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# Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century

Sarah Paterson \*

**Abstract:** Thomas Jackson famously described the role of all bankruptcy law as reducing the incentive for individual enforcement against the assets of a distressed company. Although scholars have debated other aspects of Jackson's thesis, most have continued to identify with this as the central tenet of bankruptcy law. This paper proposes a new taxonomy: the law of corporate distress comprised of insolvency law and restructuring law. It argues that Thomas Jackson's description remains apt for part of that taxonomy but draws a distinction between the constituent parts. It reframes the unifying aim of the law of corporate distress as the facilitation of the reallocation of resource in the economy to best use and draws a distinction between insolvency law's role in reducing the incentive for individual enforcement and restructuring law's role in providing a deadlock resolution procedure. Adopting a comparative Anglo-American approach it examines the implications of this distinction for insolvency law and restructuring law in the twenty-first century.

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## INTRODUCTION

Thomas Jackson famously described the role of all bankruptcy law in terms of the hypothetical bargain which creditors would reach if they were negotiating the position on insolvency *ex ante* behind a Rawlsian veil of ignorance. In this situation, creditors would face a classic Prisoner's Dilemma. Each creditor would have an individual incentive to race to collect assets from the insolvent debtor but this would result in the dismemberment of the firm and therefore produce a worse overall return for creditors as a whole. As creditors could not know whether they would win this race or not, in the hypothetical bargain they would prefer a bankruptcy law which imposed a stay on creditor action thus keeping the firm together and maximising aggregate return (creditor wealth maximisation), which respected pre-insolvency contractual rights and which divided proceeds of sale *pari passu* amongst unsecured creditors. Bankruptcy law has legitimacy in Jackson's contractarian analysis because it reflects pre-bankruptcy rights and the hypothetical bargain. It is not the role of bankruptcy law to consider the interests of other stakeholders. Other branches of law, such as labour law and tort law, determine how their interests are to be dealt with. Otherwise, bankruptcy law may create incentives for stakeholders to forum shop between bankruptcy law and non-bankruptcy law in circumstances in which the goal of creditor wealth maximisation is not fulfilled.<sup>1</sup>

Others have argued for a more inclusive vision, with a redistributive role for bankruptcy law based on notions of fairness and on a wider group of stakeholder interests brought into the account, including employees and tort victims. Bankruptcy law should create a forum in which all those with an interest in the company's failure can be heard. It creates the right conditions for debate on where losses should fall and takes hard decisions on those distributional questions. Scholars from the values and forum schools of thought tend to accord bankruptcy law a central role in promoting the survival of a company as an independent objective in order to save jobs and, it is argued, maximise social welfare. Judges, and not self-interested and powerful creditors, should decide whether the company should be saved or not.<sup>2</sup> However, whilst followers of the contractarian school or followers of the progressive school might disagree about bankruptcy law's distributional aims, both would agree that a key function of bankruptcy law

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

<sup>2</sup> E Warren, 'Bankruptcy Policy' (1987) 54 *The University of Chicago Law Review* 775; D Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 717.

is to maximise the value of the assets and, hence, would agree with the central role of the automatic stay in preventing the break-up of the company.<sup>3</sup>

Suppose, for a moment, that we start from a different point (i) replacing the term ‘bankruptcy’ with ‘the law of corporate distress’ (ii) describing the central role of the law of corporate distress as facilitating the allocation of capital in the economy to best use<sup>4</sup> and (iii) splitting the law of corporate distress into two separate branches (a) insolvency law and (b) restructuring law. I start with an umbrella term ‘law of corporate distress’ because I wish to draw a distinction between, on the one hand, what a US lawyer might call ‘liquidation’ (and I include here a pre-packaged going concern sale by means of section 363 of the US Bankruptcy Code to a third party) and a UK lawyer might call ‘insolvency’ – both describing the situation in which some or all of the existing stakeholders who finance the firm no longer wish to support it and new financiers cannot be found and, on the other, a restructuring, which describes the situation in which the majority of the existing financial stakeholders wish to continue to remain invested in the firm but must agree a new bargain (because their old bargain no longer accurately reflects the risks of the business).

I have avoided using the term ‘bankruptcy’ as my umbrella term because bankruptcy to a UK lawyer refers to individuals and I will only be concerned with companies in this paper. Equally, I will generally use the term ‘company’ and not ‘firm’ because ‘firm’ to a UK lawyer connotes partnerships and I am more particularly concerned here with limited liability companies (although much of what I am about to say might also apply to large professional partnerships).

The reason for drawing a distinction between two different branches of the law of corporate distress will become clearer as the paper progresses but for the moment the argument is made that:

- i. the nomenclature in US law which sweeps reorganisation (Chapter 11), a pre-packaged going concern sale (section 363) and a break-up sale of assets by a trustee (Chapter 7) under the single umbrella term ‘bankruptcy’ without separately distinguishing insolvency on the one hand and restructuring on the other; and
- ii. the approach in US scholarship in treating restructuring as a virtual ‘sale’ of the business and assets to the incumbent stakeholders,<sup>5</sup>

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<sup>3</sup> See, for example, JL Westbrook, ‘The Control of Wealth in Bankruptcy’ (2004) 82 *Texas Law Review*, 798, 821.

<sup>4</sup> It is important to note here that this idea of the efficient allocation of capital is a central part of Thomas Jackson’s philosophy (for a recent description of the theory in this context see KM Ayotte and D Skeel, ‘Bankruptcy Law as a Liquidity Provider’ (2013) 80 *The University of Chicago Law Review* 1577, 1563-1564). But it is not often put up front and central in the account which traditionally focuses on the need to stop the so-called ‘race to the courthouse door’ or (more technically) the common pool problem.

<sup>5</sup> See, for example, RC Clark, ‘The Interdisciplinary Study of Legal Evolution’ (1981) 90 *The Yale Law Journal* 1238, 1250-54; DG Baird, ‘The Uneasy Case for Corporate Reorganizations’ (1986) 15 *The Journal of Legal Studies* 127, 127; D Baird and R Rasmussen, ‘Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations’ (2001) 87 *Virginia Law Review*, 921-922. For an excellent early critique of this approach see Korobkin *Supra* n 2.

have both contributed to blurring two quite distinct ways in which the law responds to the State's desire to facilitate the allocation of capital to best use in the twenty-first century. The distinction is clearer in the UK because, until very recently, the law played almost no part in facilitating restructuring. Thus, when the situation changed in the noughties, it resulted in a new branch of scholarship, 'restructuring', which was reflected in book titles, university courses and, perhaps most significantly, the title of the relevant departments in most City law firms as something quite distinct from 'insolvency'. Later, I will chart a little of the history of this development.

Henceforth, therefore, I will not use the term 'bankruptcy' at all (which is now replaced by the jurisdictionally neutral term 'the law of corporate distress') and I will refer on the one hand to insolvency law (the term generally used in Europe to refer to any procedure where the existing stakeholders which finance a company are no longer willing to support it and new financiers cannot be found) and restructuring law on the other. I have opted for the term 'insolvency' rather than 'liquidation' because (i) I wish to include within it going concern sales of businesses and assets to a third party and these are not generally referred to as liquidation sales in the UK (in the UK 'liquidation sale' is generally taken to include only the break-up of the business and the sale of the assets)<sup>6</sup> and (ii) I include within the term a going concern sale to a third party by way of a pre-packaged section 363 sale in addition to a Chapter 7 sale in the US.

I will argue that in both insolvency and restructuring the State is interested in facilitating the allocation of capital to best use in order to promote growth.<sup>7</sup> This, then, is the overall goal of the law of corporate distress. Once the stakeholders have decided that they no longer wish to remain invested in the firm and no new stakeholders can be found to replace them (the situation with which insolvency law is concerned), Thomas Jackson's thesis continues to describe (with caveats which I will come to) the principal aim of modern insolvency law. In a dispersed creditor economy, a collective procedure must be imposed in order to restrict the incentive for individual enforcement and to maximise capital flowing back to productive use in the economy. The caveat is that, as LoPuicki and Whitford have argued, it is right to include here a wider range of stakeholders than merely

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<sup>6</sup> The different ways in which US lawyers and UK lawyers use the term 'liquidation sale' is also highlighted in J Armour, A Hsu and A Walters, 'Corporate Insolvency in the United Kingdom: the Impact of the Enterprise Act 2002' (2008) 5 *European Company and Financial Law Review* 148, 151.

<sup>7</sup> In a recent piece Thomas Jackson and David Skeel have also put this point up front and centre, see TH Jackson and DA Skeel Jr 'Bankruptcy and Economic Recovery' University of Pennsylvania Law School Institute for Law and Economics Research Paper No 13-27, 2 'Modern bankruptcy law primarily exists to help reduce the frictions that otherwise would impede assets from moving to their highest and best use. Even those who think this is too narrow a description of the purposes of bankruptcy law would almost certainly agree it is a, if not the, *primary* purpose.' It has also received attention in the work of George Triantis see G Triantis, 'The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines' (1996) 16 *International Review of Law and Economics*, 101.

creditors because otherwise a series of costs are externalised (such as the cost of lost jobs) which ought properly to be taken into account in assessing whether the overall amount of capital which is effectively redeployed is maximised.<sup>8</sup> I therefore advocate a more inclusive approach<sup>9</sup>, and I include other constituencies, but not in the terms which Elizabeth Warren and others have suggested. Insolvency law responds not only to questions of external allocation of capital (ensuring that capital is allocated to companies best able to use it) but also internal allocation of capital (the investment of capital within a company). Thus it imposes duties on directors to ensure that capital is not invested in risky projects designed only to further shareholder interests, and it adjusts payments made in the vicinity of insolvency to reduce incentives to favour some stakeholders over others.

However, whilst virtually all modern insolvency laws provide a stay restricting the incentive for individual enforcement,<sup>10</sup> we do not find the same continuity when we come to consider the role of the law of restructuring in the twenty-first century. Many bankruptcy scholars continue to see restructuring law as solving the same problem as insolvency law. Seen through this lens, in a restructuring scenario there is a group of creditors who would prefer an enforcement sale and distribution of the proceeds. However, the consequent dismemberment of the firm and sale of the assets would not be value maximising and thus restructuring law responds to the same challenge as insolvency law – imposing a collective procedure to reduce the incentive for some creditors to take individual enforcement action. With very few exceptions, US scholars of all stripes have traditionally subscribed to this idea of the law of corporate distress as preventing a creditor who wishes to enforce and exit from exercising that right.<sup>11</sup> Disagreement has rather centred on who should control selection between continuing the business and selling it and, specifically in a US context, whether the way in which US federal law responds to the problem causes the inefficient perpetuation of

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<sup>8</sup> LM Lopucki and WC Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 14 *University of Pennsylvania Law Review* 669, 752.

<sup>9</sup> See Korobkin *Supra* n 2.

<sup>10</sup> There are differences in the quality of the stay between jurisdictions and, in England, between proceedings see, for example, the extent of the moratorium available in the administration procedure (Insolvency Act 1986 Schedule B1 paragraph 43 which prohibits enforcement of security without consent of the administrator or leave of the court) compared with the extent of the stay in liquidation (section 130(2) of the Insolvency Act 1986 which does not prohibit enforcement by a secured creditor who may appoint a receiver to carry out enforcement and sale of the secured property *In re David Lloyd & Co.*, (1877) 6 Ch. D. 339, 343-46) and compare both with the US Bankruptcy Code which prohibits enforcement by a secured creditor in Chapter 7 and Chapter 11. This point is also made in J Armour, BR Cheffins and DA Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 *Vanderbilt Law Review* 1699 1737-1738. However, the important point for present purposes is that English law does offer one insolvency procedure which stays secured creditor action in order to encourage sale of the business and assets as a going concern.

<sup>11</sup> See J Rogers, 'The Impairment Of Secured Creditors' Rights In Reorganizations' (1983) 96 *Harvard Law Review*, 975; L Bebhuk 'A New Approach to Corporate Reorganisations' *Harvard Law Review* 101(4) 775, 776; Clark *Supra* n 5, 1252; LM LoPucki, 'The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's the End of Bankruptcy' (2003) 56 *Stanford Law Review* 645, 916 all cited in Westbrook, 'The Control of Wealth in Bankruptcy' *Supra* n 3, 811 n 52.

companies which ought properly to fail.<sup>12</sup> This has resulted in a lively academic exchange on the legitimacy of management or financial creditors controlling whether or not the company should be saved and the level of control which each should exercise in determining the outcome.<sup>13</sup>

It has never been the case that there is always a creditor who wishes to enforce and sell the assets in every restructuring scenario.<sup>14</sup> But I suggest that it is even more likely today that in a dispersed creditor economy all creditors at the time of the restructuring will wish to remain invested. This is because the distressed debt market now offers the means for financial creditors who no longer wish to remain invested to exit without the risks of an enforcement and sale of the business and assets. Certain types of stakeholder may continue to prefer an enforcement and sale but, for reasons I will explain, none of them is incentivised proactively to file for insolvency proceedings. As a result, I will venture to suggest that in most modern cases there will no longer be an explicit role for restructuring law in preventing enforcement action. There are still reasons why we might argue that restructuring law should offer a stay on creditor action but, unlike insolvency law, restructuring law may operate very well without a stay (and indeed it has done so in England in the Great Recession) even in complex capital structures. The principal function of restructuring law is to encourage the best allocation of resource by solving the coordination problem between creditors in agreeing a new bargain so that the company can emerge with a balance sheet which enables it to compete in the economy and contribute to growth. After the restructuring, capital is allocated to a company which is able to use it productively.<sup>15</sup> Without the restructuring, capital would be tied up in a business which is forced to divert all of its resources to meet its financial liabilities, leaving it with no capital for investment, capital expenditure or effective competition with its peers whilst

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<sup>12</sup> DA Skeel Jr, 'Creditors' Ball: The New New Corporate Governance in Chapter 11' (2003-2004) 152 *University of Pennsylvania Law Review*, 920-21 describing in particular the egregious case of Eastern airlines which sought Chapter 11 protection at a time when "it was clear to just about everyone that Eastern should be sold" with the result that by the end of the bankruptcy case when the assets were sold they were worth a fraction of the value which they had at the beginning of the case; DA Skeel Jr, 'Rethinking the line between Corporate Law and Corporate Bankruptcy' (1994) *Texas Law Review* 471, 535 ('Like an antitakeover device, bankruptcy can impair the market's ability to discipline managers because it may substitute reorganization procedures for market mechanisms that would otherwise lead to the ouster of managers outside of bankruptcy') cited in 'Creditor's Ball', 933.

<sup>13</sup> See, for example, M Bradley and M Rosenzweig, 'The Untenable Case for Chapter 11' (1992) 101 *The Yale Law Journal*; L Bebchuk and H Chang, 'Bargaining and the Division of Value in Corporate Reorganization' (1992) 8 *Journal of Law, Economics and Organization* 179; B Adler, 'Financial and Political Theories of American Corporate Bankruptcy' (1993) 45 *Stanford Law Review*; A Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107 *The Yale Law Journal* 1807 all cited in KM Ayotte and ER Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 *Journal of Legal Analysis* 511.

<sup>14</sup> DG Baird 'Present at the Creation: the SEC and the Origins of the Absolute Priority Rule' *American Bankruptcy Institute Law Review* 18(2), 591, 601.

<sup>15</sup> For an excellent recent account of the role of restructuring law in solving the so-called 'debt overhang' problem (the reluctance of new lenders to provide liquidity to a company for investment because of the extent of its existing financial liabilities) see K Ayotte and DA Skeel Jr, 'Bankruptcy Law as a Liquidity Provider' *University of Chicago Law Review*, 80(4), 1557-1624.

creditors wrangle over a new bargain; the so-called ‘zombie company’ or, as Harvey Miller puts it, ‘the walking wounded’.<sup>16</sup> As we shall see, it may be argued that a stay will facilitate this role for restructuring law but it is not essential. Restructuring law rather steps in at the last moment to facilitate a new bargain if, notwithstanding the shadow which it casts, creditors cannot ultimately agree. It offers a deadlock resolution procedure.

Restructuring law must, though, solve the deadlock situation in a way which does not expropriate value from stakeholders with a continued interest in the company (subject to a possible gloss which I will come to in due course). If it does facilitate expropriation, it risks damaging the market for capital for healthy firms because creditors will be wary of the risk of expropriation *ex post* when deciding to advance credit *ex ante*.<sup>17</sup> Restructuring law thus balances the desire for capital to be allocated to firms in the economy best able to use it (which may militate in favour of a significant write down of debt in an over-leveraged company) with the need to ensure that this does not occur at the expense of expropriating value from those with a continued interest in the company thus damaging the *ex ante* ability of companies to raise capital, and the depth and breadth of the finance markets. As we shall see, the question of who has an interest in the company which ought to be protected when the company is to be saved, rather than its business and assets sold to a third party, is a challenging one. But for the moment it is sufficient to highlight that, whereas insolvency law remains concerned with the incentive for individual enforcement and maximising and distributing proceeds once the assets have been collected in and sold, restructuring law must resolve coordination problems by providing a means of dealing with ‘hold outs’ (cram down),<sup>18</sup> balancing allocation of capital to firms able productively to use it with preservation of value for stakeholders who continue to have an interest (valuation) and incentivising quick agreement notwithstanding that the firm may be at an early stage of distress, thus dealing with issues of time and cost which reduce value (which may result in the imposition of a stay or other incentives).

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<sup>16</sup> For ‘zombie company’ see ‘The Zombie Businesses Phenomenon: An Update’ R3 January 2014 available at <http://www.r3.org.uk/index-cfm?page=1215> and ‘The Trading Dead. The Zombie Firms Plaguing Britain's Economy, And What To Do About Them’ Tom Papworth available at <http://www.adamsmith.org/research/reports/the-trading-dead>. For ‘walking wounded’ H Miller ‘Chapter 11 in Transition - From Boom to Bust and into the Future’ (2007) 81 *American Bankruptcy Law Journal*, 375, 383.

<sup>17</sup> Jay Westbrook draws a distinction between a decision in English law to support the senior secured creditor and a decision in the US to leave the mix of secured and unsecured debt and equity to the market – resulting in what he describes as ‘neutrality’ see Westbrook *Supra* n 3, 826. The point was also made in a review of company rescue and reconstruction in the UK in May 2000, see Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms*, 2000, 19 paragraph 67. On the *ex ante* effects of distribution in bankruptcy more generally see L. Bebchuk, ‘Using Options to Divide Value in Corporate Bankruptcy’ (2000) 44 *European Economic Review* 829, 831.

<sup>18</sup> For a discussion of the problem of hold-outs see MJ Roe ‘The Voting Prohibition in Bond Workouts’ (1987) 97 *Yale Law Journal* 232, 235-8 and R Gertner and D Scharfstein ‘A Theory of Workouts and the Effects of Reorganisation Law’ (1991) 46 *Journal of Finance* 1189, 1200-1201 both cited in J Armour and S Deakin, ‘Norms In Private Insolvency Procedures: The ‘London Approach’ To The Resolution Of Financial Distress’ (2001) *Journal of Corporate Law Studies*, 42.

## RESTRUCTURING LAW IN THE US: 1979 TO 1990

The first phase of restructuring law with which this paper is concerned is the period from 1979 to 1990. During this period, as others have noted, not only were US equity markets highly dispersed but so too were US debt markets.<sup>19</sup> This gave rise to a number of problems. In the first place, the effectiveness of creditors as monitors of firm performance was weak. Whilst creditors may, collectively, have had an interest in monitoring the performance of the firm, no one creditor had an incentive to put time and money to work in doing so.<sup>20</sup> Secondly, severe coordination issues existed between creditors in deciding on a concerted course of action at the first sign of distress.

US restructuring law had its start at the end of the nineteenth century with the restructuring of railroads.<sup>21</sup> The logic of restructuring the railroads was, as David Skeel has described, ‘irresistible’<sup>22</sup> (as Miller and Waisman put it: ‘There was a broad national consensus that the troubled railroad industry must be saved, the absence of which would leave ‘nothing but a streak of iron-rust on the prairie’<sup>23</sup>). In some ways the clarity of purpose for restructuring law in the railroad era may have clouded understanding of its role in the century and a half which followed.<sup>24</sup> The complexity of the railroads was staggering and vast numbers of bondholders had liens on different assets across the swathes of track which were built across the United States.<sup>25</sup> Thus the concern of insolvency law, to prevent individual enforcement and dismemberment of the company, was also the primary concern of railroad restructuring.<sup>26</sup>

Yet the difficult question was how to ensure that a restructuring was initiated at the earliest possible sign of trouble, given the coordination challenges between

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<sup>19</sup> On the appearance first of banks, then bank syndicates and finally public bond holders in US restructuring cases see Miller ‘Chapter 11 in Transition’ *Supra* n 16, 389.

<sup>20</sup> J Armour and S Frisby ‘Rethinking Receivership’ (2001) 21 *Oxford Journal of Legal Studies* 73, 84.

<sup>21</sup> Many US scholars have provided an account of this period. See, for example, A Martin, ‘Railroads and the Equity Receivership: An Essay on Institutional Change’ (1974) 34 *The Journal of Economic History* 685; Korobkin, *Supra* n 2; DA Skeel Jr, ‘An Evolutionary Theory of Corporate Law and Corporate Bankruptcy’ (1998) 51 *Vanderbilt Law Review* 1325, 1353-1358; DA Skeel, Jr., *Debt’s Dominion: a History of Bankruptcy Law in America* (Princeton University Press 2001); DG Baird and R Rasmussen, ‘Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations’, 925-936; H Miller and S Waisman, ‘Does Chapter 11 Reorganisation Remain a Viable Option for Distressed Businesses for the Twenty-First Century?’ (2004) 78 *American Bankruptcy Law Journal*; DG Baird, ‘Present at the Creation’ *Supra* n 14.

<sup>22</sup> Skeel, *Debt’s Dominion*, n 21, 63.

<sup>23</sup> Miller and Waisman *Supra* n 21, 161, citing *Cent. Trust Co of NY v Wabash* 29 F. 618, 626 (E.D. Mo. 1886).

<sup>24</sup> Baird and Rasmussen have made a similar point, see DG Baird and RK Rasmussen, ‘The End of Bankruptcy’ (2002) 55 *Stanford Law Review* 751, 754.

<sup>25</sup> Miller and Waisman *Supra* n 23 164; for a good description of the practice of granting discrete sections of track or assets as collateral see Skeel ‘Evolutionary Theory’ *Supra* n 21, 1355-1356 and Skeel, *Debt’s Dominion* *Supra* n 21, 62.

<sup>26</sup> See Westbrook *Supra* n 3, 810 for a distinction between an ‘ordinary’ secured creditor and a dominant one. There were many ordinary secured creditors in the railroads.

creditors in a diffuse debt capital market,<sup>27</sup> whilst preserving going concern value to maximise overall creditor return.<sup>28</sup> David Skeel and Douglas Baird have shown how the likes of JP Morgan fulfilled this function in the era of the railroads, both raising capital in the primary markets and coordinating restructuring efforts when issuers faced financial distress.<sup>29</sup> But the ability of the Wall Street Banks to fulfil this coordination role was neutered by the New Deal reforms following the Great Depression.<sup>30</sup> The solution was to incentivise management to coordinate the restructuring effort. Before 1979 (and in large part as a reaction to the Great Depression) management had been replaced by a trustee in Chapter X of the Chandler Act.<sup>31</sup> This had resulted in very few Chapter X cases and efforts to adapt Chapter XI for large corporate restructurings. Thus, in the reforms of 1979, management was allowed to remain in place and other incentives were built into the Chapter 11 process making it an attractive option for management, encouraging its use.<sup>32</sup> At the same time, a number of safeguards were built into the process to guard against the risk of unjustified expropriation, notably the use of valuation opinions to benchmark who should receive value in the restructuring and in what amounts.<sup>33</sup> This is a theme to which I will return.

### RESTRUCTURING LAW IN THE UK: 1979 TO 1990

The finance market in the UK during this period was very different. It was dominated by powerful deposit-taking or ‘clearing’ banks which provided the vast bulk of finance in the economy.<sup>34</sup> These banks had very different incentives from those of the widely dispersed creditors in the US. They had every incentive to monitor the companies they invested in, calling management to account at the earliest signs of distress.<sup>35</sup> Coordination problems could still arise where more than one bank provided credit to a company but from the 1980s onwards these were dealt with under ‘The London Approach’ – a set of principles on how banks ought to behave when a company faced distress originally seeded by the Bank of England and subsequently enforced through the threat of reputational sanction in

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<sup>27</sup> Baird and Rasmussen, *Supra* n 21, 927.

<sup>28</sup> Westbrook *Supra* n 3.

<sup>29</sup> Baird and Rasmussen *Supra* n 21, 928.

<sup>30</sup> *Ibid*, 934-935; Skeel, ‘An Evolutionary Theory’ *Supra* n 21, 1368.

<sup>31</sup> *Ibid* Skeel 1368-1372; Skeel ‘Creditor’s Ball’ *Supra* n 12, 920; Miller and Waisman *Supra* n 21, 169-70.

<sup>32</sup> *Ibid* Miller & Waisman, 176-7; Skeel ‘An Evolutionary Theory’ *Supra* n 21, 1377-1380; Miller, ‘Chapter 11 in Transition’ *Supra* n 16, 386-387.

<sup>33</sup> See K O’Rourke, ‘Valuation Uncertainty in Chapter 11 Reorganizations (Activism, Uncertainty, and Abuse: Current Issues in Bankruptcy Law)’ (2005) 25 *Columbia Business Law Review* 403, 7 describing how the Supreme Court has discouraged lower courts from reaching decisions on value based on exposure to the market.

<sup>34</sup> For a description of why bank financing prevailed in the UK see Armour, Cheffins and Skeel *Supra* n 10, 1773.

<sup>35</sup> See, for example, Armour and Frisby *Supra* n 20, 73.

a small market of repeated interaction amongst a defined number of players.<sup>36</sup> Thus law took almost no part in solving the coordination problems between banks, stepping in only once the stakeholders had decided that they were no longer willing to finance the business to provide the necessary procedure to enable, where possible, the business and assets to be sold to a third party or, where this was not possible, a break-up of the business and a sale of the assets.<sup>37</sup>

Two concerns dogged this model of ‘concentrated creditor’ governance.<sup>38</sup> The first was a concern that the insolvency procedure in the shadow of which banks negotiated (receivership, renamed administrative receivership after the Cork Report in 1982)<sup>39</sup> afforded them too many control rights so that, rather than persevering with a restructuring, they may be incentivised simply to put the business into receivership, sell the assets and realise the proceeds.<sup>40</sup> The concern (based largely on theoretical analysis and perhaps without much empirical support)<sup>41</sup> was that this caused losses to other stakeholders which ought to have been avoidable, causing issues of efficient reallocation of capital. In effect, English insolvency law measured up poorly to the central aims which Jackson would set for any modern insolvency system. Ultimately, this was to lead to the abolition of administrative receivership and its replacement with a more collective procedure, administration.<sup>42</sup> The second concern achieved real profile after a visit by Peter Mandelsson, then Secretary of State for Trade and Industry, to Silicone

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<sup>36</sup> For a description of how the London Approach worked in practice see J Flood, R Abbey, E Skordaki and P Aber, *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach* (1995); Armour and Deakin *Supra* n 18 ; Armour, Cheffins and Skeel *Supra* n 10, 1774.

<sup>37</sup> See also Armour, Cheffins and Skeel’s point that a market based on informal renegotiation would prefer a ‘strong’ default procedure in order to encourage management to reach agreement Armour, Cheffins and Skeel Jr *Ibid*, 1770. For a description of resort to formal insolvency only where efforts to renegotiate had failed see J Armour, ‘The Rise of the ‘Pre-Pack’: Corporate Restructuring in the UK and Proposals for Reform’ in RP Austin and F JG Aoun (ed), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Ross Parsons Centre of Commercial, Corporate and Taxation Law 2012), 3-4.

<sup>38</sup> This phrase is borrowed from Armour, Cheffins and Skeel Jr *Ibid*. Jay Westbrook has called it ‘a contractualist system based upon a dominant security interest’ see Westbrook, *Supra* n 3, 796.

<sup>39</sup> It is important to note that at this stage there was no truly collective insolvency procedure in English law. It has been a relatively simple matter, since the Courts of Chancery embraced the idea of a floating charge, for a creditor of an English company to take security over all, or substantially all, of the company’s assets. During this period a floating charge holder had the right to appoint a receiver over the secured assets. As this security would comprise substantially all of the assets, junior creditors had no ability to take control of individual assets and a single creditor controlled the collective action problem see Armour, ‘The Rise of the ‘Pre-Pack’ *Supra* n 37; Armour, Cheffins and Skeel Jr *Ibid*, 1739; Armour and Frisby *Supra* n 20, 86-91; S Frisby, ‘In Search of a Rescue Regime: The Enterprise Act 2002’ (2004) 67 *Modern Law Review* 247, 253. The reforms introduced by the Cork Report included a new collective procedure for rescuing the company as a going concern, administration, but this was motivated by concerns as to the position where there was no security holder entitled or willing to appoint an administrative receiver rather than concerns with the process of administrative receivership itself and the procedure was little used.

<sup>40</sup> See, for example, Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms*, 14-15. For suggestions that this point was overdone see Armour and Frisby *Ibid*; Armour, Hsu and Walters *Supra* n 6, 157.

<sup>41</sup> On the lack of empirical evidence see Frisby, ‘In Search of a Rescue Regime: The Enterprise Act 2002’, *Supra* n 39, 253.

<sup>42</sup> Enterprise Act 2002.

Valley in 1998.<sup>43</sup> This was that the UK had a somewhat Victorian approach to failure grounded in disgrace and loss of standing in the community. Mandelsson was highly impressed with what he saw of the dynamic approach to restructuring in the US and determined to reform English insolvency law so that it could fulfil a similar function.<sup>44</sup>

But two challenges persisted. The first was the power of the clearing banks which led to compromises to the reform which severely inhibited its ability to change the status quo.<sup>45</sup> But arguably more profoundly, creditors and practitioners all struggled to identify the most significant difference between US restructuring law and restructuring in England (which, as we have seen, was not at the time a function of law at all but rather of the market). That difference was that US restructuring law encouraged management to restructure with a sustainable level of debt, facilitating a new capital structure through a developed cram down mechanic and a feasibility test. In England, on the other hand, banks controlled the restructuring process and they remained very reluctant to write off debt.<sup>46</sup> Although debt-for-equity swaps did happen, they were comparatively rare. More often banks would agree to a series of non-core disposals (to pay down debt) and covenant holidays and revised amortisation schedules (to create space for the company to get back on its feet). Sometimes this would be successful but a company with high financial or operational gearing had the cards stacked against it in turning things around compared with the far more dynamic reshaping of the balance sheet in the US. Because this distinction was poorly understood at the time, the reform efforts were somewhat wrong-headed. They purported to incentivise management to seek rescue through administration but left administration as a manager-displacing procedure.<sup>47</sup> They afforded rescue of the company primacy in a hierarchy of objectives for the administrator but provided no explicit cram down machinery to implement a restructuring.<sup>48</sup> Coupled with a few small but highly significant concessions obtained by the banks, nothing was to

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<sup>43</sup> 'Silicon Ballyhoo' *The Economist* 5 November 1998; G McCormack 'Control and Corporate Rescue – An Anglo-American Evaluation' (2007) *International and Comparative Law Quarterly* 56(3) 515-551, 524.

<sup>44</sup> Skeel puts it thus '[...] the American fascination with second chances and reversals of fortune' Skeel 'Evolutionary Theory' *Supra* n 21, 1353. We need to be careful not to overstate the longevity of this point, however. Harvey Miller has described the loss of stigma associated with bankruptcy in American economic life as a modern phenomenon, associating it with the general change in the business climate in the US in the 1960s see Miller, 'Chapter 11 in Transition' *Supra* n 16, 376. On the political desire to facilitate 'the transition to the new moral order' in the UK see IF Fletcher, 'UK Corporate Rescue: Recent Developments - Changes to Administrative Receivership, Administration, and Company Voluntary Arrangements - The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002' (2004) 5 *European Business Organization Law Review (EBOR)* 119, 128 'The prevalent political catchword of the moment was 'Enterprise', and a series of Ministerial pronouncements appeared to signal a determination to emulate the 'American way' of regarding insolvency – whether corporate or individual – as a routine hazard of life, to be accepted as a natural component of a thriving, entrepreneurial economy'.

<sup>45</sup> R Stevens 'Security after the Enterprise Act' in Getzler and Payne (eds) *Company Charges: Spectrum and Beyond* (Oxford: Oxford University Press 2006).

<sup>46</sup> Armour and Frisby 'Rethinking Receivership' *Supra* n 20, 93.

<sup>47</sup> This term is borrowed from Skeel, 'An Evolutionary Theory' *Supra* n 21.

<sup>48</sup> Insolvency Act 1986 Schedule B1 paragraph 3(1)(a).

change. Administration became the insolvency procedure against which banks sought to renegotiate, restructuring generally still occurred out of court and administration was reserved for a sale of the business and assets to a third party if the banks decided that they were no longer willing to support the business.

## **THE BIRTH OF THE DISTRESSED DEBT MARKET AND THE RISE OF SECURED CREDIT: US**

Profound change was, however, to occur in the practice of restructuring on both sides of the Atlantic as a result of the development, first in the US in the 1980s and 90s<sup>49</sup> and latterly in the UK, of distressed debt investing as a specialist form of investment, and the rise of secured credit. Crucially, these two developments effectively neutered the use of Chapter 11 as a threat by management to control creditor power. This is because lenders who have explicitly bought into the debt in order to control the restructuring increasingly have security over all of the company's assets put in place either before default, or immediately after default as a condition of continued support, such that they effectively control the ability of the company to access financing. Whereas taking security over substantially all of a company's assets has been comparatively straightforward as a legal matter in England ever since the courts of Chancery embraced the idea of the floating charge in the nineteenth century, it has been a more challenging matter in the US until the introduction of Article 9 of the Uniform Commercial Code and, particularly, later amendments to it.<sup>50</sup> Today the level of control which lenders can exercise through secured debt has eclipsed any ability of management to control a Chapter 11 case.<sup>51</sup>

As LoPuicki and Whitford explain with admirable clarity, restructuring seeks to capture the difference between the value of the business if it were to be sold at the time of the restructuring and an exit after the restructuring of the existing

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<sup>49</sup> Michelle Harner dates the start of distressed debt investing in the US to the 1930s in the aftermath of the Great Depression but the real explosion of sophisticated activist distressed debt investing to the late 1980s and the 90s, see M Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (2008) 77 *Fordham Law Review* 703, 710 at n 22; see also Miller 'Chapter 11 in Transition' *Supra* n 16, 389.

<sup>50</sup> For a description see D Baird and R Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 *University of Pennsylvania Law Review* 1209, 1288.

<sup>51</sup> See, for example, Miller 'Chapter 11 in Transition' *Supra* n 16 ('They consider themselves to be the owners of the debtors, a super board-of-directors of sorts, and they view the debtors' management to be merely a nuisance in their path to ultimate control.');

Skeel 'Creditor's Ball' *Supra* n 12; Baird and Rasmussen, 'The End of Bankruptcy' *Supra* n 24; Baird and Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' *Supra* n 50; Ayotte and Morrison, 'Creditor Control and Conflict in Chapter 11' *Supra* n 12; G Nini, D Smith and A Sufi, 'Creditor Control Rights, Corporate Governance, and Firm Value' (2012) 25 *Review of Financial Studies* 1713; B Adler, V Capkun and L Weiss, 'Value Destruction in the New Era of Chapter 11' (2013) 29 *Journal of Law, Economics, and Organization* 461.

capital structure.<sup>52</sup> It is for this reason that the description of a restructuring as a ‘sale’ of the business to the existing investors runs into so much trouble. It is evidently not what is happening – the investors have decided to renegotiate their bargain with the firm so that they can hold their investment in hope of better times. Envisioning restructuring as a ‘sale’ elides the difference between insolvency on the one hand and restructuring on the other. Distressed debt investors may have different investment strategies but all of these seek to exploit the rise in the value of the company after the restructuring. Some will adopt a ‘trading’ strategy, buying debt at a deep discount to par or face value in the expectation that the price of the debt will trade up in the secondary market after a successful restructuring such that they will be able to sell at a profit. This is a comparatively short term investment horizon. Others seek to capture the difference between the sale price of the business today (reflected in the price at which debt is trading in the secondary market) and the sale price after things have settled down in two or three years. These investors seek to buy up debt which they regard as trading cheaply, having regard to their own assessment of the prospects of the business, and to make maximum profit (often far in excess of the par value of the debt) after deleveraging the balance sheet through a debt-for-equity swap, fixing certain operational issues in the business or, simply, waiting until the market has recovered.<sup>53</sup>

It is hopefully already obvious that the distressed debt market can fulfil a very useful function in the effort to allocate capital in the economy to best use and is something which modern capital markets should support and encourage. Distressed debt traders can act as the effective monitors of companies which may be experiencing distress in the absence of effective monitoring from incumbent lenders; indeed, their entire business model depends upon the recruitment of bright analysts to look for and model opportunities and the development of vast amounts of proprietary information to spot targets. This market reality, coupled with the consequences of financial structure, together mean that the role which has hitherto been accorded to management in the US in initiating restructuring talks has passed to the distressed debt investors who are likely to put a company ‘into play’ as soon as they see weakness. Distressed debt investing provides a means for those who no longer wish to remain invested in a firm with a new risk profile to exit without the cost and risk of enforcement and sale. It consigns the role of what I have called ‘insolvency law’ solely to dealing with those companies which have no future and which ought to be dissolved so that capital can be employed by companies best able to use it, with the market selecting which companies are able to survive and which companies should be liquidated having

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<sup>52</sup> LoPuicki and Whitford *Supra* n 8, 758.

<sup>53</sup> *Ibid* 716-17, 755 (discussing subsequent profit at exit). Several scholars refer to the short term strategy as if it leaves the short term distressed debt investor completely disinterested in the prospects for a restructuring. But this is not correct. More often than not the distressed debt investor foresees the uplift in value only once a restructuring has happened. He will see profit comparatively quickly after the consummation of the restructuring but he is not disinterested in the prospects for success.

regard to capacity in the market. The development of these market mechanisms makes much of the old debate about the role of restructuring law in the US ‘imposing’ a restructuring on creditors redundant.<sup>54</sup>

Nonetheless, the question arises as to whether the policy responses which were developed in the US in a different environment continue to operate effectively after the advent of this sophisticated new market. Does the response to the problem of determining who has a continuing interest – which has hitherto been to make the bankruptcy judge the ultimate arbiter of value in a complex valuation fight – continue to have legs once sophisticated parties whose very business is to understand distress slug it out with ever more complex models?<sup>55</sup> Given that the price at which the distressed debt fund has bought in will often be a heavy discount to par value and an even greater discount to the expected return on restructuring and exit, is there sufficient control on costs? Is a stay still necessary and, if it is, in the same terms? In particular, as debt structures increasingly move towards secured debt, are the control rights which secured creditors wield too powerful, notably the ability to control access to cash in the business as a result of the consent rights afforded through the automatic stay? These issues have culminated in the launch of a commission by the American Bankruptcy Institute with the stated purpose of investigating the need for reform of Chapter 11 given the very different environment prevailing in the equity and debt capital markets from that which existed at Chapter 11’s inception in 1979.

### **THE BIRTH OF THE DISTRESSED DEBT MARKET AND THE RISE OF SECURED CREDIT: UK**

Changes in the UK debt market, coupled with the arrival of the distressed debt traders in the UK, (which I have dated from the Barings case in 1999) were to have an even more profound effect. In the first place, banks started to move from the model of ‘concentrated creditor governance’ described above towards a model of arranging loans but subsequently distributing their own participation in them.<sup>56</sup> This was to severely weaken the model for achieving a restructuring in the UK given that it challenged the ongoing effectiveness of the London Approach and reduced the incentive for any one bank, or small group of banks, to undertake monitoring. Furthermore, increasingly other sorts of investors bought participations in loans. And as these diverse stakeholders suffered increasing coordination issues, borrowers also started to access debt capital markets to a far greater extent. Finally, although it has historically been straightforward to take a

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<sup>54</sup> For debate on this issue in the US scholarship see references at n 13 above.

<sup>55</sup> US Bankruptcy Code section 1128, 1129.

<sup>56</sup> Armour ‘The Rise of the Pre-Pack’ *Supra* n 37, Part 3.

security interest over all of a company's assets in England and Wales, until the emergence of highly leveraged debt structures most large company financings were unsecured. This was to change with the private equity boom, yet management had no credible levers to pull given the 'manager-displacing' features of administration. As a result of all of these factors, corporates experiencing financial distress suffered many of the coordination problems in renegotiating with lenders as those in the US had found before them.

There was, therefore, a role for law to play in solving these coordination problems but no one procedure had been properly designed to deal with them. Administration, as a standalone option, did not fit the bill for all the reasons already given. As a result, English lawyers developed two different techniques. The first, where unanimity could not be achieved in every class but a majority in each supported the restructuring, was to use the scheme of arrangement procedure which had been on the statute books since the nineteenth century. The second, where some class of stakeholders was unwilling to support the plan or was to be offered nothing within it, was to 'twin' the scheme of arrangement with a pre-packaged administration. In a pre-packaged administration, the administrator is introduced to management before appointment, observes the negotiation of a sale from the side lines, satisfies him or herself that the sale offers the best way forward and implements it immediately upon appointment. In a restructuring scenario, the pre-packaged administration is used to 'sell' the operating subsidiaries comprising the business to a Newco owned by those stakeholders to whom equity has been allocated in the restructuring, leaving those who have been offered nothing stranded in a bankrupt finance company with no assets.

Thus the administration 'sale' is used for a purpose for which it was never envisaged and the disadvantages of a truly manager-displacing structure avoided (there is nothing to stop management emerging as the directors of Newco, often with significant equity in the new business).<sup>57</sup> But this use of old procedures for a new purpose is problematic. Neither administration nor schemes of arrangement has developed in response to the explicit challenges modern restructuring law must meet, particularly the balance of interests described above, because they have not had to. Until extremely recently these procedures were either consigned to something of a backwater (debt restructuring schemes) or used for a different purpose (enforcement sales to a third party and distribution of proceeds in the case of administration). But it is essential that the questions which a modern restructuring law must answer are addressed if the practice of dynamically restructuring businesses which are suffering stress is to be encouraged without

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<sup>57</sup> And it is interesting to note here that a shift occurs from a 'manager-displacing' regime in the terms of Skeel's account in 'An Evolutionary Theory' *Supra* n 21 as Britain moves from a 'concentrated creditor' model of governance to a more dispersed creditor universe consistent with the analysis advanced by Armour, Cheffins and Skeel in 'Corporate Ownership Structure' *Supra* n 10. The critical point is that although what may appear to be the principal regime for restructuring in English insolvency law (administration) remains apparently manager-displacing, the way in which the procedures are used in action results in a system which is at least manager-implemented.

compromising the depth and breadth of the finance markets for healthy companies.

### AT THE CROSSROADS

Thus, through very different routes and in some ways from opposite ends of the telescope, US and UK restructuring law arrive at the same place. US restructuring law, which developed in response to the problem of creditor coordination in a diffuse debt capital market by affording significant incentives to management to pursue a restructuring so that capital could be allocated to best use in the economy as efficiently as possible, must now consider whether that architecture can be exploited by the new creditor controllers to the detriment of other stakeholders such that the balancing act which all restructuring law must undertake between facilitating the allocation of resource to best use in the economy on the one hand, and sufficient preservation of rights to maintain the integrity of the finance markets on the other, is no longer properly undertaken. English law, whilst welcoming the ingenuity of lawyers in taking procedures designed to achieve a sale of an insolvent business once its stakeholders are no longer willing to support it and adapting them to achieve a debt restructuring, must address the different policy questions which arise in a restructuring scenario now that market norms no longer operate to incentivise restructuring notwithstanding the (senior) creditor friendly legal environment.<sup>58</sup>

Before considering this in more detail, I must return to a point I made right at the outset. I stated that there may still be creditors who would prefer enforcement and sale but that none was individually incentivised to file for insolvency. First, let us consider a senior creditor who believes that they are amply covered by the value of the assets in the business and who does not like the price quoted in the distressed debt market. In their article on restructuring in the UK in the early 1990s, Armour and Deakin note that it is ‘rational for [...] a creditor to refrain from enforcing if it thinks that the returns to renegotiation will be higher than its likely return in insolvency’.<sup>59</sup> The senior secured creditor who is amply covered by the collateral in the business but who considers the distressed debt market is mispricing his return given the prospects for a restructuring is ordinarily in this position. Certain types of creditor may have particular incentives to prefer a legal process. Collateralised loan obligations (CLOs) may be limited in their ability actively to vote on a restructuring – but they are also likely to prefer to collect fees

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<sup>58</sup> For the ‘hyper-rationality’ of the new kids on the financing block see Miller ‘Chapter 11 in Transition’ *Supra* n 16, 390 ‘They became more aggressive and disinclined to share their collateral with others’ and S Paterson ‘Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards’ (2014) JCLS 14(2) 333, 337-342.

<sup>59</sup> Armour and Deakin *Supra* n 18, 38.

for as long as possible and are unlikely to favour an enforcement sale. Holders of credit default swap (CDS) protection may actively prefer an enforcement sale because it will be a clear trigger event in their documentation. However, these holders are not incentivised to initiate an enforcement sale because doing so may lead to concerns that they are not entitled to claim as a consequence of having brought about the trigger event. And junior creditors and equity have no incentive to enforce because the priority rights afforded to senior creditors means this will almost certainly result in a loss of value.<sup>60</sup> Thus, although there may not be an identity of interest amongst the creditor group and the trustee may be a very uneasy one, in most cases there is a practical stay on action absent a legal one.<sup>61</sup>

Turning, then, to the questions which arise on both sides of the Atlantic:

1. What conditions should attach to use of the procedure given the desire to encourage early use on the one hand, and the need to ensure that the process is not used to give an unfair competitive advantage on the other?
2. How is the business to be valued in determining who should retain a continuing stake and who has no continuing interest?
3. Who is the ultimate arbiter of the process?
4. What is management's interest in the process and do any special issues arise?
5. Should creditor rights be stayed whilst renegotiation takes place?
6. How is the business to be financed whilst the restructuring is negotiated?
7. To what extent should restructuring law have regard for private ordering?

The final part of this paper will consider the contours of each of these issues in turn.

**WHAT CONDITIONS SHOULD ATTACH TO USE OF THE PROCEDURE GIVEN THE DESIRE TO ENCOURAGE EARLY USE ON THE ONE HAND AND THE NEED TO ENSURE THAT THE PROCESS IS NOT USED TO GIVE AN UNFAIR COMPETITIVE ADVANTAGE ON THE OTHER?**

As we have seen, insolvency law facilitates the reallocation of capital once financial creditors have decided that they no longer wish to remain invested in the company. All stakeholders will contract to have the right to withdraw their investment if they consider that it is applied wastefully and the law should support this exit right because it wishes capital to be employed for the best use in the

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<sup>60</sup> Armour and Frisby *Supra* n 20, 87 citing R. Picker, 'Security Interests, Misbehavior, and Common Pools' (1992) 59 *The University of Chicago Law Review* at 669-75 which argues that allocation of rights of priority to payment can solve collective action problems.

<sup>61</sup> Baird and Rasmussen have also made the point that senior lenders are unlikely to prefer liquidation in a modern restructuring of a large company, see Baird and Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' *Supra* n 50, 1246.

economy. If stakeholders have decided that their capital is best employed elsewhere, the law should support the reallocation. As we have also seen, insolvency law's particular objective in this situation is to restrict the incentive for individual enforcement by providing a collective procedure in order to maximise the amount of capital which is effectively redeployed. The circumstances in which an insolvency process can be invoked are therefore relatively easy to articulate.

More complicated questions arise when we consider the circumstances in which a company should be able to avail itself of restructuring law. As I have argued, it is the very function of restructuring law to encourage early restructuring so that capital is allocated to companies best able to use it. Restructuring law helps to avoid what has become known as the 'zombie company' problem – companies weighed down by so much debt that they use all their cash resources to service interest payments and are left with no capital to invest. In this view, there should perhaps be no particular condition attaching to the use of restructuring law.

The problem with this approach is the challenge with describing the circumstances in which it is appropriate to shake off liabilities. Of course, at the extreme every company would enjoy a better competitive position if it did not have to meet all of its liabilities. A key concern of restructuring law is, therefore, to avoid becoming a charter for the unscrupulous who gain an unfair competitive advantage whilst, at the same time, offering low barriers to entry to incentivise restructuring so that resources are allocated to best use as efficiently as possible. In practice, the market may impose its own solution to this challenge. Even where a solvent company can avail itself of a procedure (such as a scheme of arrangement in England), it is likely to be necessary to show that absent the restructuring the business will fail in order to create the right conditions for the new bargain to be struck. In practice, therefore, it is unlikely that an entirely solvent concern would seek to use the procedure even if it were technically able to do so. In other words, the market may impose its own conditions even if restructuring law does not.

#### **HOW IS THE BUSINESS TO BE VALUED IN DETERMINING WHO SHOULD RETAIN A CONTINUING STAKE AND WHO HAS NO CONTINUING INTEREST?**

As already described, it is the function of insolvency law to impose a collective procedure to minimise the incentive for individual enforcement so that the business can be kept together and hopefully sold for a higher price. The focus of insolvency law is thus on maximising the amount of capital which will be redeployed in the economy. Most insolvency laws provide safeguards against those in control selling the business too cheaply (because all that they need to do is to cover their own exposure) at the expense of other creditors who could properly have received a return if the business had been marketed more effectively. The focus of insolvency law is thus on achieving the best price reasonably obtainable on the sale of the business (taking into account the very special circumstances in which the sale is taking place).

A central policy of Chapter 11 is to identify cases in which the value of the business if it continues to operate exceeds the value of the business if it is sold (or if that is not possible the assets are sold) at the time of the reorganisation.<sup>62</sup> Confusion between US and UK scholars is a particular danger here as sometimes, when US scholars describe capturing the difference between going concern value and liquidation value, they do not mean the difference between a sale of the business and assets as a going concern on one hand and a break-up of the business and sale of the assets on the other. Rather they mean the possibility of future value accruing to the investors if they continue to hold the business on one hand compared with the value of an immediate sale of either the business and assets as a going concern or the assets on a break up basis on the other.<sup>63</sup>

It is crucial to the success of a restructuring that tools are available to bring dissenters into line.<sup>64</sup> This problem has only recently come to the fore in the UK as a result of the demise of the collective action norms inherent in the London Approach. But it was a point which was well-understood in the US from the 1930s where the need to pay dissenters in cash (which was, of course, not readily available) was seen to have impeded the success of more than a few restructurings during the depression era.<sup>65</sup> In a US restructuring the problem is solved by providing a mechanism in restructuring law to place a value on the company which is used to determine where in the capital structure to allocate value and encouraging the parties to bargain in the shadow of this law. But the question then arises as to how that valuation is to be calculated.

The traditional approach in much of Europe has been to have regard only to the price that the business would fetch in the market if it were sold today (treating this as effectively what is happening because, in effect, the business is being 'sold' to the existing stakeholders). The advantage of this approach is that, provided the usual safeguards which insolvency law employs to ensure that the best price reasonably obtainable on a sale are followed, we should obtain an objective measure of the value of the company for the purposes of redistributing the value of the firm amongst the stakeholders.<sup>66</sup> However, restructuring often takes place when the market is depressed. Buyers may not be able to raise finance for a bid.<sup>67</sup>

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<sup>62</sup> See L LoPucki and W Whitford 'Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1990) 139 *University of Pennsylvania Law Review*, 127; W Blum, and S Kaplan 'The Absolute Priority Doctrine in Corporate Reorganizations' (1973) 41 *The University of Chicago Law Review*, 659-660.

<sup>63</sup> *Ibid.*

<sup>64</sup> Blum and Kaplan *Supra* n 62.

<sup>65</sup> E Levi, 'Corporate Reorganization and a Ministry of Justice' (1938) 23 *Minnesota Law Review* 3, 4; Skeel has explained why interest groups who might have been expected to resist the legislative changes to restructuring practice during the New Deal era did not in fact raise objection in part because of the pressing need to deal with this problem, see 'An Evolutionary Theory' *Supra* n 21 and *Debt's Dominion* *Supra* n 21, 103-104.

<sup>66</sup> As Roe puts it, '[...] the market is likely to be a more accurate gauge of value than is the court and a potentially quicker gauge of value than is the bargain' M Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganisation' (1983) 83 *Columbia Law Review*, 527, 531.

<sup>67</sup> A Shleifer and RW Vishny, 'Liquidation Values and Debt Capacity: A Market Equilibrium Approach' (1992) 47 *The Journal of Finance* 1343.

Furthermore, the business may be suffering a cash squeeze as a result of loss of confidence. The auction process may not be perceived as real which will only exacerbate the unwillingness of bidders to commit time and resource to making an offer when there can only be one successful buyer. And other natural bidders for the business may be in the same sector and may also be experiencing some level of financial distress.<sup>68</sup> Many of these things may turn around quite quickly once a downturn eases, values begin to recover and a planned exit strategy is launched. I have covered these points in detail elsewhere – but the short point is that there may be a significant gap between the value that the market would put on the business if it were sold today and the value of the business if it is held for two or three years and then sold, or its shares offered on the public markets.<sup>69</sup> Where the existing stakeholders have determined that they no longer wish to remain invested in the company, if this upside materialises the third party buyer will capture it. But where the stakeholders are renegotiating their bargain this question of valuation will be much more pertinent because any upside will be captured by those stakeholders fortunate enough to keep a stake whilst others lose everything.

The challenge with the approach is thus, as a direct consequence of the problems with using current market price for distressed businesses identified above, it may enable some stakeholders to capture a disproportionate share of the upside post restructuring. This is of concern to us because of the essential balancing act which all restructuring law must perform – between the efficient allocation of capital to best use in the economy on the one hand and ensuring that the expropriatory effects of the procedure do not cast a chill over the depth and breadth of the finance markets for healthy companies on the other. Modern restructuring law balances the desire to allocate capital to companies best able to use it with the need to ensure that it does not expropriate value from creditors who have an interest. What I have called elsewhere the ‘counterfactual’ approach is too blunt an instrument for this balancing exercise. It answers the charge that creditors would have been better off exiting the investment and so should not be forced to remain invested in the company but it does not deal with the charge that the restructuring is expropriatory because it enables some stakeholders to recover too much upside at the expense of others. Accordingly, this extreme (which is arguably the prevailing view in Europe at the moment) does not seem very attractive.

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<sup>68</sup> *Ibid*; LoPuicki and Whitford cited in O Hart, P Aghion and J Moore ‘The Economics of Bankruptcy Reform’ (1992) 8 *Journal of Law, Economics, & Organization* 523, 528; Skeel ‘An Evolutionary Theory’ *Supra* n 21, 1340-1341.

<sup>69</sup> Paterson ‘Bargaining in Financial Restructuring’ *Supra* n 58 348-352. Aghion, Hart and Moore put the point nicely ‘[...] the conclusion that a competitive auction will inevitably lead a firm to be sold to the highest willingness-to-pay bidder at its (maximized) value is extreme. Auctions work well if raising cash for bids is easy and there is plenty of competition among bidders. However, even in the most advanced Western economies, these conditions often will not be met’; see Hart, Aghion and Moore ‘The Economics of Bankruptcy Reform’ *Supra* n 68, 527.

The traditional approach to questions of valuation in Chapter 11 is still to ‘collapse the future possibilities of different values to a single present value’.<sup>70</sup> But given the problems I have identified above with market price, traditionally market value has been established by professional valuers using, in particular, discounts of future income streams to present value.<sup>71</sup> The difficult question of agreeing value is then left to be decided by bargaining and, in the absence of agreement, judicial decision.<sup>72</sup> Yet the absence of an objective measure of value gives rise to concerns either that the system provides too much negotiating power to junior creditors who will receive an allocation in the bargaining process merely so that senior stakeholders can avoid an expensive and potentially protracted valuation fight or, conversely, that it may exclude stakeholders who ought properly to have shared in the future upside.<sup>73</sup> Second, concerns arise that the bargaining and litigation model increases the time it takes to reach agreement and, thus, cost.<sup>74</sup> Indeed, some US scholars have advanced a more European approach based on auction value as a solution to these problems.<sup>75</sup>

An alternative solution is to move away from the idea of collapsing future possibility to a single value which is negotiated or litigated (what US scholars would refer to as the ‘bargaining and litigation approach’) not in favour of a system which relies on market price (an ‘auction approach’) but rather to a system which preserves the ability of those at the bottom of the capital structure to make a return if things turn out well (what is referred to in the US literature as the ‘options approach’). We cannot know whether upside will emerge or not and until we do someone may always be willing to pay something for claims at the bottom of the capital structure on the chance that they will strike lucky. In this version, no stakeholder would ever be left empty-handed. Instead, a system is devised which preserves the option value of those lower in the capital structure.<sup>76</sup> Building on the

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<sup>70</sup> LoPuicki and Whitford ‘Corporate Governance’ *Supra* n 8, 773 citing DG Baird and TH Jackson ‘Bargaining After the Fall and the Contours of the Absolute Priority Rule’ (1988) 55 *University of Chicago Law Review* 738, 761. See also Baird and Rasmussen, ‘Control Rights’ *Supra* n 21, 936.

<sup>71</sup> LoPuicki and Whitford ‘Equity’s Share’ *Supra* n 62, 136-7.

<sup>72</sup> On the development of the role of bargaining (so that a judicial decision was not required in every case) see LoPuicki and Whitford ‘Bargaining Over Equity’s Share’ *Supra* n 62, 132-133; Bebchuk, ‘A New Approach to Valuing Secured Claims in Bankruptcy’ (2001) *Harvard Law Review* 114(8) 2386.

<sup>73</sup> Blum and Kaplan *Supra* n 62, 656 ‘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’; Bebchuk *ibid*, 2404-2405.

<sup>74</sup> Bebchuk *Ibid* 2405-2406 noting, in particular, that this concern includes not only increased direct costs (such as professional fees) but also the indirect costs caused by the ‘limbo’ period in which the business finds itself as a solution is sought.

<sup>75</sup> Baird, ‘The Uneasy Case for Corporate Reorganizations’; M Jensen ‘Corporate Control and the Politics of Finance’ (1991) *Journal of Applied Corporate Finance* 4(2) 13-34. Mark Roe has raised his own concerns with the auction approach echoing many of the deficiencies I have highlighted and has suggested his own variant on it in which 10% of the business is sold to investors M Roe *Supra* n 66. This would seem to bring its own challenges and is not explored in further detail here.

<sup>76</sup> L. Bebchuk, ‘A New Approach to Corporate Reorganizations’ (1988) 101 *Harvard Law Review*; Aghion, Hart and Moore, ‘The Economics of Bankruptcy Reform’ *Supra* n 68, 523; O Hart, *Firms*,

seminal work of Black and Scholes,<sup>77</sup> the junior creditors have an option with a strike price equal to the full amount of the senior claims and equity holders have an option with a strike price equal to the full amount of the senior and junior claims. Even if the creditors face liquidity constraints in exercising their options, they have a corporate security (the option) which has a value and which they are able to sell in the market.<sup>78</sup> The idea is essentially to devise a scheme which removes the litigation and bargaining which currently characterises Chapter 11 schemes in the US. But the problem with this is that we are most concerned with the efficient allocation of resource in the economy. Ultimately, the firm should emerge with a capital structure which properly reflects its future prospects and problems may arise if the capital structure with which the firm emerges is too complex.<sup>79</sup> In order for an option holder to know whether or not to exercise his option, he will need to have information rights concerning the state of the debtor. The options are not, therefore, costless in terms of their impact on the stakeholders in the company. And it might perhaps be suspected that they are most likely to trade at low value into the hands of stakeholders looking to buy in on a litigation strategy. Concerns thus arise that this model will reduce the amount of debt finance which healthy firms can raise.<sup>80</sup> Finally, in a vision of commercial law reflecting the bargain which stakeholders would have reached amongst themselves, we might legitimately ask whether the option model has widely emerged as a natural option in the bargaining and litigation structure of US bankruptcy law. If it has not, we might perhaps wonder whether the market remains sceptical about its potential.

It is suggested therefore that restructuring law must adopt a middle ground between the ‘best price reasonably obtainable’ approach of insolvency law and the value destructive risks inherent in a subjective valuation approach. Current proposals to deal with this issue in the US include adoption of a valuation ombudsman to arbitrate on questions of value<sup>81</sup> and I have made my own suggestions for UK law elsewhere.<sup>82</sup>

### **WHO IS THE ULTIMATE ARBITER OF THE PROCESS?**

Insolvency law is traditionally manager-displacing. Once the stakeholders have decided that they are no longer willing to support the business, management steps

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*Contracts and Financial Structure* (Oxford University Press 1995); Bebchuk, ‘Using Options to Divide Value in Corporate Bankruptcy’ *Supra* n 17.

<sup>77</sup> F Black and M Scholes ‘The Pricing of Options and Corporate Liabilities’ (1973) 81 *The Journal of Political Economy*.

<sup>78</sup> Bebchuk ‘Using Options to Divide Value’ *Supra* n 17, 839.

<sup>79</sup> See Roe, ‘Bankruptcy and Debt: A New Model for Corporate Reorganization’ *Supra* n 75, 529.

<sup>80</sup> *Ibid* 945-947.

<sup>81</sup> ABI Commission to Study the Reform of Chapter 11 Field Hearing 21 February 2013 Las Vegas, Nevada Transcript of Proceedings available at <http://commission.abi.org>.

<sup>82</sup> S Paterson ‘Bargaining in Financial Restructuring’ *Supra* n 58, 353-364.

aside and an independent person steps in to complete the sale of the business and assets or assets to a third party. I have included paragraph 363 sales to a third party within my definition of insolvency (as opposed to restructuring) law and no independent person necessarily steps in in a 363 sale. But I would argue that the court effectively takes the role of the independent party. More typically a trustee of some sort steps in in an insolvency sale. This is partly for the reasons which an English QC, Gabriel Moss, has identified. Whilst it will often not be the case that management is solely to blame for the businesses failure, when an insolvency proceeding is implicated then on some level the business has failed and so to leave management in place is akin to leaving the alcoholic in charge of the pub.<sup>83</sup> Management do not need to be incentivised to seek insolvency protection, which follows from a decision by existing stakeholders to cease to support the business and so we need not be concerned with the manager-displacing function of insolvency law.

Matters are more complicated, yet again, for restructuring law. Given restructuring law's principal aim of encouraging the allocation of capital to best use, it may be implicated at a far earlier stage in the life cycle of distress (indeed, ideally it will be). This means that there may be no need to remove incumbent management and, indeed, it may be value maximising to inflict the least upset possible on the company's business and operations whilst it is in what LoPuicki and Whitford describe as the restructuring negotiation 'inefficient holding pattern'<sup>84</sup>. Yet we remain concerned about the other side of restructuring law's scales – ensuring that restructuring law is not used opportunistically to gain an unfair competitive advantage and that it does not expropriate value unjustifiably from some stakeholders for the benefit of others. We must, therefore, find a guardian for the process. In the US this role is fulfilled by the bankruptcy judge but this poses a number of challenges. Although modern scholarship has suggested that concerns that judges are insufficiently expert to arbitrate on matters which are essentially a function of commercial decision-making may be overdone, nonetheless the judge may be at a disadvantage in presiding over complex battles between stakeholders of very different levels of financial sophistication.<sup>85</sup> Furthermore, use of the court implicates a significant amount of state resource which is highly relevant for our objective of efficient allocation of capital.<sup>86</sup> And use of the judge as arbiter is expensive and time-consuming, potentially drawing out our 'inefficient holding pattern'. I have suggested elsewhere that English law should respond to this problem in a different way, carving out a role for the

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<sup>83</sup> G Moss, 'Chapter 11: An English Lawyer's Critique' (1998) 11 *Insolvency Intelligence*, 17, 18-19, cited in G McCormack *Supra* n 43, 522.

<sup>84</sup> LoPuicki and Whitford *Supra* n 8, 778

<sup>85</sup> For arguments that it is see ER Morrison, 'Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies' (2007) 50 *Journal of Law and Economics* 381.

<sup>86</sup> JC Lipson 'The Shadow Bankruptcy System' 89 *Boston University Law Review*, 1609, 1651. As one judge stated: 'The problem with the hedge funds is that they use the bankruptcy court as a battleground without paying any rent.'

insolvency practitioner.<sup>87</sup> Whilst this is not without its own challenges, it is suggested that it is a better route than relying on greater court involvement.

**WHAT SHOULD MANAGEMENT'S INTEREST BE IN THE PROCESS AND DO ANY SPECIAL CONCERNS ARISE?**

When a company is insolvent, it is tolerably clear that directors' duties to the company should represent the interests of creditors. At this point, there will be insufficient realisations to afford a return to shareholders and so directors should not be undertaking risky wealth maximising policies but rather should be concentrating on the preservation of the value of the business and assets for creditors. Thus no particular issues of corporate governance arise and a well-advised board will understand the context in which it is operating.

Matters are not so simple for restructuring law. As will be clear by now, restructuring law seeks to create the right incentives for stakeholders to renegotiate their bargain at an early stage of financial distress. A business may, therefore, be at a very early stage on the continuum from financial distress to insolvency or it may be at a comparatively late stage. This may make it more challenging for directors to articulate who they owe their duties to at any one time. Although some scholars have made a case for the complete replacement of shareholder interest whenever creditor interests hove into view, it is suggested here that this risks either discouraging the early intervention of restructuring law and our goal of the dynamic allocation of capital to promote economic growth or a lack of control on value expropriation from junior classes in the capital structure and a consequent chill on the raising of finance for healthy companies. Accordingly, I would advocate Wishart's solution 'there is a continuum of regard for creditor interests from being one interest amongst many competing interests to being the prime consideration'.<sup>88</sup> As I have said, many scholars would not share this view. And the practical realities of a modern restructuring may accord creditors significant control rights which make it difficult for shareholders to feel that their residual rights are protected.<sup>89</sup>

**SHOULD CREDITOR RIGHTS BE STAYED WHILST RENEGOTIATION TAKES PLACE?**

I have already argued that Thomas Jackson's description of the role of law in imposing a collective procedure to deal with individual incentives for enforcement remains apposite for all insolvency law. Once the financial creditors have

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<sup>87</sup> Paterson 'Bargaining in Financial Restructuring' *Supra* n 58, 356-364.

<sup>88</sup> D Wishart 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323, 331 cited in A Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *The Modern Law Review* 665, 671.

<sup>89</sup> Skeel 'Creditor's Ball' *Supra* n 12.

determined that they no longer wish to support the firm each has an incentive to race to recover 'its' assets first, with the consequent dismemberment of the firm and the loss of overall wealth. It is therefore an essential feature of insolvency law that a moratorium is imposed if the business is to be realised as a going concern.

The same inescapable logic does not apply to restructuring law. On the one hand, precisely because restructuring law often deals with the situation in which creditors wish to remain invested in the firm but face coordination challenges in renegotiating their bargain, restructuring law may be able to function without the imposition of a stay. Thus English law has operated effectively throughout the recent financial crisis without the option of a stay in a scheme of arrangement. On the other hand a stay may perform useful functions in a restructuring scenario. In the first place, whilst I have argued that Jackson's vision of a group of creditors who would prefer an enforcement sale is often not present in a modern restructuring, it may be that a minority of creditors have their own reasons for preferring it which may be quite idiosyncratic and which will not result in maximising capital allocation. Whilst it is not the case that individual incentives for enforcement will always arise in a restructuring scenario, they may arise in certain circumstances and thus restructuring law may wish to borrow insolvency law's solution of a moratorium. Furthermore, one of the challenges for restructuring law is minimising the time taken to renegotiate (and thus the 'inefficient holding pattern' and increasing transaction costs which will reduce the amount of capital ultimately put to work in the economy) in circumstances where the business has not yet run out of cash and so is apparently able to continue to function. In the language of the market this is known as the 'lack of a burning platform'. Essentially, without a liquidity crisis in which stakeholders cease to be paid, conditions are not created in which they are incentivised to reach a new bargain. This difficulty is heightened where distressed debt investors have bought into the debt of the company very cheaply. In these circumstances they may be able to bear quite some delay and cost to drive the bargain which they are looking for.<sup>90</sup> It is therefore common to declare that current payments due on debt will not be met until a new deal is agreed.

This is an uncomfortable position for management in those jurisdictions where restructuring law offers no moratorium. Their own legal position in deciding to cease payments may be difficult to analyse. It may be impractical to put in place a stay through contract, depending on the numbers of creditors involved, and in any event may be unjustifiably time-consuming or expensive. In this situation the imposition of a moratorium in restructuring law can potentially create the right commercial conditions to incentivise agreement and minimise time and cost, perhaps with safeguards (such as court approval or a time-limited

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<sup>90</sup> Harner *Supra* n 49, on concerns that the presence of distressed debt investors increases delay and cost. But see also Miller and Waisman *Supra* n 16, 181 for the concern that as the time value of money is very important to the distressed debt trader, they may be focused on exit from the Chapter 11 case and realisation of their investment rather than full rehabilitation of the debtor.

approach) to deal with the risk of providing an unfair competitive advantage to early-stage distressed firms.

### **HOW IS THE BUSINESS TO BE FINANCED WHILST THE RESTRUCTURING IS NEGOTIATED?**

This problem is common to both insolvency and restructuring. In insolvency the question arises as to how the process is to be funded whilst efforts are made to maximise sale proceeds. In a restructuring, on the other hand, the question arises in the context of the restructuring negotiation. Still, the quality of the problem may be different. Ultimately, in an insolvency situation it is likely to be necessary to sell the business relatively quickly, because of other pressures including the difficulties of keeping the stakeholders in a failed business actively engaged with it and the costs of the process which can only ever diminish returns. This may not be the case for a ‘run down’ strategy in which the business is to be run down over time but a business susceptible to this strategy is likely to be throwing off cash which can be used to fund it. In a restructuring, in contrast, it may be necessary to fund the business for some time whilst negotiations continue. Restructuring may create a credit spiral meaning that the company has to look for additional source of funds providing opportunities for distressed debt investors to obtain control in return for cash.<sup>91</sup>

In the US the solution to this problem has been the availability of DIP finance.<sup>92</sup> Originally, DIP finance was a profitable activity for a number of finance houses. More recently, it has been the method by which secured creditors have exerted control over the Chapter 11 case.<sup>93</sup> In the UK, the challenge has been met by clear signalling to trade creditors that the restructuring involves only financial creditors<sup>94</sup>, coupled with ad hoc loans obtained from creditors who have been afforded super priority with consent. The question, however, of whether a DIP finance regime would be of value in the UK is likely to enter back onto the agenda as the law's role in restructuring increases.

### **PRIVATISATION OF BANKRUPTCY**

In comparatively recent times, a significant strand of scholarship has grown up in the US arguing for ‘privatisation of bankruptcy’; in other words, that contract law could provide an effective substitute for what I have called ‘the law of corporate

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<sup>91</sup> Harner *Supra* n 49, 728; Miller and Waisman *Supra* n 16, 182-3.

<sup>92</sup> *Ibid* 735 for a pithy description of DIP financing.

<sup>93</sup> Skeel ‘Creditor’s Ball’ *Supra* n 12, 924-5; Miller and Waisman *Supra* n 16, 185.

<sup>94</sup> See, for example, the press release issued by Hibu during its recent restructuring process dated 27 November 2013 available at <http://corporate.hibu.com/en/news/news-releases/2013/27-11-2013> (accessed on 27 April 2014).

distress'.<sup>95</sup> Whilst this remains controversial in the area of what we might call 'full insolvency' in which the interests of many different stakeholders are implicated, in the types of debt restructuring with which this paper is concerned sophisticated financing documents will be negotiated which will seek to specify how control rights are allocated and controlled in default.<sup>96</sup> A number of US scholars have taken up this argument arguing that, chapter 11 is 'no longer a negotiated process among classes of creditors'.<sup>97</sup> Baird has described how investors 'allocate control rights among themselves through elaborate and sophisticated contracts that already anticipate financial distress'. He has suggested that the presence of these contracts renders a law of corporate reorganizations largely unnecessary.<sup>98</sup> We might, therefore, argue that the law should do no more than respect these contractually negotiated control rights; that, in effect, this is an area ripe for 'privatisation' and that we do not need restructuring law at all.<sup>99</sup>

But there will always be a need for restructuring law as an option for those creditors who do not enter into contracts. Skeel, for example, has noted the impossibility of privatisation if there are outside shareholders.<sup>100</sup> And disputes will arise over the contracts which will require consideration of many of the issues which have been discussed above. But most significantly of all, restructuring law casts an explicit shadow under which bargains are negotiated. Thus the negotiating power of the creditors *ex ante* will often depend in part on the legal default rules. Senior lenders will argue that they are not creating new rights, merely reflecting the law on the books. Thus what that law on the books is becomes a critical lever in agreeing negotiated rights. In the UK we have a good example of this. In the early stages of the Great Recession, attempts were made in 'model form' intercreditor agreements in the market to cement firmly a market price approach to valuation on a restructuring. As case law became more equivocal on the correct approach, and the market price/value choice was better understood, this express reliance on one approach was replaced in the model form with options for the parties to select between. In other words, the model form sought to reflect the law rather than to impose a market solution which existed independently of the law.

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<sup>95</sup> R Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 *Texas Law Review* and A Schwartz, 'A Contract Theory Approach to Business Bankruptcy'. For a good overview and more comprehensive references to the extensive literature see S. Block-Lieb, 'The Logic and Limits of Contract Bankruptcy' (2001) *University of Illinois Law Review*, 505 and fn 7 and 8.

<sup>96</sup> Baird and Rasmussen 'The Missing Lever of Corporate Governance' *Supra* n 50, 1247.

<sup>97</sup> S Lubben, 'The "New and Improved" Chapter 11' (2005) 93 *Kentucky Law Journal* 839, 842.

<sup>98</sup> Baird and Rasmussen, 'The End of Bankruptcy' *Supra* n 24, 755.

<sup>99</sup> Miller and Waisman *Supra* n 16, 191-2.

<sup>100</sup> Skeel 'An Evolutionary Theory' *Supra* n 21, 1391 fn 266.

## CONCLUSION

Although many scholars would disagree with Thomas Jackson's vision of bankruptcy law as adistributional, most would subscribe to his conception of insolvency law as solving the common pool problem or 'Prisoner's Dilemma'. I have suggested that this unifying theory of insolvency law (as opposed to restructuring law) in dispersed creditor economies remains as true today as it did when Thomas Jackson was writing in the 1980s.

However, I have suggested that this is not the principal objective of restructuring law, which is rather concerned with solving the deadlock position of creditors unable to agree to a new bargain. And in drawing this distinction between insolvency law and restructuring law I have suggested a new jurisdictionally neutral umbrella term of 'the law of corporate distress' and have emphasised a different aspect of Thomas Jackson's theory as the unifying feature of all of the law of corporate distress – facilitating the allocation of capital to best use in the economy. I have explained how insolvency law and restructuring law each respond to this problem and why, in the main, different issues arise in each context. I have highlighted the need for US lawyers to consider whether US restructuring law, which was conceived in a different finance market, effectively responds to these issues today and for English lawyers to consider whether English law, which has adapted legal tools designed for insolvency to achieve restructuring, explicitly responds to these issues at all.