan based upon so illusory a figure is criticized as capricious. The process is said to deceive by treating 'soft' information as if it were 'hard' and by cloaking predictions in the guise of mathematical certainty, under circumstances where consequences are drastic and final. Dependency of the valuation process upon the future outlook as of a particular moment adds to the dissatisfaction. The resultant value figure is inextricably related to the then accepted set of expectations and assumptions.

Or, as another commentator has put it more succinctly: 'In practice, no problem in bankruptcy is more vexing than the problem of valuation.'[53]

THE ABSOLUTE PRIORITY RULE AND THE PARTICIPATION OF FORMER SHAREHOLDERS IN THE REORGANISED COMPANY

The absolute priority rule mandates that unless creditors are to be paid in full, or unless each class of creditors consents, the company's old shareholders are not entitled to receive or retain any property through the bankruptcy process on account of their old shares. Effectively, the absolute priority rule provides senior creditors with the right to appropriate the entire going-concern surplus. It has been argued that the mere willingness of shareholders to invest in the

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52 'The Absolute Priority Doctrine in Corporate Reorganizations' (1974) 41 U of Chicago L Rev 651 at 656–657.

53 See E Warren 'A Theory of Absolute Priority' [1991] Annual Survey of American Law 9 at 13.

reorganisation of an insolvent company constitutes an admission that senior creditors are not being paid in full. If senior creditors were fully compensated, then the shareholder managers would have nothing left to buy.[54]

The absolute priority rule was originally applied in nineteenth-century railroad cases to prevent senior creditors and shareholders from colluding to squeeze out junior creditors.[55] More recently, law and economics scholars have argued that deviations from the absolute priority rule are too costly and will result in increases in the cost of borrowing – lenders adjust their rates to reflect the fact that shareholders retain some value that would otherwise have gone to the lenders.[56] Or, to put it another way, the failure to enforce the absolute priority rule will affect investment decisions, drive up the cost of capital and distort allocations between equity and debt. These arguments are based on perfect market theories that are not necessarily sound in practice.[57]

The Supreme Court in the *La Salle* case[58] considered the reason behind the absolute priority rule to be that a plan proposed by the company will simply turn out to be too good a deal for the company's owners. The court also referred to a concern about the 'ability of a few insiders, whether representatives of management or major creditors, to use the reorganisation process to gain an unfair advantage'[59] and also a belief that 'creditors, because of management's position of dominance, were not able to bargain effectively, without a clear standard of fairness and judicial control'.[60]

But there is the counter view advanced by others that the effects of pro-debtor deviations from the absolute priority principle can be economically beneficial. These deviations may encourage employees and managers to commit themselves to a particular enterprise; facilitate the transfer of information to

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54 See generally John D Ayer 'Rethinking Absolute Priority after *Ahlers*' (1989) 87 Michigan Law Review 963; Douglas G Baird and Thomas H Jackson 'Bargaining After the Fall and the Contours of the Absolute Priority Rule' (1988) 55 U Chi L Rev 738 at 787–789.

55 National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 547.

56 See R Rasmussen 'The Ex Ante Effects of Bankruptcy on Investment Incentives' (1994) 72 Washington University Law Quarterly 1159; A Schwartz 'The Absolute Priority Rule and the Firm's Investment Policy' (1994) 72 Washington University Law Quarterly 1213; B Adler 'Bankruptcy and Risk Allocation' (1992) Cornell Law Review 439.

57 National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 566.

58 (1999) 526 US 434.

59 (1999) 526 US 434 at 444 referring to House of Representatives Doc No 93-137, part 1, p 255 (1973).

60 (1999) 526 US 434 at 444 referring to J Ayer 'Rethinking Absolute Priority after *Ahlers*' (1989) 87 Michigan Law Review 963 at 969–973.

creditors; prompt timely use of Chapter 11 as well as alleviating the over- and underinvestment problems haunting financially distressed enterprises.[61] It should be noted that the absolute priority rule is statutorily mandated only for confirmation of a non-consensual case. In a consensual case senior classes can agree to surrender value to junior classes provided that the plan satisfies the best-interests-of-creditors' test. A leading study has revealed that:[62]

> [I]n the reorganization cases of small businesses in which managers are also the principal shareholders, equity frequently dominates the bargain to such an extent that the absolute priority rule is stood on its head. In such cases, the claims of creditors are compromised, but shareholder-managers usually retain their shares without dilution. The dependence of the business upon the continuing services of the shareholder-manager is the primary bargaining leverage used to accomplish this feat.

As far as larger companies are concerned, the same study concluded that equity nearly always participated in a distribution under the plan although a strict application of the absolute priority rule would have precluded their participation. The percentage was relatively small-scale, however, compared with the absolute amount distributed. There was also a finding that

> the relative size of equity's recovery appeared to be not so much a product of the financial conditions of the company as it was a product of the quality and aggressiveness of equity's representation. . . . [The] observed deviations from absolute priority were not to any significant degree the product of difficulties in valuation. In nearly every case, the negotiators knew the company was insolvent and that equity would be entitled to nothing in an adjudication. Equity was allowed to share in the distribution for a wide variety of reasons. Central among them was a generalized desire to have a consensual plan – one supported by the debtor, the official committees, and major creditors. Part of the reason for seeking such a plan was a concern that equity might make trouble if there was an attempt to exclude it. Yielding to such a fear was easier for creditors because the cost of a distribution to equity was spread among so many creditors that the portion borne by each one was too small to justify resistance. To a large degree, however, the preference for a consensual plan rather than an adjudication was a matter of legal culture.[63]

Empirical studies also suggest that payments to shareholders in excess of what they would receive under the absolute priority rules are essentially

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61 Omer Tene 'Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganisations' (2003) 19 Bankruptcy Developments Journal 287 text accompanying footnote 540.

62 L LoPucki and W Whitford 'Bargaining over Equity's Share in the Bankruptcy Reorganizations of Large, Publicly Held Companies' (1990) 139 U Pa L Rev 125 at 149.

63 (1990) 139 U Pa L Rev 125 at 194–195.

purchases by creditors of the shareholders' option to delay the reorganisation process and to impose future legal and administration costs on creditors.[64] In most of the cases involving public companies, old equity has tried to maximise its hold-up value, but has not offered additional new value in return for participation in the reorganised entity.[65]

Even in non-consensual cases, the courts have permitted old shareholders to acquire new equity positions in exchange for fresh contributions of capital under the 'new value exception' or 'new value corollary' to the absolute priority principle. The principle was not intended to disqualify shareholders in every instance from supplying new money to the reconstituted company in exchange for new shares.[66] In the history of the absolute priority principle two dominant themes stand out. Firstly, to maintain hierarchical priorities and secondly, to prevent collusive arrangements that undermine the ordained hierarchy.[67] Similarly, the history of the new-value doctrine contains two dominant, albeit differently aligned, goals. The first is to facilitate reorganisations and the second is to prevent new-value arrangements that might undermine the absolute priority principle. The absolute priority principle and its new-value corollary are essentially complementary but they are both 'susceptible to artful manipulation and their interaction is often strained by the exigencies of financial distress'.[68]

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[64] See L Weiss 'Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims' (1990) 27 Journal of Financial Economics 285; J Franks and W Torous 'An Empirical Investigation of US firms in Reorganization' (1989) 44 Journal of Finance 747.

[65] A more recent empirical study finds fewer violations of the absolute priority rule in the new Chapter 11 of increased creditor control – see Arturo Bris, Ivo Welch and Ning Zhu 'The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization' (2006) 61 Journal of Finance 1253 at 1289.

[66] See *Mason v Paradise Irrigation District* (1946) 326 US 536 at 541–542: 'it has long been recognized in reorganization law that those who put new money into the distressed enterprise may be given a participation in the reorganization plan reasonably equivalent to their contribution. . . . That rule is based on practical necessities. Without the inducement new money could not be obtained.'

[67] See generally K Klee 'Adjusting Chapter 11: Fine Tuning the Plan Process' (1995) 69 American Bankruptcy Law Journal 551 at 570–571: '[A] plan should not be permitted to be crammed down where a senior class gives up value to a junior class while skipping over an intermediate or co-equal class. Although the argument can be and has been made that senior creditors should be entitled to do what they want with their property, the lessons of history should suffice to impose a per se rule that precludes senior creditors from collaborating with junior creditors or equity owners at the expense of intervening classes.'

[68] See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory' 1475 text accompanying footnote 45.

There is a line of authority emanating from *Re SPM Manufacturing Corp* (1993) 984

There is an argument that any opportunity for shareholders to continue participation in the company – even if in exchange for an infusion of additional cash – enhances their leverage against creditors and should be prohibited.[69] On the other hand, while there are certain cases, particularly involving small businesses, that should be scrutinised carefully for possible abuses, a strict interpretation of the absolute priority principle may be insufficiently subtle for this purpose.[70] Shareholders may often serve as an important source of capital for the ailing entity. It is unwise effectively to choke off this source of capital simply because one class of creditors objected to the terms of a plan regardless of the reason for the objection.[71] In recognition of the fact that prior owners may sometimes be the best buyers of a reorganised company, particularly a closely held company, the courts are reluctant to squeeze the old owners out entirely. The new-value doctrine can also incentivise key managers to stay with the company and to come up with fresh money that ensures that the company is adequately capitalised.[72]

Current statutory language restricts the absolute subordination of a junior class to what it 'receives' or 'retains' on account of its claim or interest. This seems to leave an opening for a junior class to participate in a reorganisation

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F 2d 1305 which suggests that secured creditors may give up all or part of their entitlements to junior creditors. On this analysis, a secured creditor may allocate its share of the reorganised entity in whatever way it pleases just as it can with any other asset that it owns. *Re Armstrong World Industries Inc* (2005) 320 BR 523, on the other hand, states clearly that such an approach entails a breach of the absolute priority principle. The court affirmed bluntly that 'no amount of legal creativity or counsel's incantation to general notions of equity or to any supposed policy favoring reorganization over liquidation supports judicial rewriting of the Bankruptcy Code.'

69 See K Klee (1990) 'Cram Down 11' 64 American Bankruptcy Law Journal 229 at 244: 'The vice of the new value exception is that it enables the debtor's owners to purchase an ownership interest based on a court-approved valuation without validation of the price in the market place. Valuation by the court is, of course the norm for distribution of reorganization securities under the fair and equitable test. But when a reorganization security is to be sold, in effect, for a new contribution, rather than distributed in satisfaction of claims or interests to a class of creditors or owners under a plan, perhaps a market test should be applied as would be done with the sale of any other asset of the estate. At the very least, to maintain the balance of relative right, Chapter 11 creditors who argue that the proposed capital contribution is too low should have the opportunity to match or exceed the pending offer.'

70 See National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 564.

71 See R Mann 'Strategy and Force in the Liquidation of Secured Debt' (1997) 96 Michigan L Rev 159.

72 See generally National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 554.

plan on account of a contribution of new value to the debtor.[73] Such participation is not 'retained' or 'received' but rather purchased for new value. According to the National Bankruptcy Commission Report however, the mere mention of the new value exception sets off an analysis of semantics, history and statutory interpretation.[74] The resulting litigation is expensive and delays the negotiation process. The parties squabble over something that is crucial to the basic question of how equity financing of business will be structured. There is always a risk that managers may propose a plan that grants disproportionate rights to existing shareholders at the expense of creditors. There is also a concern that the valuation of the business will be inaccurate thereby allowing shareholders to capture value that should have gone to the creditors.[75] The courts have attempted to control these risk factors by crafting a number of restrictions onto the new value doctrine itself.[76]

In *Case v Los Angeles Lumber Products Co*[77] the US Supreme Court stated that 'where necessity exists and old stockholders make a fresh contribution and receive, in return, a participation reasonably equivalent to their contribution, no objection can be made'. In other words, where the debtor is insolvent, the shareholder's participation must be based on a contribution in money or in money's worth that is reasonably equivalent in view of all the circumstances to the participation of the shareholder. In *Case*, the court refused to allow shareholders to retain an interest in the reorganised firm in exchange for their promise to contribute value in the form of continuity of management and their financial standing and influence in the community. Douglas J held that shareholders' intangible promises had no place as an asset in the balance sheet of the new company reflecting merely vague hopes or possibilities.

Similarly, in *Norwest Bank Worthington v Ahlers*[78] a farmer promised future contributions of 'labour, experience and expertise' in exchange for keeping his farm. The court rejected the plan and said that the debtor's promise of future services was intangible, inalienable and in all likelihood, unenforceable. It had no place in the asset column of the balance sheet.[79] The Supreme Court, while implicitly acknowledging the existence of the new value corollary, was adamant that in order to constitute money or money's worth, the new

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73 See R Maloy 'A Primer on Cramdown – How and Why It Works' (2003) 16 St Thomas L Rev 1 at 34.

74 National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at pp 549–550.

75 Ibid at p 552.

76 See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory' 1475 text accompanying footnote 88.

77 (1939) 308 US 106 at 121.

78 (1988) 485 US 197 at 202–203.

79 (1988) 485 US 197 at 205–205.

contribution must be tangible and not merely a promise of future services.[80] As judicially developed, the new value doctrine requires that shareholder contributions of capital must be new; substantial; represent money or money's worth; be necessary to the reorganisation and reasonably equivalent to the value of the new equity interests received.[81] The 'new' requirement means that contributions must constitute an infusion of value that is not simply a 'disguised donation of pre-existing property of the debtor's bankruptcy estate.'[82] It ensures that old equity holders do in fact pay for their new interests and do so with their own money.

The 'substantiality' requirement was not explicitly mentioned in *Case v LA Lumber Products*[83] but is designed to screen out contributions that are unreasonably small. In the absence of some requirement that old equity contributes sufficient funds to place the company on a stable financial footing, old equity may have an incentive to propose a plan that maintained the company in a highly leveraged position. This would depress the value of the company and make it easier for old equity to purchase their new shares for less money. Without substantial funds of their own at stake, shareholders might gamble with the company's assets at creditors' expense. The 'substantiality' requirement at least ensures that the company stands on solid financial ground and potentially minimises the effects of undisclosed private information. Although the two standards overlap, the 'substantiality' requirement differs from the 'feasibility' test which is an independent requirement for confirmation of a reorganisation plan[84] because it serves a different purpose – namely, to prevent manipulation of the company's capital structure at the expense of creditors.

In *Bank of America v 203 North LaSalle Street Partnership*[85] the Supreme Court addressed the new value controversy in the context of a non-consensual plan that granted old shareholders an exclusive option to purchase a new equity stake over the objection of an unpaid creditor. The case concerned the ailing fortunes of an insolvent limited partnership – essentially an investment vehicle for certain speculators seeking profits and generous tax breaks. Because the debt owed to the bank exceeded the value of the collateral, the bank's claim was divided into two parts for classification and voting purposes;

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80 See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory' 1475 text accompanying footnote 102.

81 See *Re Bonner Mall Partnerships* (1993) 2 F 3d 899 but compare *Kham & Nate's Shoes (No 2) Inc v First Bank of Whiting* (1990) 908 F 2d 1351.

82 See G Eric Brunstad and Mike Sigal 'Competitive Choice Theory' 1475 text accompanying footnotes 252, 253.

83 (1939) 308 US 106.

84 S 1129(a)(11).

85 (1999) 526 US 434 at 455–456.

a secured claim that equalled the value of the collateral and an unsecured deficiency claim for the balance. The plan proposed to pay the bank's secured claim in full but most of its unsecured claim would never be repaid. Other unsecured claims such as trade creditors and unpaid tax liabilities were placed in a different category and paid in full, but without interest. The plan granted existing partners an exclusive option to contribute new capital to the reorganised debtor and, in return, contributing partners would receive all the new equity in the reorganised entity. By preventing enforcement of the collateral and retaining control of the company, the partners would avoid significant personal tax liabilities. The bank's unsecured deficiency claim had been put in a class by itself so that its objection could be overcome by cramdown under s 1129.

The Supreme Court held that the partners' exclusive option to purchase the new equity 'free from competition and without benefit of market valuation' contravened the absolute priority principle and so cramdown was not allowed. At the same time however, the Supreme Court said that the legislative history

> does nothing to disparage the possibility . . . , that the absolute priority rule . . . may carry a new value corollary. Although there is no literal reference to new value in the phrase 'on account of such junior claim', the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.[86]

Souter J observed that the words 'on account of' such junior claim in 1129(b)(2)(B)(ii) modify the strict prohibition against distribution of interests to junior claimants where senior creditors are not fully paid. All that the statute required was that the old equity holders offer something in exchange for their new shares. It was suggested that, on a commonsense view, the phrase 'on account of' meant simply 'because of'.[87] This standard required consideration of the causal link between what a junior claimant received under the plan and what s/he contributed to it. The US Government, as *amicus curiae*, took what the Supreme Court called the 'starchy position', not only that any degree of causation between earlier equity interests and a retained shareholding will activate the bar but also that whenever existing shareholders end up with some equity in the reorganised company there will be some causation. When 'old equity, and not someone on the street, gets property the reason is res ipsa loquitur'.[88] An old equity holder cannot take property under a plan if creditors are not paid in full.

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86 (1999) 526 US 434 at 449.
87 (1999) 526 US 434 at 450.
88 (1999) 526 US 434 at 451.

The court suggested however, that if there was intended to be an absolute prohibition the legislature would have forgone the 'on account of' language altogether. It made sense not to exclude prior equity categorically from the class of potential owners following a cramdown. Prior equity may well be in 'the best position to "make a go" of the reorganised enterprise and so may be the party most likely to make the most of an equity-for-value reorganisation'. The statutory prohibition came into play however when the equity holders obtained or preserved an ownership interest for less than someone else would have paid. According to the Supreme Court, what was objectionable in this particular case was the fact that the prior owners were given an exclusive opportunity to acquire the equity interest in the reorganised entity. Unless the very purpose of the transaction was to do old equity a favour, they should not need the protection of exclusiveness.[89]

The court suggested that, in the main, the best way to determine value is through exposure to a market.[90] The judgment embodies a general preference for economic self-determination, with the court observing that Chapter 11 was enacted in the belief 'that creditors and equity holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees or [governmental agencies such as] the SEC'.[91]

It has been argued however that market valuation has an Alice-in-Wonderland quality in cases like *LaSalle*.[92]

> There are exactly two bidders for the equity interest in real estate subject to a restructured secured claim measured by the present value of the real estate – the bank holding the mortgage and the old equity holders who for tax and speculative reasons wish to retain their ownership interest. A negotiation between these two parties, not an auction or competing 'reorganization' plans is the answer.

Post *LaSalle*, some courts have endorsed auctions of the debtor's equity where anyone can bid but the difficulty with this procedure is that it divests the court of its own independent review of the factors required for confirmation of a new value plan. It also requires establishing an auction process and a

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89 (1999) 526 US 434 at 456.

90 See B Markell 'Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations' (1991) 44 Stanford L Rev 69 at 73: 'Reorganization practice illustrates that the presence of competing bidders for a debtor, whether they are owners or not, tends to increase creditor dividends.'

91 (1999) 526 US 434 at 457 n 28 referring to Brunstad, Sigal & Schorling 'Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One' (1998) 53 Business Lawyer 1381 at 1406 n 136.

92 See William D Warren and Daniel J Bussell *Bankruptcy* (New York, Foundation Press, 7th ed, 2006) at p 806.

reorganisation plan format that is acceptable to the debtor as well as to potential bidders. The company's management can structure the terms of an auction so as to advantage old equity. If no one else bids, then the bid by old equity is accepted. With auctions, the possibility of self-dealing is not entirely eliminated.[93]

CORPORATE RESCUE PROCEDURES IN THE UK

In Chapter 2 of this book the point was made that administration in the UK is not a stand-alone procedure in the same way that Chapter 11 is in the US. It is more a gateway to other procedures, whether this be an agreement with creditors or liquidation or dissolution of the company. The legislation conceives of a framework under which the administrator manages the company's affairs on a day-to-day basis while making investigations and inquiries with a view to formulating proposals to achieve the goals of administration. Another legislative assumption is that, in return for the moratorium on enforcement of their rights, creditors should have an important say on the conduct of the administration. While, generally speaking, the administrator must gain the consent of creditors to his proposals at a meeting,[94] the requirement to hold a creditors' meeting can be dispensed with in certain circumstances, and moreover, the administrator is permitted to sell the company's business in advance of the meeting.[95] Such a sale may make the meeting largely redundant.

Chapter 2 also made the point that the substantive rights of creditors cannot be changed simply through approving proposals made by an administrator. Such proposals cannot be equated with a Chapter 11 reorganisation plan.[96] Something more has to be done before creditors' rights can be discharged or varied. There are however a number of statutory possibilities for achieving binding effect and overcoming hold-outs among minority creditors to something like a debt-forgiveness plan or a debt/equity swap. If the agreement of each creditor had to be obtained there might be considerable coordination costs in assembling the necessary parties and bringing them into the agreement.

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93 See National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at pp 562–563.

94 Schedule B1 Insolvency Act 1986, para 51.

95 See *Re Transbus International Ltd* [2004] 2 All ER 911.

96 The empirical study 'Report on Insolvency Outcomes' – a paper presented to the Insolvency Service by Dr Sandra Frisby which is available on the Insolvency Service website – www.insolvency.gov.uk reports (at p 63) a 'general view that the only genuine rescue mechanism is the CVA within the protection of administration. Of those rescue outcomes recorded on the database all but two involved CVAs within administration, which would appear to support that view.'

There is also the free-rider issue in that some parties have incentives to hold out for a better deal for themselves or to free ride on the sacrifice of other parties by remaining outside the agreement in the expectation that others would sign up to it, thus leading to an improvement in the company's fortunes from which they would also benefit. Thus some concession to majoritarianism seems appropriate but a simple majority rule principle appears to involve too great an infringement on the rights of individual creditors. One option for overcoming objections is through a scheme of arrangement under what is now s 895 of the Companies Act 2006, with another possibility being a voluntary arrangement under the insolvency legislation. A third possibility is a voluntary arrangement coupled with a moratorium also under the insolvency legislation but this alternative is not likely to be part and parcel of an administration since it comes with its own moratorium on individual creditor enforcement actions. Chapter 2 of this book sets out the broad feature of schemes of arrangement and voluntary arrangement. The present chapter will highlight particular points of difference and comparison between these procedures and a Chapter 11 reorganisation plan.

SCHEMES OF ARRANGEMENT UNDER THE COMPANIES ACT

Schemes of arrangement have been described as complex and difficult to organise, demanding of expensive legal resources and generally the preserve of larger companies.[97] Like Chapter 11 reorganisation plans they involve multiple court applications, division of creditors into classes and the requirement to obtain judicial sanction of the scheme. On the plus side, some of the detailed requirements of Chapter 11 are absent but on the minus side, the moratorium, which is such a conspicuous feature of Chapter 11, is not an inherent part of schemes of arrangement. The latter difficulty is removed, however, if the scheme comes as part of an administration because advantage can then be taken of the moratorium that accompanies administration. While schemes of arrangement can be, and have been used, to buy out minority shareholders compulsorily, they have also been used to facilitate corporate restructurings. Schemes of arrangement enable a company, irrespective of solvency, to enter into a compromise or arrangement with any class of creditors, or members. In this way, the capital structure of companies in financial

[97] See generally on the process Andrew Wilkinson, Adrian Cohen and Rosemary Sutherland 'Creditors' Schemes of Arrangement and Company Voluntary Arrangements' in Harry Rajak ed *Insolvency Law: Theory and Practice* (London, Sweet & Maxwell, 1993) p 319.

difficulties may be reorganised. A scheme of arrangement may also be used as an alternative to liquidation or within liquidation as a means of reaching a compromise with creditors. The statute requires that a majority in number representing 75 per cent in value of the class of shareholders or creditors affected must accept the scheme and court sanction is also required. Once these conditions are fulfilled, the arrangement binds abstainers or dissenters.

It was pointed out by Chadwick LJ in *Re Hawk Insurance Co Ltd*[98] that there are three parts to approval of a scheme. The first stage is an application to the court for an order that a meeting or meetings be summoned. Secondly, the scheme proposals are put to the relevant meetings and are approved, or not, as the case may be. Thirdly, if there is approval, there must be a further application to the court for its sanction of the compromise or arrangement. Each of those stages serves a distinct purpose. At the first stage, the court is concerned to ensure that those who are to be affected by the proposal have a proper opportunity of being present at the relevant meetings. The second stage ensures that the proposals are acceptable to the necessary majorities. At the third stage, the judicial focus is to ensure that the views and interests of those who have not approved the proposals receive impartial consideration.

The practice in the Companies Court prior to the *Hawk* decision was stated by Lord Millett in *Re UDL Holdings Ltd.*[99] He said that it is the company's responsibility to decide whether to summon a single meeting or more than one meeting. If the meetings were improperly constituted, then objection should be taken on the application for sanction and the company ran the risk that the application would be dismissed. Significant defects in this practice were highlighted by Chadwick LJ in *Hawk*. Basically, the question of what meetings the scheme actually requires is left to be decided at the third stage and by this time a wrong decision at the outset will have led to a considerable waste of time and expense.[100]

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98 [2001] 2 BCLC 480.

99 [2002] 1 HKC 172, 184. Lord Millett was sitting as a judge of the Court of Final Appeal in Hong Kong. See Practice Note issued by Eve J [1934] WN 142 'In proceedings . . . for the sanction by the Court of a compromise or arrangement between a company and its creditors, or a class of them, his Lordship said that the responsibility for determining what creditors are to be summoned to any meeting, as constituting a class, is the applicant's; and if the meetings are incorrectly convened or constituted or an objection is taken to the presence of any particular creditors as having interests competing with the others the objection must be taken on the hearing of the petition for sanction, and the applicant must take the risk of having it dismissed.'

100 Chadwick LJ added ([2002] 2 BCLC 480 at para 20) 'But what seems to me unacceptable – and likely to lead to justifiable dissatisfaction with what is plainly intended to be a useful and beneficial jurisdiction – is that the existing practice has led, in the present case, to the court reviewing of its own motion, at the third stage, the utility of the order which it made at the first stage.'

These comments led a change in direction and a new Practice Statement.[101] The new procedure is designed to enable, so far as possible, that the determination of all issues relating to the composition of the relevant classes takes place at the first 'leave' stage. These are matters which go to the court's jurisdiction to sanction a scheme, rather than the exercise of any discretion to grant or withhold sanction. In *Re Equitable Life Assurance Society*[102] Lloyd J said that it was appropriate for the court to come to a prima facie view as to whether the class or classes put forward by the company were appropriate. At the same time however, he emphasised that this could only be a provisional conclusion and the matter could be reopened when the court was asked subsequently to sanction the scheme. But as David Richards J pointed out in *Re Telewest Communications plc*,[103] there is no point in the court convening meetings to consider the scheme if it can be seen now that it will lack the jurisdiction to sanction it later. The distinctiveness of the various stages was also emphasised in *Telewest*: David Richards J stressed that the function of the court at the first stage was emphatically not to consider the merits or fairness of the proposed scheme. It was primarily to decide about the number of meetings and to decide the manner in which meetings should be summoned and conducted. Class composition issues should be dealt with at the first stage.[104]

JUDICIAL SANCTIONING OF SCHEMES OF ARRANGEMENT

When it comes to judicial sanctioning of schemes of arrangement a classic statement of principle comes from Astbury J in *Re Anglo-Continental Supply Co Ltd*[105] who said:

> In exercising its power of sanction . . . the Court will see: First that the provisions of the statute have been complied with. Secondly, that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent and thirdly, that the arrangement is such as a man of business would reasonably approve.

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101 [2002] 1 WLR 1345.

102 [2002] BCC 319.

103 [2004] BCC 342, 348.

104 He added that there was much to commend an approach which enabled the court to sanction a scheme in an appropriate case, where the classes had been incorrectly constituted in a way which would not have affected the outcome of the meetings. The judge conceded however that this was not the position under the section.

105 [1922] 2 Ch 723 at 736.

This statement of principle has been refined and applied on many occasions. Basically, a scheme will be in jeopardy if dissentients can show that the majority at one of the class meetings had a conflict of interest or some special interest not shared by other members of the class. On the other hand, if the power of the majority to bind the minority is exercised for the purpose of benefiting the class as a whole, and not merely individual members, the scheme should pass judicial muster. In *Re BTR plc*[106] Chadwick LJ stressed that:

> [T]he court is not bound by the decision of the meeting. A favourable resolution at the meeting represents a threshold which must be surmounted before the sanction of the court can be sought. But if the court is satisfied that the meeting is unrepresentative, or that those voting at the meeting have done so with a special interest to promote which differs from the interest of the ordinary independent and objective shareholder, then the vote in favour of the resolution is not to be given effect by the sanction of the court.

At the same time however, the same judge in the *Hawk Insurance*[107] case observed that the court should be careful not to allow a minority of creditors to frustrate the wishes of the majority. Plowman J in *Re National Bank Ltd* [108] implied that the court will be slow to differ from the meeting, 'unless either the class has not been properly consulted, or the meeting has not considered the matter with a view to the interests of the class which it is empowered to bind, or some blot is found in the scheme'. In *Telewest (No 2)* the court suggested that this formulation in particular recognises and balances two important factors. First, in deciding whether to accord judicial sanction to a scheme, the court must be satisfied that it is a fair scheme – one that 'an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve'. Secondly, the scheme proposed need not be the only fair scheme or even, in the court's view, the best scheme. There is room for reasonable differences of view on these issues and in commercial matters members or creditors are much better judges of their own interests than the courts. Lewison J in *Re British Aviation Insurance Co Ltd*[109]

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106 [2000] 1 BCLC 740.

107 [2001] 2 BCLC 480.

108 [1966] 1 WLR 819. See also the comments of Lewison J in *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 at para 113 that the court may, at the third stage, refuse to endorse the majority vote if it is satisfied that the meeting is unrepresentative or that those voting at the meeting have done so with a special interest to promote which differs from the interest of the ordinary independent and objective creditor.

109 [2005] EWHC 1621 at para 75. The judge added: 'Where, as here, those who voted in favour of the scheme are large and sophisticated corporations, the rigid application of this test as the sole criterion would rarely, I think, enable the court to refuse

pointed out that the test is not whether the opposing creditors have reasonable objections to the scheme. A creditor may be equally reasonable in voting for or against the scheme and in these circumstances creditor democracy should prevail.

Where a scheme being sanctioned is for the purposes of, or in connection with, a reconstruction or amalgamation and the transfer of the whole or part of one or more companies' businesses to another company, then the court can make various ancillary orders by virtue of s 900 Companies Act 2006.[110] It can transfer the whole or any part of a company's undertaking or property and also its liabilities. The usefulness of s 900 in the context of corporate restructurings has however been much reduced by the decision of Mann J in *Re Mytravel Group plc*.[111] He decided that the essence of a reconstruction of a company in the context of s 900 was that the shareholders in the new company should be the same or substantially the same as in the old company.

Where only 4 per cent of the shares in the new company were held by the entirety of the shareholders in the old company, there was not a substantial identity between the two bodies of shareholders. Accordingly a proposed scheme of arrangement along these lines, while it could be approved by the court pursuant to s 895, could not have the benefit of the s 900 ancillary orders. The decision means that s 900 will not be available in most cases of corporate restructuring since old equity are likely to have only a small stake in the new company formed out of the old corporate embers.

CVAs VERSUS SCHEMES OF ARRANGEMENT

If an administrator decides that corporate restructuring is the best way forward for a company rather than the sale of assets, the restructuring is normally achieved by means of a company voluntary arrangement (CVA) rather than through a scheme of arrangement. The use of CVAs under the Insolvency legislation has considerable advantages compared with schemes of arrangement. Generally, the process is administratively simpler and less cumbersome. At one time, unknown creditors could be bound by a scheme of arrangement but not by a CVA. The Insolvency Act 2000, however, makes the CVA binding on creditors who were not given notice of the meeting. This caters for the

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to sanction the scheme. It is also not entirely clear to me how the rigid application of this test sits with statements that the court has an unfettered discretion.'

110 Formerly s 427 Companies Act 2006.

111 [2005] 1 WLR 2365. See the comment by C Derrick [2005] Insolvency Intelligence 136 at 137: 'it appears unlikely that the provisions of s 427 will be available in the future to an insolvent company as any scheme of arrangement as part of a financial restructuring would be likely to involve a debt for equity swap.'

difficulty presented by insolvent insurance companies where it would be difficult in a CVA to give notice to all creditors. Schemes of arrangement were formerly used in such cases. In a CVA, there is no need for two separate applications to the court and to sort out tricky issues concerning the proper composition of a class of creditors. Creditors under CVAs are dealt with as a single collective group and not as members of separate classes.

The question of the proper composition of a class for scheme of arrangement purposes has attracted much attention. While the volume of litigation may be less, it has perhaps generated as much controversy as the same issue has done in the US Chapter 11 context. The 'business justification' test for judging separate classification schemes that has found favour in US case law has not, however, achieved judicial prominence in England. The seminal case in this area is *Sovereign Life Assurance Co v Dodd*,[112] where the Court of Appeal held that for the purposes of a scheme which affected the policyholders of an insurance company, the holders of matured and unmatured policies should be in separate classes. Two different approaches are discernible from the judgments. Lord Esher MR said 'if we find a different state of facts exists among different creditors which may differently affect their minds and their judgment they must be divided into different classes . . .'. Bowen LJ's approach is narrower and to be preferred lest small groups be given veto powers over the decision-making process:[113]

> it seems plain that we must give such a meaning to the term 'class' as will prevent the section being so worked so to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

Chadwick LJ in *Re Hawk Insurance Co Ltd*[114] was very conscious about not giving a veto to minority groups, saying that the safeguard against majority oppression is that the court is not bound by the decision of the meeting. The relevant tests should not be applied in such a way that they become an instrument of oppression by a minority:[115]

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112 [1892] 1 QB 573.

113 [1892] 2 QB 573 at 583. See the comments of Nazareth J in the Hong Kong High Court in *Re Industrial Equity (Pacific) Ltd* [1991] 2 HKLR 614 at 625: 'Is every different interest to constitute a different class? Clearly not, but where then is the line to be drawn? The difficulties in identifying shareholders with such interests . . . could raise in terms of practicality virtually insuperable difficulties. It is determination by reference to rights of shareholders that meets such difficulties, while leaving any conflict of interest which may result in a minority being overborne or coerced to be dealt with by the courts when their sanction is sought.'

114 [2001] 2 BCLC 480 at para 33.

115 [2001] 2 BCLC 480 at para 32. Chadwick LJ also referred to the observations

> [T]he relevant question at the outset is: between whom is it proposed that a compromise or arrangement is to be made? Are the rights of those who are to be affected by the scheme proposed such that the scheme can be seen as a single arrangement; or ought the scheme to be regarded, on a true analysis, as a number of linked arrangements?

In his view, it was necessary to ensure not only that those whose rights really are so dissimilar that they cannot consult together with a view to a common interest should be treated as parties to distinct arrangements – so that they should have their own separate meetings – but also that those whose rights are sufficiently similar that they can properly consult together should be required to do so. The test is based on similarity or dissimilarity of legal rights against the company, not on similarity or dissimilarity of interests not derived from such legal rights. The fact that individuals may hold divergent views, based on their private interests not derived from their legal rights against the company, was not a ground for calling separate meetings.

In *Re Telewest Communications plc*[116] David Richards J held that subordinated bondholders should form a separate class apart from general creditors of the company. Although the company was not then in liquidation, the judge said that the reality is that they will not be able to enforce their contractual rights. In the absence of the scheme, or other arrangements, their rights against the company will be those arising in an insolvent liquidation. The appropriate comparator was an insolvent liquidation rather than the theoretical possibility that the company might remain solvent. Since the bondholders had different rights in liquidation than ordinary unsecured creditors it was appropriate that they should be put in a separate class.

Bringing about restructuring through a CVA avoids all this controversy about separate classes. In the CVA context there are no separate classes. Approval of a CVA requires a majority in excess of 75 per cent in value of creditors present at the creditors' meeting, but a resolution is invalid if those voting against it include more than half in value of independent creditors. A CVA, however, may not affect the rights of secured creditors without their consent nor the rights of preferential creditors to be paid ahead of unsecured creditors. There is no procedure, though, whereby the objections of secured

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of Lush J in the Australian case *Nordic Bank plc v International Harvester Australia Ltd* [1982] 2 VR 298: 'To break creditors up into classes, however, will give each class an opportunity to veto the scheme, a process which undermines the basic approach of decision by a large majority, and one which should only be permitted if there are dissimilar interests related to the company and its scheme to be protected. The fact that two views may be expressed at a meeting because one group may for extraneous reasons prefer one course, while another group prefers another is not a reason for calling two separate meetings.'

116 [2004] EWHC 924.

creditors can be overcome unlike Chapter 11 cramdown. There are other significant differences with Chapter 11. The CVA approval seems much less legalistic, with far fewer separate requirements having to be satisfied. There is no need to go to the court as such for approval of the CVA. While a dissenting creditor can challenge the CVA within a tight timescale both on procedural grounds and on grounds of unfair prejudice, the matter otherwise does not come to court. [117] There is no requirement for obtaining court sanction.

The language of 'unfair prejudice' comes from the protection of minority shareholders under the Companies legislation. In that situation, the 'unfair prejudice' remedy has been used to protect shareholders in the context of a 'quasi-partnership' where one of the so-called 'partners' has been unfairly excluded from participation in management and effectively denied any income from the company. But how the concept translates into protection for dissentient creditors in the Insolvency framework is not entirely clear. The concept carries the same sort of resonance as 'fair and equitable' treatment and the absence of unfair discrimination under Chapter 11, though it may not have exactly the same implications. It may not, for instance, import the absolute priority doctrine in all its ramifications even though a creditor whose claims for payment have been squeezed out in favour of shareholders by other creditors pursuing an extraneous agenda may have grounds for complaint.

These issues were addressed in *IRC v Wimbledon Football Club Ltd.*[118] It was suggested that:[119]

> (1) to constitute a good ground of challenge the unfair prejudice complained of must be caused by the terms of the arrangement itself; (2) the existence of unequal or differential treatment of creditors of the same class will not of itself constitute unfairness, but may give cause to inquire and require an explanation; (3) in determining whether or not there is unfairness, it is necessary to consider all the circumstances including, as alternatives to the arrangement proposed, not only liquidation but the possibility of a different fairer scheme; (4) depending on the circumstances, differential treatment may be necessary to ensure fairness . . . (5) differential treatment may be necessary to secure the continuation of the company's business which underlines the arrangement . . .'

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117 S 6(7). A procedural irregularity does not invalidate the approval given at a meeting unless it is the subject of a successful statutory challenge. Where the court is satisfied that grounds for challenge are made out, it may revoke or suspend approvals given by the meetings and direct the summoning of further meetings, either to consider a new proposal from the original proposer or to reconsider the original proposal. The court itself has no power to devise a new proposal for consideration.

118 [2005] 1 BCLC 66.

119 [2005] 1 BCLC 66 at para 18.

In this case the company (Wimbledon Football Club) held a share in the Football League Ltd which entitled it to participate in competitions run by the Football League. The administrator proposed to sell this share but under its rules the Football League could effectively block a transfer unless the buyer paid 'Football creditors' in full. The company suggested a CVA under which preferential creditors (namely the Revenue) would receive 30 per cent of their debts but Football creditors (as defined by Football League rules) would be paid in full. The Revenue objected alleging a breach of s 6 (unfair prejudice) and s 4(4)(a) under which the court should not approve a CVA if, without the creditor's consent, 'any preferential debt of the company is to be paid otherwise than in priority to such of its debts as are not preferential debts'. The court, however, took the view that the section did not preclude payment of non-preferential creditors by third parties ahead of preferential creditors out of their own free money. Nevertheless:[120]

> It would of course be different if the company put third party in funds to do so. It would be different if the Sale Agreement were a sham or device adopted to disguise payments by the company to non-preferential creditors ahead of preferential creditors e.g by agreeing an artificially low purchase price payable to the company for its undertaking in return for the assumption by the purchaser of an obligation to pay non-preferential creditors.

It was suggested that the single-minded pursuit by the Revenue of their principled objection to the payment in full of 'Football creditors' could only bring down the whole edifice and secure a nil return for all concerned. But, as the court also recognised, it was a commercial necessity for the buyer to pay off the Football creditors in full. The commercial necessity must surely reduce the price that the buyer would otherwise pay for the company assets. While the price may not have been, in the judge's words, 'artificially low', it was surely lower than it might have been had the 'commercial necessity' not presented itself.

Corporate restructuring by means of a CVA route may be preferable than through schemes of arrangement, but CVAs are not without their own shortcomings, particularly at the practical level.[121] It is a truism that necessary

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120 Ibid at para 17.

121 But see the conclusion from the empirical study conducted by Gary Cook, Naresh Pandit, David Milman and Carolynne Mason *Small Firm Rescue: a Multi-method Empirical Study of Company Voluntary Arrangements* (ICAEW 2003) at p vi: 'The CVA emerges as being a successful regime along a number of dimensions. All classes of creditor receive good dividends when compared to other insolvency regimes, especially unsecured creditors. . . . The rate of company preservation is good compared to insolvency regimes in general. CVAs generally perform broadly in line with the plan

conditions to the success of a CVA include a realistic reorganisation proposal and secondly also creditor support for that proposal. In many cases, it seems that creditors will simply not accept a proposal and will look for repayment out of the proceeds of a business or asset sale.[122] An Insolvency Service study found that

> many of the companies entering either administration or receivership had, at some time in the near past, been the subject of a CVA that had failed. It is not implausible to suggest that to the extent that CVAs regularly fail then creditors, particularly repeat players such as secured creditors and the Crown, begin to doubt the procedure's integrity and prospects for success as a whole. Following on from this, it may be that even realistic proposals will not clear the hurdle of acquiring creditor support.[123]

There are a number of significant differences between reorganisations under Chapter 11 and by means of a CVA.

1. CVAs are not predicated on the division of creditors into separate classes whereas this is an intrinsic feature of Chapter 11.
2. The percentages required for obtaining creditor approval at the relevant meetings are different under the two procedures. Chapter 11 requires a majority in number of creditors representing two-thirds of value whereas CVAs need three-quarters in value.
3. Chapter 11 reorganisation plans require court approval unlike CVAs. The latter will only go to court if challenged on procedural grounds or on the basis that it involves unfair prejudice to a creditor.
4. A dissenting creditor even within a class of creditors that, as a whole, has given its approval, may object to a Chapter 11 plan on the ground that the creditor would have received more in a straightforward Chapter

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set out in the proposal or better. It must be acknowledged that there is possibly a selection effect at work in that generally only the more promising cases may be likely to be placed in a CVA compared to other insolvency regimes.'

[122] See Gary Cook et al, ibid at p vi: 'A key reason for not using CVAs more widely for turnaround is simply a lack of suitable cases. Often this is because there is a preference for making a clean break and saving some or all of the business (rather than a company). A prime reason for this preference is the burden of making repayments during the life of the CVA. Another reason for the lack of suitable cases is that many companies come forward too late for turnaround via CVA to be appropriate.'

[123] 'Report on Insolvency Outcomes' at p 63 – a paper presented to the Insolvency Service by Dr Sandra Frisby – available at www.insolvency.gov.uk and for a synopsis see 'Not Quite Warp Factor 2 Yet? The Enterprise Act and Corporate Insolvency' (2007) 22 Butterworths Journal of International Banking and Financial Law 327.

7 liquidation of the company. This is the 'best interests of creditors' test but there is no equivalent in the context of a CVA.

5. In Chapter 11 the court has to make a determination on whether a reorganisation plan is 'feasible'. No such judicial determinations are required in the case of CVAs, which leaves it up to the creditors and shareholders of the relevant company to decide on the economic merits of a proposed restructuring.
6. A class of secured creditors whose rights have been impaired can be 'crammed-down' and forced to accept a Chapter 11 plan against its wishes. This is simply not possible with a CVA, which cannot tamper with the rights of secured creditors where creditor consent is not forthcoming.
7. Chapter 11 imports the 'absolute priority' rule, i.e. a higher-ranking class of claimants must be paid in full before a junior class can receive anything. There is no explicit requirement as far as CVAs are concerned.
8. There are a number of highly specific requirements about what Chapter 11 plans must provide for. These include provision for the payment in cash of administrative expense claims and specified pre-bankruptcy claims including certain tax claims. The legislation governing CVA does not descend into this level of details. CVA may, or may not, include provisions along these lines. There are no mandatory requirements.

CONCLUSION

Reorganisations in the traditional sense may be a declining part of the world of Chapter 11 practice. Particularly where larger companies are concerned the bankruptcy may have been largely 'pre-packaged' with the court consummating a deal involving the going-concern sale of the major part of the company assets. The major part of the negotiations concerning the deal will have been done before Chapter 11 bankruptcy. 'In Chapter 11, the judge ensures that the sale is conducted in a way that brings the highest price . . . Chapter 11 has morphed into a branch of the law governing mergers and acquisitions.'[124] But leaving these cases aside, a UK observer may not help thinking that the Chapter 11 reorganisation plan is a strange, complicated animal. The procedures appear cumbersome and complicated compared with the simplicity of a CVA. There are a lot of legalistic requirements about what the Chapter 11 plan must, and must not contain. Secured creditors can be coerced through cramdown but this possible advantage in bringing about a corporate restructuring

[124] See Douglas G Baird *Elements of Bankruptcy* (New York, Foundation Press, 4th ed, 2006) at p. 232.

comes at the price of a whole host of procedural and substantial conditions that may not be easy to interpret, apply and satisfy in practice. Albeit aided by expert testimony, the court is called upon to judge whether a plan serves the economic interests of creditors and whether the plan passes muster on business viability grounds. The UK approach leaves these matters to the judgement of creditors. Indeed, unlike in Chapter 11, there is no need for judicial sanction of a CVA. CVAs seem easier to organise and to respect more the values of simplicity and economic self-determination on the part of creditors and shareholders.

9. Conclusion

This concluding chapter looks at the similarities and differences between the corporate reorganisation codes in the UK and US. It first of all considers the similarities highlighting the automatic stay and the provisions for overcoming hold-outs. It then addresses the differences focusing in particular on ease of access to the respective procedures and control of the company during the reorganisation process. The differences are usually summed up in the expression that the UK law is pro-creditor and the US law pro-debtor. An attempt is made to unpack the expression and the conclusion is reached that while the statement is somewhat of an over-simplification it is probably true to say that the US law is more pro-manager or pro-shareholder than the UK. Secured creditors however, may be no less well protected in the US than in the UK though the form of protection is different. In the US it takes the form of loan covenants whereas in the UK protection is enshrined in statute. The chapter then summarises the impact of the reforms introduced by the Enterprise Act 2002 which had the explicit objective of pushing UK law in an American direction. It suggests that the reforms are less thorough than they might appear on the surface. Administrative receivership has been scrapped in the majority of cases but the new-style administrator has taken on some of the habits and colouring of the receiver. The Act may have introduced greater accountability and transparency but the emphasis in practice continues to be on preserving value through asset disposals and business rescue rather than on corporate rescue as such. Finally, the chapter makes the point that Chapter 11 has assumed much more of a market mantle in recent years and this appears to have muted calls for its complete overhaul. At the same time however, there is still much more of an emphasis in the US on keeping alive the existing corporate entity as a business vehicle. Chapter 11 contains features such as a specific mechanism for super-priority new financing that might usefully be replicated if corporate rescue as such is going to play the same role in the UK.

THE UK AND US – SIMILARITIES AND DIFFERENCES

In the Insolvency Codes of both the UK and the US there are possibilities for both the reorganisation/restructuring of ailing companies as well as for the

liquidation of such companies.[1] In the UK Insolvency Act there is provision for compulsory winding up by order of the court or for members' or creditors' voluntary liquidation. The Insolvency Act also contains an administration regime that is expressly designed for rescuing the business of the company as a going concern as well as for company voluntary arrangements which allow the company to modify the rights of creditors and shareholders if a prescribed percentage of the requisite group agrees. The US Bankruptcy Code contains Chapter 7, dealing with the liquidation of companies and also Chapter 11, where the statutory goal is the preparation and confirmation of a reorganisation plan.[2]

Both the UK and US are committed to the concept that the going-concern value of company assets is, or may be, greater than the value if these assets are liquidated on a piecemeal basis.[3] The two countries are also at one in the view that this going-concern premium may be captured and realised in different ways. A fundamental feature of the legislation in the two countries is the moratorium (as it is called in the UK) or automatic stay (as it is referred to in the US) on creditor enforcement actions during the currency of the administration or Chapter 11 period.[4] The details of the moratorium or stay may differ as between the two countries; whether, for example, criminal proceedings against the company are covered. Nevertheless, the basic features are the same in that creditors are precluded from taking enforcement action either against the company or against company assets during the currency of the rehabilitation

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[1] See B Carruthers and T Halliday *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998); Julian Franks and Walter Torous 'Lessons from a Comparison of US and UK Insolvency Codes' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) at p 450; John Armour; Brian R Cheffins and David A Skeel Jr 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 Vand L Rev 1699; JL Westbrook 'A Comparison of Bankruptcy Reorganisation in the US with the Administration Procedure in the UK' (1990) 6 Insolvency Law and Practice 86; R Broude 'How the Rescue Culture Came to the United States and the Myths that Surround Chapter 11' (2000) 16 Insolvency Law and Practice 194; Nathalie Martin 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367.

[2] *Bank of America v 203 North LaSalle Street Partnership* (1999) 526 US 434.

[3] For a somewhat sceptical perspective on the existence of a going-concern surplus see Douglas G Baird and Robert K Rasmussen 'The End of Bankruptcy' (2002) 55 Stan L Rev 751 at 758: 'We have a going-concern surplus (the thing the law of corporate reorganizations exists to preserve) only to the extent that there are assets that are worth more if located within an existing firm. If all the assets can be used as well elsewhere, the firm has no value as a going concern.'

[4] Section 362 of the US Bankruptcy Code and para 43 Schedule B1 Insolvency Act 1986.

period. The temporary prohibition may be relaxed however, with the consent of the court and, in the UK, the administrator may also give consent for enforcement action to be taken. The purpose of the stay/moratorium is to give the company a breathing space to allow survival prospects to be assessed.

The UK and US also have special provisions to overcome hold-outs by creditors. In other words, a prescribed number and/or percentage of creditors can bind dissentients to accepting a modification of their rights. If the specified numbers of creditors agree to a degree of debt forgiveness and/or conversion of debt into equity, then this agreement becomes binding on other creditors who did not individually sign up to the plan.[5]

Notwithstanding these obvious similarities, there are also clear differences in the legal framework governing corporate restructuring in the two countries and this, in turn, impacts on the practice. The clearest difference lies in who is in control of the company during the restructuring period. Chapter 11 is based on debtor-in-possession, which means that the existing corporate governance structure remains in place notwithstanding the formal commencement of the restructuring process.[6] Management displacement in favour of an outside administrator (or trustee as it is called in the US) is a possibility, but the statute confines the opportunities for this to occur to exceptional cases such as fraud.[7] The half-way house appointment of an examiner is also possible but this is equally rare. The contrast with the UK is quite stark. Mandatory displacement of management in favour of an external administrator is an intrinsic feature of administration. The Insolvency Act 2000 introduced, in effect, a debtor-in-possession type procedure for smaller companies; namely, the company voluntary arrangement with a moratorium. Management control is subject, however, to oversight by an insolvency practitioner in the shape of the nominee who performs a continuing monitoring function. The nominee is supposed to pull the plug on the process if s/he considers that the company has insufficient funds to continue trading during the restructuring or where there is no reasonable prospect of the arrangement with creditors being approved. In any event, these provisions of the Insolvency Act 2000 have hardly been used in practice. CVAs with a moratorium remain a rarity.[8]

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5 See s 1129 of the Bankruptcy Code on the conditions for getting a reorganisation plan approved.

6 On this general issue of the relative merits of debtor-in-possession versus practitioner in possession reorganisation regimes see D Hahn 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 JCLS 117; G McCormack 'Control and Corporate Rescue – An Anglo-American Evaluation' (2007) 56 ICLQ 515.

7 S 1104 of the US Bankruptcy Code.

8 See the statistical information available on the Insolvency Service website – www.insolvency.gov.uk/.

Chapter 5 tries to explain why there is such a superficially stark difference between the UK and US when it comes to control of the company during administration/Chapter 11. Various reasons were adduced and put through their paces. These reasons included different attitudes towards entrepreneurship and risk-taking; differences in the nature of the task to be performed by the administrator and debtor-in-possession; path dependency or the continued gravitational pull of historical circumstances and finally, the issue of concentration in debt markets and the extent to which it is possible for a single concentrated creditor to exert control over the process. This chapter concluded by suggesting that there is no single knock-out factor that explains the divergence but that the individual reasons, when viewed collectively, have a greater explanatory power that they lack when considered singly.

The chapter also made the point that the differences between the two countries can be exaggerated in that informal restructurings, based more or less on the continuation of existing governance structures, are more the norm for larger companies in the UK.[9] In the US, there is easy access to Chapter 11, with a company having more or less an unfettered right to invoke the procedure if it has a genuine reorganisational objective in mind. This may mean that, comparatively, completely informal restructurings are less common than in the UK, though it is often the case that some negotiations take place before and outside Chapter 11 (substantial negotiations in some cases) and then recourse is had to Chapter 11, possibly to overcome hold-outs by dissentient creditors.[10] Another important point to note is that there appears to be increasingly greater creditor control over the Chapter 11 process; in particular through provisions in debtor-in-possession financing agreements (DIP financing).[11] Creditors may condition their support for the company during the

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[9] See generally J Armour and S Deakin 'Norms in Private Bankruptcy: the "London Approach" to the Resolution of Financial Distress' [2001] Journal of Corporate Law Studies 21.

[10] See generally S Gilson 'Managing Default: Some Evidence on How Firms Choose between Workouts and Chapter 11' in J Bhandari and L Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) 308; S Gilson, K John and L Lang 'Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default' (1990) 27 Journal of Financial Economics 315; J Franks and W Torous 'A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations' (1994) 35 Journal of Financial Economics 349; B Betker 'The Administrative Costs of Debt Restructuring: Some Recent Evidence' (1997) 26 Financial Management 56; Harvey R Miller and Shai Y Waisman 'Is Chapter 11 Bankrupt' (2005) 47 Boston College Law Review 129.

[11] Douglas G Baird 'The New Face of Chapter 11' (2004) 12 American Bankruptcy Institute Law Review 69; Douglas G Baird and Robert K Rasmussen 'The End of Bankruptcy' (2002) 55 Stan L Rev 751; 'Chapter 11 at Twilight' (2003) 56 Stan

restructuring period on management changes being implemented. A Chief Restructuring Officer may be brought in at the instigation of creditors to oversee the reorganisation process. Empirical evidence suggests that in the majority of cases the identities of top management personnel will change at least once as a company goes through Chapter 11.[12] DIP financing may be a particularly lucrative line of business for lenders with more favourable (i.e. higher) interest rates on loans as well as an array of transactions fees that are often obscured from the casual observer.[13] Lenders may also use the opportunity that DIP financing provides to bootstrap earlier loans and gain an advantage over other creditors. So the overall message is that debtor-in-possession in Chapter 11 may be different from management displacement in UK administration, but solely to focus on this fact gives a misleading impression. The overall picture is much more subtle and nuanced.

The same message emerges in many other places in the book. The two procedures are quite different but the differences are quite different (if that makes sense) from what might originally appear.[14] Take, for instance, the oft-stated generalisation that UK law in this area is pro-creditor whereas US law is pro-debtor.

PRO-DEBTOR VERSUS PRO-CREDITOR – A MEANINGFUL COMPARISON?

US law is often said to be pro-debtor[15] because it allows for easy access to Chapter 11; it is based on debtor-in-possession; it contains the automatic stay;

L Rev 673 but for a slightly different perspective see L M LoPucki 'The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy' (2003) 56 Stan L Rev 645; Karen Gross 'Finding Some Trees but Missing the Forest' (2004) 12 American Bankruptcy Institute Law Review 203.

12 See SC Gilson 'Management Turnover and Financial Distress' (1989) 25 Journal of Financial Economics 241. See however, Ethan S Bernstein 'All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress' (2006) 11 Stanford Journal of Law, Business & Finance 298 who presents new evidence that 'filing for bankruptcy did not change the rate of CEO turnover when one controls for financial condition. This statistically significant finding indicates that the "shadow of bankruptcy" has lengthened, making bankruptcy law a central tenet of governance policy regardless of whether a Chapter 11 petition is ever filed.'

13 See James J White 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139.

14 This calls to mind the comment often attributed to former US Secretary of Defense Donald Rumsfeld about 'unknown unknowns'.

15 See generally R La Porta, F Lopez-De-Silanes, A Shleifer and R Vishny 'Law and Finance' (1998) 106 Journal of Political Economy 1113.

existing security interests can be 'primed' or trumped by a DIP financier and finally creditors, including secured creditors, can be 'crammed down', i.e. forced to accept a reorganisation plan against their wishes. Moreover, the company can assume or reject so-called 'executory' contracts which means that ipso facto clauses whereby another contracting party purports to terminate a contract on the company's entry into Chapter 11 are generally of no effect.[16] All this is true but two comments are appropriate. Firstly, in certain respects, like the automatic stay, Chapter 11 is not fundamentally different from UK administration. Secondly, what does it mean to say that Chapter 11 is 'pro-debtor'? The debtor in this case is a company – an artificial entity that is purely the creature of the law. In the broadest sense, it has no life of its own. One has to disentangle the community of interests that make up the company. For a start, one might take five separate or independent interest groups – shareholders, creditors, directors or management, employees and finally, and more amorphously, the environment. Shareholders obviously benefit if insolvent entities are given the opportunity to restructure and continue their business operations. In insolvency, shareholders are out of the money. Their investment in the company is financially worthless if the company is liquidated. Their interest is only worth something to the extent that they can obstruct and delay efforts by others who have something still of value to lose. If the company is allowed to remain alive, then shareholders may benefit financially in that they have the opportunity of coming back into the money. To the extent that the law allows insolvent ailing companies to remain alive, despite creditor objections, one might say that the law is 'pro-shareholder'.

Creditors are part of the community of interests that sustain the company. It is often been stated judicially, on both sides of the Atlantic, that the primary focus of directors, in carrying out their duties on behalf of the company, should switch from maximising long-term shareholder value to maximising creditor value or, at least, move in this direction.[17] But in common characterisations of corporate reorganisation law, 'pro-creditor' is often, indeed normally, juxtaposed with 'pro-debtor'. The contrast does not really make sense if creditor concerns are regarded as part of what makes up the debtor.

It probably makes sense to say that a corporate restructuring law is 'pro-manager' or 'pro-director' if it allows the existing board of directors, and the management and governance structure as a whole, to remain as it were

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16 See s 365 of the Bankruptcy Code.

17 See A Keay *Company Directors' Responsibilities to Creditors* (London, Routledge-Cavendish, 2007); P Davies 'Directors' Creditor – Regarding Duties to in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 European Business Organisation Law Review 301; B Adler 'A Re-Examination of Near-Bankruptcy Investment Incentives' (1995) 62 U Chi Law Review 575.

notwithstanding the fact that the company is in a restructuring process. Managers do not lose their positions automatically. Their reputation may have taken a hit to a greater or lesser extent, depending on the causes of the company's financial difficulties, but they have a chance to turn things around. Managers have a greater chance of seeing their entrepreneurial, or risk-taking, strategies paying off despite the fact that the company may have experienced some temporary dislocations or financial difficulties.[18] More generally, one might say that Insolvency or Bankruptcy Law is 'pro-manager' or at least 'pro-entrepreneurship' if it allows a company to ride out some short-term economic squalls instead of being pressured into liquidation by a few anxious creditors.

UK Company Law says that the interests of a company include the interests of its employees as well as the interests of its shareholders, though there is no general statutory statement to equivalent effect in the US. One might say that the law is 'pro-employee' if employees' interests are factored into the restructuring decision, for example, if they are consulted on major decisions affecting the company's future and the company cannot renege on existing commitments to employees in cost-cutting measures, at least without going through some major consultation procedure. Another issue to consider is whether terms and conditions and employment are protected in the course of any business transfers that might occur as part and parcel of corporate restructuring. In all this, US law does not score very highly.[19] Collective bargaining agreements freely negotiated with unions can be abrogated, or modified, during Chapter 11, though there is a prescribed consultation process that has to be gone through.[20] There is no protection in Chapter 11 of existing terms and conditions of employment during business transfers. In the enumerated respects, UK law is much more friendly towards employees. A supporter of the US position might contend that UK law makes it much more difficult to achieve business rescue.[21] This is a version of the 'rising tide raises all boats' philosophy. Business works best, and brings about greater increases in employment and prosperity when management are not fettered by labour law constraints. Chapter 7 endeavoured to consider these competing ideologies in more detail. Suffice it to say here that if 'pro-debtor' is regarded as a synonym for 'pro-employee' then US law is not 'pro-debtor'.

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[18] See E Warren 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 Michigan Law Review 336 at 358.

[19] See D Skeel, Jr 'Employees, Pensions, and Governance in Chapter 11' (2004) 82 Wash U LQ 1469 at 1472.

[20] S 1113 of the US Bankruptcy Code. See also s 1114 on retiree benefits.

[21] See generally J Armour and S Deakin 'Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive' (2003) 22 International Review of Law and Economics 443.

As regards the environment, Chapter 11 is supposed, broadly speaking, to be neutral. It does not really differ in this respect from UK administration. A company in Chapter 11 is supposed to comply with the provisions of the general law. It cannot violate environmental regulations in the same way that it cannot sell cocaine.[22] The automatic stay does not bar criminal proceedings from being brought against the company nor does it bar regulatory action from being taken by environmental protection agencies. The position is slightly different in the UK where the moratorium is sufficiently broad to encompass the institution of criminal proceedings against the company and probably also administrative actions of the enforcement variety.[23] Nevertheless, it appears that the courts, almost invariably, will allow both criminal proceedings and regulatory proceedings to go ahead. Therefore, there does not appear to be a great deal of difference between Chapter 11 and UK administration when it comes to environmental protection.

From this summary, one might fairly conclude that Chapter 11, to a certain extent at least, is 'pro-manager' and also 'pro-shareholder', though even here one has to impose substantial qualifications. For example, Chapter 11 reorganisation plans must conform to the absolute priority rule, i.e a senior class of claimants must be paid in full before a class of junior claimants receives anything. All creditors are superior in the hierarchical pecking order to shareholders, which means that shareholders should not receive any stake in the reorganised company unless creditor claims are met in full. Consensual plans, i.e. plans where all classes sign up to the agreement, normally will leave something on the table for equity. In other words, shareholders, whatever the theoretical position, are given some stake in the restructured business.[24] If a class, or classes, of creditors object to this, then their objections can be overcome (crammed down) if the dissenting class will receive at least as much under the plan as it would do in a liquidation and provided that the shareholders are putting something on the table in return for their stake. This is the 'new value' exception to the absolute priority rule which US courts have tentatively recognised.[25]

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22 See s 959 of the Bankruptcy Code.

23 *Re Rhondda Waste Disposal Ltd* [2001] Ch 57 but cf *Re Railtrack plc* [2002] 1 WLR 3002. See generally David Milman 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue' [2004] Conv 89.

24 See generally L LoPucki and W Whitford 'Bargaining over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies' (1990) 139 U Pennsylvania Law Review 125. A more recent empirical study finds fewer violations of the absolute priority rule mandating payment of creditors in full before shareholders receive anything in the new Chapter 11 world of increased creditor control – see Arturo Bris, Ivo Welch and Ning Zhu 'The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization' (2006) 61 Journal of Finance 1253 at 1289.

25 *Bank of America v 203 North LaSalle Street Partnership* (1999) 526 US 434.

One might say that UK administration is less 'pro-manager' than Chapter 11 in that it involves automatic management displacement but, so far as being less 'pro-shareholder' is concerned, the picture is not as clear-cut. Administration can be a gateway towards reorganisation rather than liquidation and, in that respect, offers shareholders the opportunity of earning a return on their investment. Administration, or rather CVAs, in formal terms do not have anything like the new-value exception to the priority principle which states that creditors must be repaid before shareholders. Nevertheless, it appears to be normal practice for existing shareholders to keep a stake in a restructured company and, depending on the size of the stake, the existing shareholders may put up some new capital. As explained in Chapter 8, CVAs are much less circumscribed by legalistic requirements than Chapter 11 plans of reorganisation. There is a great deal of flexibility about what may, or may not, be in a CVA, apart from the deference shown to secured creditors whose ability to enforce collateral cannot be adversely affected without their consent.

THE POSITION OF SECURED CREDITORS IN RESTRUCTURING

On the surface, there is much greater respect shown in administration for the rights of secured creditors than in administration. The absence of 'cramdown' in administration and CVAs has already been noted. This means that the wishes of secured creditors must be accommodated in whatever 'rescue' plan is envisaged as resulting from administration, or else they must be left out of the equation entirely, with them being paid off or left to enforce their collateral. Generally, the secured creditor has no veto on a company going into administration but has an effective veto on the identity of the person appointed as administrator.[26] When the Enterprise Act revamped the administration procedure in 2002 there was a widespread assumption that the most common route into administration would entail out-of-court appointment by the general secured creditor, i.e. the creditor with a floating charge or other security that covered the whole, or substantially the whole, of a company's assets. The reality has been somewhat different, with most appointments in fact being made by the company itself though the company, before making the appointment, has to give prior notice to the floating charge holder who can step in and make its own appointment.[27] The legislation is structured in such a way that the

[26] See generally paras 14, 22 and 26 Schedule B1 Insolvency Act 1986.

[27] See the 'Report on Insolvency Outcomes' – a paper presented to the Insolvency Service by Dr Sandra Frisby. The paper is available on the Insolvency

company is likely to negotiate with the lender about who might be a suitable candidate to take on the reins of administration. If the person proposed is not acceptable to the lender, then the lender ultimately can make its own appointment. For public relations and reputational reasons, however, it seems better if the lender is not seen to drive the administration process. Therefore, nominally, the appointment is made by the company but of a person who is acceptable to the lender.

Formally there are differences with the position in the US where the Chapter 11 petition, in the vast majority of instances, is initiated by the company itself. The debtor-in-possession notion constitutes another difference, but the influence that lenders can exert through DIP financing agreements signifies a degree of creditor control over the company during the Chapter 11 period.

The fact existing security interests can be trumped by the DIP lender might be said to be another pointer towards the fact that Chapter 11 is less creditor friendly, or at least secured-creditor friendly, than UK administration. But again, the statement requires qualification. Before existing security interests can be relegated under Chapter 11 in favour of the newcomer, the court must find that the existing security interest holder is adequately protected.[28] Effectively, this means that the court must be satisfied that there is sufficient value in the collateral to support both the new and the existing lenders. This is exceptional.[29] Far more common is where the new lending is done with the consent of the existing lender. Indeed the new lender may be an existing lender. The equivalent of DIP financing does not appear to have developed in the UK, or at least not on anything like the same scale.[30] Arguably however, the legislative framework governing administration is sufficiently flexible, if Canadian experience is anything to go by,[31] to permit its use on a modest scale. The administrator's remuneration and expenses, as well as liabilities on contracts made on behalf of the company by the administrator, are payable out of assets secured by a floating charge, in priority to the floating charge holder.

Service website – www.insolvency.gov.uk and for a summary of the paper see S Frisby 'Not Quite Warp Factor 2 Yet?' at 327.

[28] See generally George G Triantis 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 Vand L Rev 901.

[29] See generally on the benefits of DIP financing S Dahiya, K John, M Puri and G Ramirez 'Debtor-in-possession Financing and Bankruptcy Resolution: Empirical Evidence' (2003) 69 Journal of Financial Economics 259.

[30] See G McCormack 'Super-Priority new financing and Corporate Rescue' [2007] JBL 701.

[31] See Janis Sarra 'Debtor in possession (DIP) financing: The jurisdiction of courts to grant super-priority financing' (2003) 21 Dalhousie Law Journal 337; Michael B Rotsztain 'Debtor-in-Possession Financing: Current Law and a Preferred Approach' (2000) 33 Can Bus LJ 283 at 284.

They are not payable though, in the same way out of assets subject to fixed-charge security. The concept of an administrator's liability on contracts may be broad enough to catch repayment obligations under financing agreements entered into on behalf of the company.[32] In the debates on the Enterprise Act, however, the government resisted the opportunity of including provisions that would mirror more closely the DIP financing regime of Chapter 11.[33] DIP financing was seen as equalling super-priority and the trumping of existing security. It did not want a situation that would effectively guarantee a return to a new lender, irrespective of the economic merits of a financing proposal. But there is more to DIP financing than super-priority. It might be argued that the merits of a specific legislative regime, dedicated to the financing of companies in financial difficulties, is that it may open up the credit market more and encourage other players to come on board. It stimulates more of an emphasis on corporate rescue as distinct from creditor wealth maximisation through asset sales and business disposals.

THE ENTERPRISE ACT AND REMODELLED ADMINISTRATIONS

When the Enterprise Act was enacted, the emphasis, very squarely and consciously, was on promoting transparency, accountability and collectivity – but to what end?[34] Business rescue and corporate rescue were talked about.[35] Rescuing the business of the company as a going concern is what the legislation refers to, rather than the preservation of empty corporate shells. That is the easy part, but there seems also to be a sense pervading the parliamentary debates that too much emphasis had been placed in the past on asset sales through the receivership route[36] – on business rescue through disposals of profitable parts of an undertaking, as it were. The government seemed determined to push an unwilling insolvency practitioner lobby down the avenue of 'corporate' rescue, at least as an alternative to asset sales. The objective was to

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32 Para 99 Schedule B1 Insolvency Act 1986.

33 See House of Lords parliamentary debates for 29 July 2002 and the discussion in Stephen Davies ed *Insolvency and the Enterprise Act 2002* at pp 20–26.

34 See generally D Milman 'Reforming Corporate Rescue Mechanisms' in J De Lacy ed *The Reform of United Kingdom Company Law* (London, Cavendish, 2002) at p 415.

35 See DTI/HM Treasury report 'A Review of Company Rescue and Business Reconstruction Mechanisms' (London, DTI, 2000) and the White Paper *Insolvency – a Second Chance* (London, HMSO, 2001).

36 But for a defence of receivership see J Armour and S Frisby 'Rethinking Receivership' (2001) 21 OJLS 73.

borrow what were perceived to be some of the best features of Chapter 11, such as the company staying alive as an economic activity but, at the same time, junking its undesirable features such as its delay and the sheer legalistic and lawyer-dominated nature of the process. Whatever the tone of the parliamentary debates, the law on the statue books plays to a somewhat different melody. There is a statutory statement of the objectives of administration, and while rescuing the business of the company as a going concern comes at the top of the statutory list, this objective cannot be pursued if some other result is likely to achieve a better result for company creditors.[37] The person who decides what is likely to produce the best result for company creditors is the administrator. Remember that the administrator, if not appointed by the main secured creditor, is going to be a person acceptable to that creditor and in tune with the creditor's way of thinking. The scope for judicial review of the administrator's judgement is very limited in that the statute uses the criterion of what the administrator 'thinks' and not some more objectively reviewable criterion.

After the passage of the Enterprise Act, there are some who predicted a sea change in attitude and practice; that administrators would put a lot of emphasis on corporate rescue and that they would go about their task in a completely different way than administrative receivers of yore.[38] Others might argue that this prospect was always an unrealistic one given, in particular, the wording of the legislation and the mindset of insolvency practitioners.[39] It appears that the latter forecast has come to pass. There is increased accountability and greater transparency and collectivity in the new administration regime, but insolvency practitioners who act as administrators do not seem to approach their task in a fundamentally different way from insolvency practitioners acting as administrative receivers. It seems that there are greater gross creditor realisations in administrations, compared with administrative receiverships, but this is balanced out by the increased cost of the procedure, which means that the net overall effect, in terms of returns to creditors, is roughly the same.[40] Of course,

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37 Schedule B1 Insolvency Act 1986 para 3.

38 J Armour and R Mokal 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' [2005] LMCLQ 28; R Mokal and J Armour 'The New UK Rescue Procedure – The Administrator's Duty to Act Rationally' (2004) I International Corporate Rescue 136.

39 S Frisby 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 MLR 247 at 262; Vanessa Finch 'Re-Invigorating Corporate Rescue' [2003] JBL527; 'Control and Co-ordination in Corporate Rescue' [2005] Legal Studies 374; Ian F Fletcher 'UK Corporate Rescue' (2004) 5 European Business Organization Law Review 119.

40 See 'The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings' a report to the Insolvency Service by John Armour,

supporters of the Enterprise Act might say that increased transparency, accountability and collectivity have also to be brought into the reckoning and these are not easily measurable as part of an economic calculus.

Another empirical finding is that 'corporate rescue' as such is achieved in only a very small minority of cases.[41] In the vast majority of cases, value is obtained through business transfers and asset sales, rather than the existing corporate vehicle being turned around and continuing to function on that basis. Again, this finding does not come as a shock to many observers who view informal restructuring rather than statutory administration as being more appropriate for larger companies because administration may lead to an immediate loss of reputation and custom. On the other hand, the coming of the Pension Protection Fund for companies in formal insolvency proceedings with pension deficits may have the effect of pushing such companies into administration instead of attempting to restructure informally as heretofore.[42]

The empirical evidence may disappoint the architects of the Enterprise Act in some of their more ambitious aspirations. It is hardly surprising, however, given the wording of the legislation. The changes of substance are not negligible but, at the same time, they can be spun into something that they are not. To some, this assessment will be a disappointment in that the promise of radical transformation has not been fulfilled. But to others, it may be unsurprising, and indeed reassuring, that beneath the 'New Labour' style rhetoric of the Enterprise Act lurks time-honoured Conservative concepts. Old-style administrative receivership has re-emerged in a new legislative guise wearing more modern, and up-to-date, clothes.

Another empirical finding is evidence of liquidation substitution, in that administration is used in the case of some companies that formerly would have

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Aubrey Hsu and Adrian Walters (March 2007) summarised in 'Recovery' (Autumn 2007) at p 39. But for a somewhat different conclusion see the interim report by Sandra Frisby to the Insolvency Service 'Returns to Creditors from Pre- and Post- Enterprise Act Insolvency Procedures' (July 2007). Dr Frisby says at p 34: 'it would appear that the policy makers were correct in their estimation that administration, as a procedure, is likely to produce better outcomes, in terms of returns, for all creditors.'

[41] See the 'Report on Insolvency Outcomes' – a paper presented to the Insolvency Service by Dr Sandra Frisby. The paper is available on the Insolvency Service website – www.insolvency.gov.uk and for a summary of the paper see S Frisby 'Not Quite Warp Factor 2 Yet?' at 327.

[42] See A Tilley 'European Restructuring: Clarifying Trans-Atlantic Misconceptions' [2005] Journal of Private Equity 99 at 102: 'New pensions legislation could be seen to be encouraging a move into UK administration to deflect under funding liabilities to a proposed government-legislated but industry-funded contingency fund. Legacy issues are not just a preserve of US airlines, it seems.'

gone into creditors' voluntary liquidation.[43] Administration is used in such a case because of a possible saving in time and expense and because the assets of the company may be more advantageously realised than in a liquidation.[44] This appears to be within the spirit of the legislation but what is less justifiable is where directors opt for administration rather than liquidation on the supposition that their conduct would be less subject to scrutiny by an administrator rather than a liquidator.[45]

WB Yeats in his poem 'Easter 1916' about the 1916 Easter Rising in Ireland, wrote that 'All changed, changed utterly: a terrible beauty is born'. The same thing cannot be said about the Enterprise Act in the UK and changes to corporate restructuring procedures. The changes have largely been on the surface, and the fundamentals in the world of practice do not appear to have changed all that much, though there have been incremental adjustments. The adjustments to the UK administration regime, one might say, have been in the direction of the US Chapter 11 but the world of Chapter 11 practice has turned, perhaps more significantly, in a more market-oriented UK administration-style direction.

MORE OF A MARKET FOCUS TO CHAPTER 11

When Chapter 11 was first promulgated in 1978, there was much talk about corporate rehabilitation, the preservation of jobs and the interests of parties other than the company and secured creditors. Community interests were given broad consideration.[46] The focus has now changed. Creditor interests

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[43] See 'Study of Administration Cases' – a report to the Insolvency Service by Alan Katz and Michael Mumford (October 2006) available at www.insolvency.gov.uk and for a summary see (2007) 20 Insolvency Intelligence 97.

[44] It should be noted that empirical evidence from the US suggests that Chapter 7 liquidations offer little advantages over Chapter 11 reorganisations. They take almost as long to resolve, require similar fees and 'in the end provide creditors with lower recovery rates – often zero – than a comparable Chapter 11 procedure' – see Arturo Bris et al 'The Costs of Bankruptcy: Chapter 7 Liquidations vs Chapter 11 Reorganizations' (2006) 61 Journal of Finance 1253 at 1301.

[45] See generally A Keay 'What Future for Liquidation in Lights of the Enterprise Act Reforms' [2004] JBL 153 at 158 and see also A Keay 'The New Era for Administrations: Pointers from Down Under' (2005) 18 Insolvency Intelligence 1.

[46] For a discussion see, for example, Karen Gross *Failure and Forgiveness: Rebalancing the Bankruptcy System* (New Haven, Yale University Press, 1997); Elisabeth Warren 'Bankruptcy Policy' (1987) 54 U Chicago L Rev 775; 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 Mich L Rev 336. See also Donald R Korobkin 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71 Texas Law Review 541; Axel Flessner 'Philosophies of Business Bankruptcy

have come to the fore more.[47] This is partly through provisions in DIP financing agreements. Creditors may also devise key employee-retention programmes (KERPS), promising those employees whose retention by the company is considered crucial, bonuses and other inducements if the reorganisation is completed quickly.[48] This leads to a momentum in favour of asset sales and quicker cases. Under s 1123, it is permissible for the company in Chapter 11 to prepare a liquidating plan as a reorganising plan. This is one vehicle for an asset sale. But another vehicle is s 363 which permits disposals outside the ordinary course of business with court approval. The courts have sanctioned the disposal of substantial parts of the company's undertaking using this provision.[49] Moreover, the dichotomy between liquidation and reorganisation no longer appears so obvious.[50] There may have been partly liquidation or realisation of assets and partly reorganisation. What emerges at the end of the process is a smaller, slimmed-down, company with only part of its original undertaking intact.[51]

In the 1980s, and early 1990s, there were many calls for the reform of Chapter 11, or its complete replacement.[52] One set of proposals involved the

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Law: An International Overview' in Jacob Ziegel ed *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford, Clarendon Press, 1994) 19; Lynn LoPucki 'A Team Production Theory of Bankruptcy Reorganization' (2004) 57 Vand L Rev 741.

47 See David A Skeel Jr 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917; 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) 25 Cardozo Law Review 101; Jay Lawrence Westbrook 'The Control of Wealth in Bankruptcy' (2004) 82 Texas Law Review 795.

48 George W Kuney 'Hijacking Chapter 11' (2004) 21 Bankruptcy Developments Journal 19.

49 For a critical assessment see GW Kuney 'Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process' (2002) 76 Am Bankr LJ 235.

50 On Chapter 11 outcomes see the bankruptcy research database compiled by Professor Lynn LoPucki available at http://lopucki.law.ucla.edu/. See also Arturo Bris et al 'The Costs of Bankruptcy' 1253.

51 See Douglas Baird, Arturo Bris and Ning Zhu 'The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study' available at www.arturobris.com text accompanying footnote 4 'In recent years, more than eighty percent of the Chapter 11s of large publicly traded businesses followed one of two patterns. The institutional lenders of a financially distressed large business reach a deal with each other on how to restructure an insolvent business and use the bankruptcy process to wipe out equity-holders and quell whatever dissent that might exist among their ranks. Alternatively (or sometimes together), the institutional lenders file a Chapter 11 in order to effect a sale of the assets.' But for small businesses the reality is different.

52 See famously M Bradley and M Rosenzweig 'The Untenable Case for Chapter 11' (1992) 101 Yale Law Journal 1043. But see also E Warren 'The Untenable Case for Repeal of Chapter 11' (1992) 102 Yale Law Journal 437; DR Korobkin 'The

introduction of a mandatory auction procedure for company assets that would come into effect, perhaps, if the company remained in Chapter 11 for a certain period of time.[53] Another set of proposals involved a compulsory debt/equity swap whereby the company's equity would evaporate on the occurrence of certain events. Senior creditors would become the new owners of the company but junior creditors, in order of hierarchy, would be given an option to buy out the senior creditors. If junior creditors did not want to exercise the option then shareholders could then do so and effectively buy back the company. A final set of proposals suggested the introduction of a special regime for small business bankruptcies that would mean simplified procedures and speedier throughput of cases. For instance, empirical research by Professors Elisabeth Warren and Jay Lawrence Westbrook has suggested that on the standard criteria, small business cases made up more than 80 per cent of Chapter 11 filings,[54] though such cases are not nearly so significant in terms of financial importance.[55] In many of these cases, an expeditious liquidation from the outset might have been the best way forward.

Apart from a new procedure for small business bankruptcies, none of the proposed reforms has come to legislative fruition though the market has moved in the direction of the reformers.[56] This is particularly evident when it comes to so-called 'auctions'. Creditor influence and, in particular, creditor control over the continuing financing tap has meant that cases are likely to be

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Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig' (1993) 78 Iowa L Rev 669; L LoPucki 'Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig' (1992) 91 Michigan Law Review 79.

[53] See generally Mark J Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 Columbia Law Review 527; DG Baird, 'The Uneasy Case for Corporate Reorganizations' (1986) 15 Journal of Legal Studies 127 and DG Baird 'Revisiting Auctions in Chapter 11' (1993) 36 Journal of Law and Economics 632; Barry E Adler 'Financial and Political Theories of American Corporate Bankruptcy' (1992) 45 Stan L Rev 311; DA Skeel 'Markets, Courts, and the Brave New World of Bankruptcy Theory' [1993] Wisconsin.Law Review 465.

[54] E Warren and JL Westbrook 'Financial Characteristics of Businesses in Bankruptcy' (1999) 73 Am. Bankr LJ 499 at 543–44 and footnotes 80–82.

[55] It seems that the total assets or liabilities of companies in this group are no more than 5 per cent of those of all the companies in Chapter 11. See also Douglas G Baird and Edward R Morrison 'Serial Entrepreneurs and Small Business Bankruptcies' (2005) 105 Columbia Law Review 2310 and especially at 2317 'Perhaps only ten to fifteen percent of all failing businesses ever file a bankruptcy petition. An even smaller fraction use Chapter 11. For the typical corporations that enter Chapter 11, the benefits and costs are both modest.' For information on the number of Chapter 11 filings (generally running at about 10,000 a year) and other bankruptcy filings see www.uscourts.gov.

[56] See generally Stephen J Lubben 'Some Realism about Reorganization: Explaining the Failure of Chapter 11 Theory' (2001) 106 Dickinson Law Review 267.

turned around faster than before, with more liquidation or realisation of assets rather than a long-drawn-out process of formulating a reorganisation plan and gaining acceptances. 'Pre-packaged' bankruptcy cases have also gained a greater prominence.[57] Features of the proposed options regime are less evident in the new reality of Chapter 11 practice but one might foresee a world in which investment banks, advising on capital structures, market a form of 'chameleon equity' to entrepreneurs and investors. 'Chameleon equity' would have some features of debt and some features of equity. The possibilities are almost endless, but basically the debt or bonds would convert into equity in certain circumstances. Legally, the question is whether a conversion mechanism would be recognised in the company's bankruptcy and, economically, the issue is how to put a proper valuation on these complex financial instruments.

On the small business bankruptcy arena, there has been legislative movement originally on an optional basis in 1994 but with the new procedures becoming compulsory as a result of the Bankruptcy Abuse Prevention and Consumer Protection Act 2005.[58] The provisions apply to all small business debtors, subject to certain monetary limits. They aim to speed up procedures by imposing tighter deadlines for the confirmation of a reorganisation plan, failing which the case will be converted into Chapter 7 liquidation. There are continuing obligations on the debtor to provide financial information that will enable the US Trustee to assess the likelihood of plan confirmation. The US Trustee is required to perform an oversight function; to weed out cases early where there is no genuine reorganisational prospect and to move for the dismissal of cases, or their conversion into Chapter 7 liquidation, where reorganisation prospects have dimmed. Finally, to reduce costs, the debtor can make use of standard form disclosure statements and the bankruptcy court can combine hearings on the adequacy of the disclosure statement to affected parties with a hearing on whether to authorise confirmation of the plan. All in all, the objective of the reforms is to reduce costs, simplify procedures and speed up cases. But the US Congress has shied away from introducing a wholly new and separate reorganisation chapter devoted to small businesses.

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[57] On the advantages of pre-packs see J McConnell and H Servaes 'The Economics of Pre-packaged Bankruptcy' in JS Bhandari and LA Weiss eds *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge, Cambridge University Press, 1996) p 323; National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 590. Pre-packaged bankruptcies are also more likely to have financing arrangements in place. On this see generally S Dahiya et al 'Debtor-in-possession Financing and Bankruptcy Resolution: Empirical Evidence' (2003) 69 Journal of Financial Economics 259 at 269–270 and see also S Chatterjee et al 'Debtor-in-possession Financing' (2004) 28 Journal of Business and Finance 3097.

[58] On which see James B Haines and Philip J Hendel 'No Easy Answers: Small Business Bankruptcies after BAPCPA' (2005) 47 Boston College Law Review 71 at 73.

Until 1978 there were two separate reorganisation chapters in the Bankruptcy Code. There was a feeling that the duplication had led to a gaming of the system and that resources had been misapplied into trying to assign cases to the appropriate chapter.[59]

Chapter 11 has changed but some of the criticisms that UK observers may have remain. [60] Cases can take a long time.[61] Apart from the small business provisions, there are no automatic cut-off points for ending a case or converting it into a liquidation. The procedures seem legalistic and cumbersome, in particular the confirmation of a reorganisation plan. The provisions and procedure also seem rather lawyer driven. All the parties involved in the process, including creditors' committees, may engage counsel whose fees and expenses may be taken out of the bankruptcy estate. Also the ease of access to Chapter 11 may crowd out informal restructurings which are often the best means of preserving value in an ailing enterprise. That is not to say that UK law may not borrow from Chapter 11 in greater respects. New financing mechanisms, stripped of their undesirable features such as bootstrapping by earlier creditors, may be one such example. Even today, the prominence placed on corporate

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[59] See generally David A Skeel Jr 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325; David A Skeel Jr *Debt's Dominion*; John Armour et al 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' at 1699.

[60] Empirical studies about the direct costs of Chapter 11 proceedings have produced somewhat different results or at least results that are open to varying interpretations. Stephen J Lubben suggests that the direct costs of reorganising large public companies in Chapter 11 consists of 3 per cent of the value of company assets – see 'The Direct Costs of Corporate Reorganization' (2000) 74 American Bankruptcy Law Journal 509. See also Stephen P Ferris and Robert M Lawless 'The Expenses of Financial Distress: The Direct Costs of Chapter 11' (2000) 61 U Pittsburgh L Rev 629. A more recent study suggests that the median Chapter 11 case takes up around 8 per cent of the pre-bankruptcy value of the company in legal fees – see Arturo Bris et al 'The Costs of Bankruptcy' at 1253. They also suggest (at p 1254) that 'bankruptcy costs are measurement sensitive. For example, the conclusions one draws depend on whether one uses at-bankruptcy declared values or end-of-bankruptcy declared values, whether one believes the value declarations filed by management, and whether one reports means or medians.'

[61] See LA Bebchuk 'A New Approach to Corporate Reorganizations' (1988) 101 Harvard Law Review 775 at 780: 'Management will use delay to take unjustified risks with the firm's assets in a feeble hope of returning the firm to solvency and providing equity holders with residual value. . . . Because high-priority creditors of an insolvent firm may have more to lose than low-priority creditors, the low-priority creditors may be able to force concessions from high-priority creditors by threatening to prolong bankruptcy through litigation over their relative entitlements' and see also Barry E Adler 'Financial and Political Theories of American Corporate Bankruptcy' (1992) 45 Stan L Rev 311 at 316. See now on the duration of Chapter 11s Arturo Bris et al at 1253.

rescue in Chapter 11 serves as an important corrective to the mindset of insolvency practitioners in the UK that the going-concern premium is invariably best captured through an asset sale.

AN END NOTE

This book has challenged the traditional thesis that UK law in the sphere of corporate bankruptcy is pro-creditor whereas US law is pro-debtor. It suggests that this characterisation is something of an over-simplification. Creditors have a greater role in the initiation of the formal procedure in the UK than they do in the US, but creditors in the US may have a decisive role in the outcome of the process and the terms of any restructuring through their willingness to grant, or withhold, new financing and the terms on which such financing is granted.

The book also points to the conclusion that there is evidence of convergence between the UK and US systems in practice. The Enterprise Act has made some modest moves down the Chapter 11 path but Chapter 11 practice has itself moved in a more market-led direction. The rescue system in the UK is market-oriented with the process centring on saving businesses rather than corporate shells. The UK 'rescue culture' embraces the sale of businesses as operational going-concerns or alternatively, the piecemeal realisation of assets where that improves the position of creditors. The company voluntary arrangement (CVA) is, however, a bargaining procedure and can be used to negotiate a rehabilitation plan between creditors and shareholders but, in practice, most CVAs are concluded in association with an administration. CVAs, in fact, may not involve reorganisation of the company, instead focusing on going-concern sales or disposal of particular assets. Practitioners have also become adept in using administration and CVAs as more efficient liquidation tools rather than rehabilitation regimes.

In Chapter 11, the process is initiated by the company and the emphasis has then traditionally been on classes of creditors and shareholders working together under the supervision of the bankruptcy court to come up with a restructuring plan. The plan comes before the court for its judgment that the required procedural safeguards for minority interests have been satisfied and that the plan itself is feasible. In other words, that the company is likely to be able to perform the promises it made in the plan. It is envisaged that the company will continue as a business entity after court confirmation of the plan. But the focus in Chapter 11 practice has shifted. Often Chapter 11 is now used as a convenient mechanism for the division up and sale of company assets. Companies may also come under pressure to sell off assets to meet funding needs if restructuring proposals agreed with creditors are not carried

through. Lenders may turn the company's financing tap on or off, depending on the speed at which restructuring is implemented. Senior managers in the company may also be offered financial inducements if they manage to complete the company's journey through Chapter 11 quickly. There has been increased recourse to pre-packaged cases where the main contours of the proposed disposition of the case have been mapped out in advance of the Chapter 11 filing.

The third general conclusion is that, despite the changes in practice and the increased market flavour to Chapter 11, certain crucial differences remain between Chapter 11 and equivalent UK procedures. Chapter 11 is centred on ensuring the survival of the existing business entity and even now, in an era of greater creditor influence, the corporate rescue outcome is much more likely than in the UK. Contrary to the claim that corporate reorganisations have all but disappeared,[62] there is evidence that many large companies do in fact use Chapter 11 as a forum for reorganisation. One empirical study of companies that enter Chapter 11 as a going concern during the 1997–2004 period found that 36.7 per cent reorganise, 42.2 per cent were acquired in whole or in part and 21.1 per cent were liquidated.[63] Broadly comparable studies of UK administrations suggest that the 'corporate rescue' outcome is achieved in very few cases. Perhaps driving the corporate rescue result, Chapter 11 contains a special funding mechanism for companies in financial difficulties and, more fundamentally, it is also based on the notion of 'debtor-in-possession'.

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[62] See Douglas G Baird and Robert K Rasmussen 'The End of Bankruptcy' (2002) 55 Stanford Law Review 751.

[63] See Greg McGlaun 'Lender Control in Chapter 11: Empirical Evidence' (February 2007) available at http://ssrn.com/abstract=961365. See also on Chapter 11 outcomes the bankruptcy research database compiled by Professor Lynn LoPucki available at http://lopucki.law.ucla.edu/.

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