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The adaptive capacity of markets and convergence in law: UK high yield issuers, US investors and insolvency law

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The Significance of the Adaptive Capacity of Markets for Prospects of Convergence in Law: UK High Yield Issuers, US Investors and Insolvency Law.

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This article examines something of a puzzle: increasing access by UK issuers of high yield bonds to US investors notwithstanding substantive differences in the approach to valuation of the issuer in financial distress in US and UK restructuring law and, therefore, in anticipated return on default. It examines the development of the market in the context of existing theories on the relationship between law and finance and suggests that previous accounts have overlooked the adaptive capacity of the finance market to legal environment and the implications of such structural adaptation for the prospects of convergence in law. Three states are identified: a state in which the market is poorly adapted to the legal environment and reinforces other pressure for change, a state in which the market is adapted to the legal environment and is a neutral influence on, or even dampens, other pressure for change and a state in which both legacy and adapted structures exist, potentially pulling in different directions at the same time.

Keywords: Financial restructuring, convergence in law, high yield bonds, Rubin v Eurofinance SA, Chapter 15, Rule 144A and Rule 10b-5

INTRODUCTION

US corporates have traditionally relied on debt raised in the capital markets to a significantly greater extent than UK corporates. Sources suggest that US borrowing has been split roughly 70:30 in favour of the debt capital markets, compared with an almost diametrically opposed split 30:70 in the UK in favour of bank debt.[1] However, following the most recent financial crisis there is increasing evidence that this picture may be changing. European banks face economic, political and regulatory

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[1] Bank of England, Trends in Lending, 2013 available at http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx (last accessed 18 July 2014)

challenges which make them unreliable as the sole source of finance for corporate Britain. Private equity sponsored businesses rely on leverage levels which may be unachievable in post-recession loan markets and cheaper institutional money may be accessible through the debt capital markets.[2]

One aspect of the changing nature of UK debt markets is an increase in the number of high yield bonds issued by UK issuers available for purchase by US investors. A high yield security is a bond which is rated less than 'investment grade' by credit-rating agencies. Credit-rating agencies assess the likelihood that a company will default on its debt. Where the risk of default is low, the credit-rating agency will provide what is known as an investment grade credit rating for the bond. Where the risk of default is higher, the credit rating will be below investment grade and investors will expect a higher interest rate and yield on their investment to compensate for the higher risk. There are a number of levels of rating and the high yield universe covers a reasonably wide spectrum, from bonds rated just below investment grade to much riskier bonds which have lost their credit rating entirely. [3]

A UK issuer seeking to issue securities for sale in the US market will normally make a so-called Rule 144A offering.[4] Rule 144A provides a means for foreign issuers to offer securities for sale to sophisticated investors in the US without becoming subject to all US securities laws requirements for public offerings.[5] It is popular as a means of persuading European investors that they will be able to access the US secondary market in trading the securities which they purchase.[6] The fact that a Rule 144A offering is included and that the bond is governed by New York Law does not, of itself, give any

[2] See AFME Annual Review 2013 and 'Unlocking Funding for European Investment and Growth' commissioned by AFME from Oliver Wyman June 2013 both available at http://www.afme.eu/ (last accessed 18 July 2014)
[3] For a description see Standard & Poor’s Financial Services LLC, High Yield Bond Primer (2014) available at http://www.highyieldbond.com/primer/ (last accessed 18 July 2013)
[4] Under Section 5 of the Securities Act of 1933, all offers and sales of securities must be registered with the SEC or qualify for some exemption from the registration requirements. Rule 144A is promulgated under the Securities Act of 1933 and provides an exemption and permits the public resale of securities if a number of conditions are met, including how long the securities are held, the way in which they are sold, and the amount that can be sold at any one time
[5] See J.A. Fanto and R.S. Karmel ‘A Report on the Attitudes of Foreign Companies Regarding a US Listing’ Stanford Journal of Business and Finance 1997, 54-55
[6] For the benefits of accessing US capital markets, *ibid* 52

indication of the number of purchasers who will actually be based in the US.[7] But even if the initial purchasers are all based in Europe, European investors demand access to the US secondary market when purchasing securities as a source of liquidity and financial advisers advising on the terms of issues are therefore focused on delivering a product which will be attractive to US investors.[8] The Rule 144A offering seeks to assure investors that a broad and deep market will be available to purchase the securities, should they decide to sell.

In addition to liquidity concerns, the investor is also likely to be focused on the possibility that the issuer will not be able to meet all of its debt obligations (the risk of default) and on the extent to which the investor's value will be preserved in any subsequent debt restructuring. In the 1990s, a group of scholars suggested that strong laws for minority shareholder protection needed to be in place within a jurisdiction before dispersed equity capital markets could develop (in short 'law matters').[9] Extrapolating the 'law matters' thesis from the relationship between corporate governance protection for shareholders and equity capital markets to the relationship between valuation protection for creditors and debt capital markets, we might expect that sufficient valuation protection would need to be provided by the laws of a jurisdiction before a high yield market can develop within it. Yet, as this article will show, a high yield market has been able to develop in the UK notwithstanding a somewhat hostile approach to preservation of bondholder value.

[7] It merely enables the securities to be purchased by investors in the US but where the securities are offered for sale in the US and in other jurisdictions it gives no indication of how many investors in each jurisdiction will purchase

[8] For the role of the secondary market in providing liquidity see V. Bencivenga, B. Smith and R. Starr, 'Liquidity of Secondary Capital Markets: Allocative Efficiency and the Maturity Composition of the Capital Stock' (1996) 7 Economic Theory 19. For the importance of US investors as a source of liquidity for bonds issued by European issuers see G. Yago and S. Trimbath, *Beyond Junk Bonds: Expanding High Yield Markets* (Oxford University Press, 2003), 89 and A. Huang, A. Guoming, M. Kalimipalli, N. Subhankar and L. Ramchand 'Pricing of International Private Debt: Evidence from the US 144A Secondary Bond Market' (13 July 2014) Asian Finance Association 2014 Conference Paper available at http://ssrn.com/abstract=2298671 (last accessed 2 December 2014)

[9] R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny. 'Legal Determinants of External Finance' (1997) 52 Journal of Finance 1131; R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny 'Law and Finance' (1998) 106 Journal of Political Economy 1113; R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny 'Corporate Ownership Around the World' (1999) 54 Journal of Finance 471. The 'law matters' phrase was coined by JC Coffee see JC Coffee , 'The Future as History: Prospects for Global Convergence in Corporate Governance and its Implications' (1999) 93 NW U.L. Rev 641, 644

This would appear to support those who have doubted the causal relationship between law and the development of capital markets proposed by the 'law matters' theorists. Thus a new case study emerges, examining the relationship between insolvency law's valuation regime and the development of high yield capital markets. In particular, we will be interested in those who have recognised the link between law and equity capital markets but have suggested a reverse causality.[10] Some of these scholars have questioned whether a desire to access equity capital markets fuelled *ex post* convergence in corporate governance standards, specifically convergence around a US model as foreign firms accessed the equity capital markets of the US for fund raising. As UK issuers increasingly seek access to US investors in high yield debt, similar questions arise as to the prospects for convergence in the UK valuation standard towards the US model. In seeking to address these questions, this article will find that none of the existing evolutionary theories provides a complete answer, and a new account will emerge of adaptation by the finance market to legal environment.

The article is organised as follows. Part 1 considers very broadly the existing evolutionary theories relevant to the account. Part 2 examines the development of the high yield securities market in the UK in the context of these theories and reveals a new account of adaptation in the high yield market to legal environment. Part 3 considers the significance of this adaptation in the finance market for the prospects of convergence between the approaches of English and US law to valuation in distress. Part 4 touches on the interaction between the high yield market and other influences on the law. The article then concludes, and a synthesis of existing evolutionary theory and the adaptive account in this article is attempted as a framework for future work on convergence between law and finance in developed economies.

THEORETICAL OVERVIEW

The purpose of this section is to provide the reader with a high level overview of existing evolutionary theories which take, as their starting point, other questions of law and finance and

[10] See text to n 23 below

which this article will examine in the context of high yield markets and valuation. As we have already touched upon, much of this work is focused on the relationship between the depth and strength of a country's equity capital markets and minority shareholder protection. Some scholars have attempted to explore the relationship between the depth and strength of debt markets in a jurisdiction and its insolvency laws,[11] but hitherto, with one notable exception, this work has looked at the general condition of credit markets and has tended to take a high level approach, in order to enable comparisons between a large numbers of jurisdictions,[12] or, alternatively, has focused on developing or transition economies.[13] In contrast, this article will be concerned with a specific condition in two highly developed economies.

The notable exception is research which has sought to investigate the link between corporate governance in insolvency and ownership structure. In 1998 David Skeel published work suggesting that there was a strong link between widely dispersed share ownership and 'manager- driven' insolvency procedures and between concentrated share ownership and 'manager- displacing' insolvency procedures. [14] The US conformed to this pattern but the UK appeared to be an anomaly as it had an established, widely dispersed equity capital market but a 'manager-displacing' insolvency regime. John Armour, Brian Cheffins and David Skeel subsequently sought to solve this puzzle, suggesting that the missing link was the nature of the credit market in the jurisdiction.[15] Specifically, they proposed that a concentrated credit market was consistent with a 'manager-displacing' insolvency procedure, whilst a dispersed credit market was consistent with a 'manager-

[11] For a good overview see R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46 Journal of Economic Literature 285, 299

[12] See, for example, S. Djankov, C. McLiesh and A. Shleifer, 'Private Credit in 129 Countries' (2007) 84 Journal of Financial Economics 299

[13] See, for example, R. Haselmann, K. Pistor and V. Vig, 'How Law Affects Lending' (2010) 23 The Review of Financial Studies 549; S. Visaria, 'Legal Reform and Loan Repayment: the Microeconomic Impact of Debt Recovery Tribunals in India' (2009) 1 American Economic Journal 59; A. Musacchio, 'Can Civil Law Countries Get Good Institutions? Lessons from the History of Creditor Rights and Bond Markets in Brazil' (2008) 68 The Journal of Economic History 80

[14] DA Skeel Jr, 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vanderbilt Law Review 1325

[15] 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

driven' insolvency procedure.[16] They suggested that movement towards a more dispersed creditor economy in the UK may drive convergence with US 'manager-driven' governance in insolvency.[17]

In the event, significant evolutions in the debt markets and restructuring practice on both sides of the Atlantic mean that Skeel's original classification of insolvency regimes as 'manager-displacing' or 'manager-driven' requires some amendment to reflect current reality and, consequently, Armour, Cheffins and Skeel's piece (which built upon it) also requires updating. The limited space in this article will not permit a full analysis which would do justice to the original work and that will have to wait for another day. One point, though, will be worthy of note and we will come back to that later in this article. The analysis begins, however, with the initial condition of the high yield market and the 'law matters' thesis.

In a 1997 paper, La Porta, Lopes-di-Silanes, Shleifer and Vishny advanced a specific theory on the relationship between law and equity capital markets.[18] A number of papers followed and in a 2008 review of the extent to which the theory had stood the test of time, three of the authors neatly summarised it as follows:

1. Legal rules and regulations differ systematically across countries, and those differences can be measured and quantified
2. These differences in legal rules and regulations are accounted for to a significant extent by legal origins
3. The basic historical divergence in the styles of the legal traditions – the policy implementing focus of civil law versus the market supporting focus of common law – explains why legal rules differ
4. The measured differences in legal rules matter for economic and social outcomes.[19]

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[16] *ibid* 1770-1772
[17] *ibid* 1774-1776
[18] La Porta *et al* 'Legal Determinants of External Finance' n 9 above
[19] La Porta, Lopez-de-Silanes and Shleifer n 11 above, 326

As with many generalised legal theories, the work has proved controversial. Some opponents have debated whether what La Porta *et al* describe as 'legal origin' is in fact a proxy for something else, most notably the influence of political institutions.[20] Building on this theme, others have taken issue with whether what emerges is ‘continent-wide evolutions, arguably linked to the process of capitalist development' rather than development linked to country-specific features.[21] Other scholars have queried aspects of the legal origin theorists’ methodology,[22] and, as discussed below, there have been a number of challenges to the legal institutional account. For present purposes, however, we are concerned not so much with the 'legal origin' controversy but rather with the objection of 'reverse causality'.

Scholars who take issue with the 'law matters' thesis on the grounds of reverse causality argue that it is not that the case that the right legal conditions need to be in place in order for markets to develop, but rather that countries improve their laws protecting investors as their financial markets develop, perhaps under political pressure from those investors. Cheffins and Coffee have argued that contrary to the account of the 'law matters' theorists, in the early stages of its development the English market offered only weak protection for minority equity investors but that other factors encouraged the emergence of a modern securities system which in turn drove change.[23] This

[20] L. Zingales and R.G. Rajan, 'The Great Reversals: The Politics of Financial Development in the Twentieth Century' (2003) 69 Journal of Financial Economics, 5 referred to in J. Sgard, 'Do Legal Origins Matter?: The Case of Bankruptcy Laws in Europe 1808 - 1914' (2006) 10 European Review of Economic History 389. And see an extensive body of work by Mark Roe, for example M. J. Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 Harvard Law Review 641; M.J. Roe, 'Backlash' (1998) 98 Columbia Law Review 217; M.J. Roe, 'Corporate Law's Limits' (2002) 31(2) The Journal of Legal Studies 233; M.J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (Oxford University Press 2006); M. J. Roe, 'Legal Origins, Politics, and Modern Stock Markets' (2006) 120 Harvard Law Review 460

[21] *ibid* Sgard, 409-410, in the context of the development of bankruptcy law in Europe

[22] M. Graff, 'Law and Finance: Common Law and Civil Law Countries Compared - An Empirical Critique' (2008) 75 Economica 60; B. Ahlering and S. Deakin, 'Labor Regulation, Corporate Governance, and Legal Origin: A Case of Institutional Complementarity?' (2007) 41 Law & Society Review 865, 866 n 1; Djankov, McLeish and Shleifer n 12 above, 300

[23] B.R. Cheffins 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2003) 23(1) Oxford Journal of Legal Studies 1; J. C. Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2001) 111 The Yale Law Journal 1, 7, 24-25, 60, 65. See also JL Rosenthal and N.R. Lamoreaux, 'Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of industrialization' (2005) 7 American Law and Economics Review 28, 44 discussing the weak position of minority shareholders in the US in the nineteenth century. But see also La Porta *et al* n 11 above, 319, challenging Cheffins’ analysis.

question of the causal relationship between legal condition and capital markets will be significant in the examination of the development of the high yield market in the UK, given the profoundly different approach to valuation of the firm in restructuring law from that prevailing in the US.

The debate also embraces a further distinction of some importance: the distinction between functional and formal convergence. If markets converge functionally, then it may be possible for them to operate in a substantively similar way, notwithstanding persistent differences in the law.[24] Coffee has provided a specific example of functional convergence in equity capital markets. In his study of cross-border convergence in corporate governance protections for minority shareholders, Coffee pointed to the fact that in accessing US equity capital markets issuers became contractually bound by the corporate governance requirements of US securities laws.[25] Whilst a regulatory contract is not of explicit interest in the context of valuation standards on default of a high yield bond issue, possible convergence in valuation standard through the complex finance documents negotiated for the issue will be. Coffee's examination of the securities laws liabilities issues with a US listing will also feature in the account. As UK issuers of high yield bonds access the US debt capital market via a Rule 144A offering, potential US securities laws liability will be implicated and we will consider the extent to which this may cause UK issuers to adopt US valuation standards in default even in the absence of a strict legal requirement to do so.

Others, though, have doubted how far functional convergence can go. Cheffins has highlighted, in the corporate governance context, the costs involved in a dual listing (which may act as a deterrent for some companies) and the limitations of minority shareholder protection through the regulatory contract, given the ongoing influence of local courts.[26] Indeed, Coffee has noted some limits to his own account of functional, as opposed to formal, convergence.[27] Formal convergence involves the

[24] R. J. Gilson 'Globalising Corporate Governance: Convergence of Form or Function' (2001) 49 The American Journal of Comparative Law 329
[25] *ibid* 694
[26] Cheffins 'Bedrock' n 23 above, 15
[27] Coffee n 9 above, 65-82

substantive harmonisation of laws and thus avoids some of the challenges left unsolved by functional convergence.[28] A number of scholars have argued that institutional persistence and path dependency militate strongly in favour of limited change in law, even where the legal regime which has emerged has significant defects.[29] This may be because of the enormous expense involved in abandoning a legal regime which has developed in a particular area, because many of the actors involved in the area have invested heavily in understanding how to operate within the status quo and because particular interest groups may have a vested interest in resisting change.[30] They have suggested, however, that outside shocks may prompt change, '… institutions which may appear fixed, because of their persistence over time, may well be destabilised, in their turn by unpredictable external shocks, or through internally generated tensions or "incoherencies"'.[31] Borrowing from evolutionary theory they identify institutional change characterised by 'punctuated equilibrium' – periods of relative statis giving way at 'critical junctures' to phases of accelerated development.[32] If functional convergence is limited or lacking, we might nonetheless discover high water marks prompting formal convergence in law.

Finally, another line of enquiry from scholars investigating the evolution of the law more generally is worthy of mention. These scholars have investigated why parties choose to litigate, as opposed to settle, and the contribution of judicial decisions to evolution in the law.[33] Armour, Cheffins and

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[28] Gilson n 24 above, 342-345
[29] See, for example, Roe 'Chaos and Evolution' n 20 above; Gilson n 24 above, 334; Aherling and Deakin n 22 above, 870; L.A. Bebchuk and M.J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127
[30] *ibid.* See also M. Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (Yale University Press, 1982) and H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 Georgetown Law Journal 439, 453
[31] Ahlering and Deakin n 22 above, 280
[32] *ibid.* See also Roe 'Chaos and Evolution' n 20 above, 643, 658-663
[33] See, for example, W.M. Landes, 'An Economic Analysis of the Courts' (1971) 14 The Journal of Law and Economics 61; R.A. Posner, 'An Economic Approach to Legal Procedure and Judicial Administration' (1973) 2 The Journal of Legal Studies 399; J.P. Gould, 'The Economics of Legal Conflicts' (1973) 2 The Journal of Legal Studies 279; P.H. Rubin, 'Why Is the Common Law Efficient?' (1977) 6 The Journal of Legal Studies 51; W.M. Landes and R.A. Posner, 'Adjudication as a Private Good' (1979) 8 The Journal of Legal Studies 235; R.Cooter and L. Kornhauser, 'Can Litigation Improve the Law without the Help of Judges?' (1980) 9 The Journal of Legal Studies 139; R. Cooter, S. Marks and R. Mnookin, 'Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior' (1982) 11 The Journal of Legal Studies 225; L.A. Bebchuk, 'Litigation and Settlement Under

Skeel have noted that 'English corporate insolvency law has developed through bursts of legislative activity interspersed with incremental development by the judiciary'.[34] This is a theme to which this article will return.

HISTORY OF DEVELOPMENT OF THE UK HIGH YIELD SECURITIES MARKET AND ENGLISH INSOLVENCY LAW

High yield debt originally developed in the US as financing for so-called 'fallen angels' – companies which had recently lost their investment grade status.[35] However, during the mergers and acquisition boom of the 1980s, led in part by Michael Milkin and the team at Drexel Burnham Lambert, a market developed for high yield debt issued as part of the financing for takeover activity. Moreover, companies which had never had an investment grade rating began to access the market.[36]

Towards the end of the 1990s a small high yield market began to develop in Europe, driven in part by reduced government bond yields, European Monetary Union,[37] and a lower cost of credit risk worldwide.[38] Developments in UK tax also encouraged the increased use of debt rather than equity.[39] As acquisition size grew, high yield bonds offered lower pricing and greater debt-raising capacity. At this stage, high yield debt was generally 'junior' debt – that is subordinated in right of payment on insolvency to senior debt. Yet its development in the UK was not precluded by the lack of a single restructuring regime, which clearly tackled how companies were to be valued in the event

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Imperfect Information' (1984) 15 The RAND Journal of Economics 404; R.D. Cooter and D.L. Rubinfeld, 'Economic Analysis of Legal Disputes and Their Resolution' (1989) 27 Journal of Economic Literature 1067; J.S. Johnston, 'Uncertainty, Chaos, and the Torts Process - An Economic Analysis of Legal Form' (1991) 76 Cornell Law Review 341; P.H. Rubin, 'Micro and Macro Legal Efficiency: Supply and Demand' (2005) 12 Supreme Court Economic Review 19

[34] Armour, Cheffins and Skeel, n 15 above, 1736

[35] Yago and Trimbath n 8 above, 12

[36] See definition of 'Junk bond' in P. Moles and N. Terry, *The Handbook of International Financial Terms* (New York: Oxford University Press, 1999) , 309 referred to in Yago and Trimbath *ibid*, 224

[37] Although, of course, this development of a unified European corporate bond market arising out of the integration of European currencies into the Euro did not apply in the UK which retained the British pound.

[38] Yago and Trimbath n 8 above, 84-87

[39] *ibid,* 87

of a reorganisation as opposed to a corporate sale. Yago and Trimbath have argued that the key contribution which the high yield market has made to the capital markets is in separating good risks from bad risks through liquidity and an active secondary market, monitoring firm performance closely and restructuring the capital structure between investors if the firm faces financial distress.[40] Financial distress, as opposed to economic distress, occurs when the firm's capital structure is no longer appropriate for its balance sheet and must be adjusted.[41] If a financially distressed business is to be reorganised, rather than sold, then as Clark explains not only is it necessary to determine whether the value of the business as a going concern exceeds the value which would be received if it were to be liquidated, but:

Some finite value had to be placed on the whole business. Otherwise, there would be no way of telling where, down the contractually created ranks of creditors and preferred shareholders, it was fair to stop issuing shares and other claims in the newly organised entity owning the business.[42]

As the high yield securities market began to develop in the US, there was already a developed restructuring law which tackled these questions. By contrast, the UK had no single restructuring procedure with clearly articulated principles for dealing with questions of value.[43] Yet despite this apparent uncertainty a high yield market began to develop in the UK as the 1990s progressed. One explanation may be that investors were investing more by reference to the probability of default than the return on investment if a default occurred.[44] Another plausible explanation, which echoes Mark Roe's note of caution about extending theories on the relationship of widely dispersed equity

[40] *ibid*, 120
[41] D.G. Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108 The Yale Law Journal 573, 581-582
[42] R.C. Clark, 'The Interdisciplinary Study of Legal Evolution' (1981) 90 The Yale Law Journal 1238, 1252
[43] For a more detailed description see S Paterson 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Sanctions' (2014) 14(2) Journal of Corporate Law Studies 333, 345-355
[44] See D.J. Wright and F.K. Reilly, 'An Analysis of Credit Risk Spreads for High Yield Bonds' (2010) 35 Review of Quantitative Finance and Accounting 179, 190

markets and the law too far beyond developing and transition economies,[45] is that whilst investors need a certain level of comfort with the legal system in a jurisdiction in order to begin to invest, in the early days of a nascent market that level of comfort and familiarity with the detail of the legal system need not be very great.

This explanation receives some support from another significant difference in the ways in which the market was to develop in these early years. On both sides of the Atlantic, the most senior part of the capital structure was generally bank debt, usually comprising a term loan and a revolving credit facility.[46] Although Kaplan and Stein have recorded a decline in the ratio of bank to bond debt in the US throughout the 1980s, bank debt remained a significant proportion of the capital structure.[47]

In the US at this time high yield bonds were traditionally contractually subordinated to senior indebtedness.[48] This meant that the borrower of the senior debt was also the issuer of the subordinated debt and once the senior creditors had been paid, the holders of the subordinated high yield debt would have access to the residual proceeds of the assets. In the UK, lending banks were extremely wary about the arrival of the high yield note holders in the market. The noteholders were an anonymous group, highly fragmented and difficult to locate. The debt could be expected to trade widely, particularly if a default were in prospect, leading to conflicting agendas between creditors.[49] Moreover, bondholders were unlikely to regard themselves bound by the so-called London Approach which still operated in the London market at the time and which established a

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[45] Roe, 'Corporate Law's Limits' n 20 above, 233-234
[46] S.N. Kaplan and J.C. Stein, 'The Evolution of Buyout Pricing and Financial Structure in the 1980s' (1993) 108 The Quarterly Journal of Economics 313, 330
[47] *ibid* 330. Kaplan and Stein find that bank debt represented over 70 per cent of total debt in 1982 to 1984 but that in 1985 it drops to 42 per cent of all debt and after that the ratio stabilises, ranging between 52 and 57 per cent from 1986 to 1989.
[48] Yago and Trimbath n 8 above, 90
[49] For the arrival of US investors in the UK market see Paterson n 43 above, 337-345; V. Finch, 'Corporate Rescue in a World of Debt' (2008) Journal of Business Law 756; V. Finch, 'The Dynamics of Insolvency Law: Three Models of Reform' (2009) 3 Law and Financial Markets Review 438 and J. Flood, 'The Vultures Fly East: The Creation and Globalisation of the Distressed Debt Market' in *Adapting Legal Cultures* D Nelken and J Feest (eds) (Oxford: Hart, 2001)

principled approach as to how lenders were expected to behave when a UK corporate experienced financial distress.[50]

The UK banks were still providing much of the senior debt in the capital structure of many highly leveraged corporates in the English market. As a result of their concerns, they insisted on structural subordination of the high yield bond, as well as contractual subordination. This meant that the bond was issued by a holding company of the borrower of the senior debt, without the benefit of the security or guarantee package provided by the operating companies for the senior debt, effectively placing the high yield bondholders further away from the assets than the trade creditors.[51] This structure was highly unpopular and there were signs that it was actively holding back development of the high yield market in the UK and in Europe more generally. The crisis came to a head in 2002 when greater losses on defaults in Europe than in the US brought home to investors the risks of structural subordination. High yield investors organised and boycotted European issuances for a number of months.[52] Although the boycott was a fragile one, it was enough to force a gradual change in stance by UK banks who increasingly allowed high yield security holders to take subordinated guarantees and asset security from operating companies. Ultimately, it was the arrival of the US bondholders as a significant source of capital which acted as the catalyst for change.

Early restructurings of high yield bonds by UK companies were to pass without significant surprise for the market. In 2002 the British cable group NTL announced that it had reached agreement in principle with an unofficial committee of its public bondholders on a comprehensive recapitalisation. The proposal involved a significant debt-for-equity swap, with only certain warrant rights allocated to equity. But crucially the restructuring was implemented using a pre-negotiated Chapter 11 plan

[50] For a description of the London Approach at this time see J. Flood, R. Abbey, E. Skordaki and P. Aber *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach* (ACCA Research Report 45 1995) and J. Armour and S. Deakin, 'Norms In Private Insolvency Procedures: The 'London Approach' To The Resolution Of Financial Distress' (2001) 1 Journal of Corporate Law Studies 21
[51] Yago and Trimbath, n 8 above, 90-91
[52] J Hickley 'Structural Subordination Struggle' European Venture Capital and Private Equity Journal 1 April, 2003. See also Yago and Trimbath n 8 above, 90

and followed a pattern of negotiation entirely familiar to the US bondholders.[53] Matters were to turn out a little differently, however, when MyTravel, a UK-based holiday company listed on the London Stock Exchange, sought to implement a restructuring of its bank and bond debt through the English courts.[54] In an attempt (ultimately successful) to persuade its bondholders to agree to a consensual, out-of-court restructuring, MyTravel proposed a scheme of arrangement pursuant to which senior lenders would receive a significant equity allocation in a new company in exchange for their debt. The new company would acquire all of the business and assets of MyTravel in consideration for this debt exchange and would offer to acquire bondholders' debt in exchange for a limited amount of equity. Bondholders who refused would find themselves stranded in the old company – now devoid of any assets to meet their claims.

The MyTravel case was to bring home to US investors in debt securities issued by UK issuers just how different the legal regimes were on either side of the Atlantic. In a Chapter 11 restructuring, equity and creditors are divided into classes for the purposes of voting on the plan, with creditors similarly situated in the capital structure voting together. Provided at least one class whose rights will be 'impaired' by the plan votes in favour of it, the bankruptcy judge may confirm the plan against the wishes of other dissenting classes provided the plan meets, amongst other things, the requirements of the 'best interests' test and the 'absolute priority rule'.[55] The first of these requires that the class is no worse off under the plan than they would be in liquidation.[56] In many cases this will not provide significant protection to holders of debt or equity securities issued by financially distressed businesses whose value in the market may be severely depressed.[57] The second test provides a

[53] 'NTL buys more time Cable group could file for Chapter 11 despite £8bn debt deal' John Cassy The Guardian 2 April 2002. See also Yago and Trimbath n 8 above, 91-92
[54] *Mytravel Group Plc, In the Matter of the Companies Act 1985* [2004] EWHC 2741 (Ch)
[55] Section 1129(a)(7) and section 1129(b) of the US Bankruptcy Code respectively
[56] For a more detailed description see R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornberg, S. Paterson, D. Singh and H. Stonefrost *Debt Restructuring* (Oxford University Press, 2011), 104
[57] Assuming that the restructuring is occurring because the business is over-leveraged (broadly, its value is less than the total amount of its debt) the current market price for the business and assets may indicate that the equity and/or the junior debt are 'out of the money'. However, there may be arguments that the current price available for the business and assets of a distressed business in the market undervalues it. For a more detailed description see Paterson n 43 above 348-353

more promising ground for challenge. The absolute priority rule requires that no class may recover under the plan until senior classes have recovered what they are owed.[58] But the corollary to this is that those in the senior class must recover no more than they are owed under the plan.[59] Where, as will often be the case, the plan involves a debt-for-equity exchange, junior security holders may argue that the senior class should not receive the entire equity allocation – otherwise, once the business or the market recovers, the senior lenders will recover more than they are entitled to under the absolute priority rule. This has been a fruitful area of litigation for junior stakeholders in the US, particularly as jurisprudence has developed to suggest that in assessing value for the purposes of a Chapter 11 valuation dispute, courts should look not only to the current market price for the business but also to valuation opinions.[60] These opinions are highly subjective and have given junior stakeholders a potentially useful weapon in defending their continued residual interest in the firm.[61] Scholars have suggested that the consequence of this legal regime is that creditors negotiating in the shadow of insolvency law in the US have been motivated to reach agreement without recourse to the full weight of a (lengthy, costly and unpredictable) Chapter 11 valuation fight, increasing the prospects that some consideration will be given to the junior class.[62]

When MyTravel came to court in 2004, the legal environment for junior security holders in the UK was far less hospitable than in the US. The UK courts had tended to focus solely on the counterfactual (what will happen if the restructuring is not agreed, typically a sale of the business and assets as a going concern or a sale of the assets on a break-up basis) such that restructurings were viewed through the lens of the current market price for the business and assets or, where a

[58] Olivares-Caminal *et al* n 56 above, 107, 3.80
[59] *ibid*
[60] Kerry O'Rourke, 'Valuation Uncertainty in Chapter 11 Reorganizations (Activism, Uncertainty, and Abuse: Current Issues in Bankruptcy Law)' (2005) 25 Columbia Business Law Review 403, discussed in Paterson n 43 above, 349
[61] *Ibid* Paterson 353-354, discussing in detail the challenges posed by the subjective nature of valuation opinions and referring to L. Enriques and J. R. Macey, 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules' (2001) 86 Cornell Law Review 1165 and L.A. Bebchuk and M. Kahan, 'Fairness Opinions: How Fair Are They and What Can Be Done about It?' (1989) 1989 Duke Law Journal 27. See also F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991), 206
[62] See D.G. Baird and D.S. Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2006) 115 The Yale Law Journal 1930, 1930

going concern sale was not regarded as feasible, the current market price for the assets on a liquidation sale.[63] This was not a promising battleground for the junior bondholders in MyTravel seeking to argue for a continued interest in the company.

The experience of US bondholders in the MyTravel case was to cause them to organise in a bid to press for change. The European High Yield Association (EHYA), a trade association representing investors in high yield bonds, made a number of specific proposals for a new English financial restructuring procedure in an open letter to the Insolvency Service. The EHYA proposed a court-supervised restructuring process involving a stay on enforcement actions, judicial resolution of disputes and a system of cram down.[64] Mindful perhaps of the powerful clearing bank lobby in the UK (as described above, likely to have lent in the senior part of the capital structure) the EHYA emphasised the benefits of cram down in preventing those who had no economic interest in the company from frustrating proceedings. Yet, at the same time, the EHYA proposal required judicial supervision and the prospect of US style valuation disputes hoved into view.

The Insolvency Service viewed the EHYA proposal as 'overriding many basic principles of insolvency law' and concluded in their reply to the EHYA that there was no evidence that the UK needed the EHYA procedure or that it was desirable.[65] But at the same time the English market was becoming more familiar with the issues at stake and the EHYA exchange did open up debate. In March 2009 what was then described as University College London's Institute of Bankruptcy, Restructuring and Insolvency hosted a roundtable entitled 'Is now the time for the UK to adopt a formal proceeding for restructuring distressed companies?' The event was attended by practitioners, academics, scholars, judges and, crucially, members of the Insolvency Service (an executive agency of the Department for Business, Innovation and Skills with responsibility for insolvency matters) who even went so far as to

[63] *ibid* and Paterson n 43 above, 344 -348
[64] Described in a reply from the Insolvency Service dated 8 May 2008 available at www.afme.eu/WorkArea/DownloadAsset.aspx?id=5097 (last accessed 18 July 2014) and discussed in Finch, 'The Dynamics of Insolvency Law' n 49 above, 439
[65] *ibid*

publish an official record of proceedings.[66] In June 2009 the Insolvency Service launched a consultation paper 'Encouraging Company Rescue' which sought views on proposals to enable all companies to apply for a court-sanctioned moratorium when proposing a Company Voluntary Arrangement (CVA) and plans to introduce US-style debtor-in-possession financing concepts.[67] Whilst these proposals were comparatively modest in scope compared with the EHYA proposals, when the Insolvency Service reported on responses to the Consultation in November 2009 they noted 'scepticism about the benefits of importing new measures drawn from the experience of other countries with very different histories and systems'.[68] Some respondents noted, in particular, the need for protections for secured creditors and, with respect to rescue financing, the principal concerns expressed were how the rights of existing fixed charge lenders would be protected, and what the effects of the proposals would be on broader lending to business in general, not just those in distress.[69] The Insolvency Service therefore announced proposals to press ahead with work on the moratorium idea but that plans to introduce rescue financing would not be taken forward.[70] In the event, however, even the moratorium concept was to run into the sand.[71]

This short history of attempts by the high yield community to lobby for legislative change is illuminating. Whilst the EHYA attempted to pitch their proposals as making only minor amendments to the status quo there can be no doubt that in reality the proposals required a radical overhaul of English insolvency law. Many scholars have noted that for major reform efforts to gain traction political institutions need to be prepared to ignore the blocking efforts of interest groups protecting existing arrangements.[72] In the case of the EHYA's efforts, it is perhaps unsurprising that in the struggle between opposing groups for limited resources the established senior secured clearing bank

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[66] Note of discussion available at http://webarchive.nationalarchives.gov.uk/20140311023846/http:/www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/policychange/Roundtable%20-%20Insolvency%20Discussion%20Record%2017032009.pdf (last accessed 18 July 2014)
[67] Insolvency Service *Encouraging Company Rescue - A Consultation* June 2009
[68] Insolvency Service *Encouraging Company Rescue - Summary of Responses* November 2009
[69] *ibid* 12-13
[70] Insolvency Service *Proposals for a Restructuring Moratorium - A Consultation* July 2010
[71] Insolvency Service *Proposals for a Restructuring Moratorium - Summary of Responses*, May 2011, 5
[72] Gilson, n 24 above, 336 n 26 ; Cheffins 'Bedrock' n 23 above, 2; Clark, n 42 above, 1255-6

lobby was to emerge victorious.[73] Furthermore, the EHYA proposals required significant expenditure comparatively soon after the Enterprise Act 2002 reforms had already purported to overhaul English insolvency law.[74] This led to only partial engagement by the Government with the reform agenda – bringing into play all of the challenges of piecemeal reform which Gilson has highlighted,[75] and Clark has noted a more subtle interplay in the evolutionary agenda – a need for lawyers 'intellectually blinded by the influence of their modes of legal thought' to shift their perspectives and embrace change.[76] Given the fledgling size of the high yield market, and the continued exposure of leading English lawyers to the old ways, it is perhaps not surprising that the market was not ready to shift its existing conceptual framework or value systems.

If formal convergence through legislative change was not to be, what was to be the impact of US bondholders on the development of English insolvency law in the cases emerging from the Great Recession? The answer is, relatively slight. As Landes and Posner have highlighted, a court system provides two types of service. One is resolution of the particular dispute between the parties. The second is what they describe as 'rule formulation' – creating rules of law through the process of dispute resolution.[77] The unanswered questions of valuation might have been expected to be a prime candidate for clarification in the recent recession. Ultimately, however, only one of the restructurings implemented through legal procedure, and involving subordinated debt, resulted in full, formal, legal challenge by junior creditors.[78] The result was neither to force change nor to clarify the status quo but rather to leave the principles by which the English court will decide a restructuring perhaps even murkier than they had been before. On the one hand, Mr Justice Mann definitely did not shut the door on arguments that a restructuring should not be judged solely by

[73] For the role played by the existing distribution of wealth and power between interest groups in the economy in enabling interest groups to mobilise and exert pressure, see Bebchuk and Roe n 29 above, 157-158.
[74] On cost and legislative reform see, for example, Gilson n 24 above, 345; Ahlering and Deakin n 22 above, 870 and Roe, 'Chaos and Evolution' n 20 above, 643
[75] Gilson n 24 above, 345
[76] Clark n 42 above, 1253
[77] Landes and Posner, 'Adjudication as a Private Good' n 33 above
[78] *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch); [2010] B.C.C. 209; [2010] 1 B.C.L.C. 338

reference to prices for the business currently available in the market but, on the other, he was unsympathetic to efforts by the junior lenders to adopt a less traditional approach to the valuation question and was willing to find in favour of senior lenders solely on the basis of submissions from Counsel and without cross-examination of the various experts in the case. It would be a brave bondholder who concluded that there had been any real formal convergence between US and UK restructuring law on valuation in the most recent downturn.

In his work on the evolution of the law through court precedent Johnston has argued that the number of cases which come to court is significant.[79] He argues that it is the very process of looking at exceptions to an apparently settled rule over a number of cases which leads judges to conclude that there may be deficiencies in the rule. Accordingly, an isolated challenge on difficult facts may not be expected to bring about radical change. Yet this does not explain why so few cases did, in fact, emerge particularly as challenges might have been expected not only from junior bondholders but also junior lenders in complex bank loan structures (with senior debt and other layers of debt subordinated (junior) to it).[80] Although a number of UK restructurings proceeded consensually, this cannot be a complete answer because in some the allocation to junior creditors was very small and in others junior creditors were effectively wiped out but chose not to mount a challenge.[81] Part of the explanation may emerge from the literature on why parties litigate. Many scholars have pointed to the importance of cost/benefit analysis in taking the decision to litigate.[82] As Posner notes, on the cost side, particular considerations arise in England as a result of the rule that the unsuccessful

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[79] Johnston n 33 above, 356

[80] Indeed, the case of *Re Bluebrook* (n 78 above) itself involved junior or 'mezzanine' bank debt rather than a bond

[81] See, for example, *Re McCarthy & Stone* [2009] EWHC 1116. At the first stage of proceedings, junior lenders had indicated that the companies' assets had been undervalued and that they planned to retain a valuer to produce a rival valuation. However, by the time of the final hearing Mr Justice Lewison commented (at [13]) 'that does not appear to have taken place but the companies themselves had a sample of assets revalued by CBRE, who came out with a lower value than that placed upon the assets by Gerald Eve'.

[82] Landes, 'An Economic Analysis of the Courts'; Gould, 'The Economics of Legal Conflicts'; Posner, 'An Economic Approach to Legal Procedure and Judicial Administration'; Bebchuk, 'Litigation and Settlement Under Imperfect Information' all n 33 above

plaintiff bears the other side's costs as well as his own.[83] Furthermore, although a number of scholars have sought to show that litigation is more likely where uncertainty prevails in the law,[84] Clark has highlighted that the risk that litigation may harden the law against the plaintiff may deter the plaintiff from litigating in the first place.[85] The analysis is made even more complex in the current context as creditors who are junior creditors today may appear as senior creditors in the next case. In other words, it may not be obvious to them what sort of law it is that they want.[86] In addition, many creditors may have the benefit of credit default swaps – which provide them with an effective hedge against the insolvency of the debtor such that they would rather take no risk on a restructuring at all but prefer either to continue to collect interest payments on the debt or collect on the credit default swap contract if the debtor fails.[87]

In addition to these creditor-orientated reasons for the paucity of cases, wider market conditions may also have played a part. A number of commentators have worried over the so-called zombie company phenomenon during this crisis.[88] One category of 'zombie' is of particular interest in the present context – a company generating enough cash to service its debt but which diverts so much of its cash resource to this endeavour that it is left with no money for investment – which should mean that it will struggle to compete as the market recovers and demand increases.[89] A number of factors may have contributed to banks allowing companies in this position to continue rather than demanding repayment of their loans in this recession. The first is that the persistently low-interest

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[83] *ibid* Posner, 428. Furthermore, the junior creditor challenging an allocation of equity in a restructuring may expect to receive only a small allocation even if he is ultimately successful. In this analysis, therefore, the risk of high costs may significantly outweigh the anticipated benefit.

[84] See, for example, Cooter and Rubinfeld, 'Economic Analysis of Legal Disputes and Their Resolution'; Rubin, 'Why Is the Common Law Efficient?' both n 33 above

[85] Clark n 42 above, 1271; Rubin, 'Micro and Macro Legal Efficiency' n 33 above

[86] And the law will only change if the party with the interest in a change in law litigates, see, for example, Rubin n 33 above, 23

[87] F. Partnoy and D.A. Skeel Jr, 'The Promise and Perils of Credit Derivatives' (2007) 75 University of Cincinnati Law Review 1019, 1023-1024

[88] See, for example, 'The Zombie Businesses Phenomenon: An Update' R3 January 2014 available at http://www.r3.org.uk/what-we-do/policy-and-public-affairs/research-reports 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 (both last accessed 18 July 2014)

[89] *ibid* r3, 2

rate environment may have enabled some companies to struggle on despite leverage.[90] A Bank also has an interest in this if it means that the bank continues to receive income and does not need to recognise a loss.[91] Government may also have contributed. First, there is some evidence of political pressure on banks not to foreclose on firms in difficulty.[92] Secondly, strict capital adequacy rules imposed by government may incentivise banks not to call in their loans for fear of crystallising a loss.[93] If the creditors apply no pressure on the business to restructure, then management and shareholders may decide that it is safer to struggle on than to risk a restructuring which may be unsuccessful and which may crystallise losses which could have been avoided or postponed.[94]

This last point receives some support from the experience of many firms who managed to stave off a restructuring and to refinance in booming credit markets, fuelled by a persistently low interest-rate environment and a relentless search by investors for yield.[95] Ironically it is the high yield market which has rode to the rescue of these struggling firms. Thus it would appear, as the market begins to turn, that leverage is still high in many UK firms and US high yield investors remain prepared to invest notwithstanding a stubbornly pro-senior legal environment. One possible explanation might be functional convergence in valuation standard through the complex finance documents negotiated by the parties to a high yield issue. There is some evidence that these documents may begin to contemplate a market value, as opposed to a market price, approach in determining whether debt can effectively be restructured without the consent of junior debt holders.[96] However, just as Brian Cheffins has noted the limits to functional convergence through the regulatory contract, so too

[90] *ibid* r3, 5
[91] Adam Smith Institute Report n 88 above, 28.
[92] *ibid*, 29 and r3 n 88 above, 5
[93] *ibid,* 29.
[94] *ibid*, 29
[95] r3 n 88 above, 2
[96] The Loan Market Association recommended form of inter-creditor agreement for leveraged loans contains optional requirements for the security agent to obtain a market value, and a fair market valuation opinion from an independent financial adviser, see C. Howard and B. Hedger *Restructuring Law and Practice* (London: Butterworths, 2nd ed, 2014), 233 fn 2 and accompanying text

protection in the intercreditor agreement is likely to be formal rather than substantive given that the subjective opinions are to be advanced by valuers appointed by controlling senior creditors.[97]

The continued growth of the market notwithstanding the lack of both functional and formal convergence in valuation standard is not as puzzling, however, as may at first appear as new adaptations have emerged in the current high yield market itself. There has been an explosion in secured high yield bond issues globally.[98] Moreover, the term loan/senior debt feature of highly leveraged capital structures appears to be in decline in the UK. Instead, either a comparatively small revolving credit facility has been raised for working capital purposes, which is entitled to priority on default, with all bond debt ranking *pari passu* behind it, or bank and bond debt have ranked *pari passu* in the senior part of the capital structure. Unlike the dramatic increase in secured debt, this adaptation in capital structure does not appear to be occurring evenly in the US and EMEA. The law firm Proskauer Rose LLP has undertaken a detailed review of high yield bond terms across the globe. Their survey results illustrate that whilst the number of high yield deals with first ranking security has increased in EMEA, exceeding two thirds of all issues in 2013, the trend in the high yield market in the US appears to be in the other direction. In their 2013 Global High Yield Report of the secured high yield market 43% of secured high yield bond issues in the US had first ranking security, 32% second ranking security and 25% 'split lien' (where the bonds have a first lien on certain assets and a second lien on other assets) compared with 73% first ranking security in EMEA, 19% second ranking security and 8% split lien. But the most recent Global High Yield Survey illustrates a fall in the number of first ranked deals in the US and a growth in EMEA.[99]

Although Proskauer Rose's data is aggregated for EMEA, the trend which their data reveals towards first priority deals in EMEA reflects data the author has compiled for high yield bond issues by UK

[97] See note 61 above
[98] See Elisabeth de Fontenay 'Do Securities Laws Matter? The Rise of the Leveraged Loan Market', 25 forthcoming Journal of Corporation Law
[99]See 2013 Global High Yield Bond Survey available at www.proskauer.com/files/uploads/2013-High-Yield-Bond-Study.pdf and 2014 Global High Yield Bond Survey available at www.proskauer.com/files/uploads/Documents/2014_Global_High-Yield_Bond_Study.pdf (both last accessed 18 July 2014)

issuers over the same period.[100] The higher incidence of second lien debt in the US may suggest that investors are more comfortable with the treatment of junior bondholders in the event of a default. In any event the adaptation in the capital structure of high yield bond issues by UK issuers may be hugely significant for the prospect of convergence in restructuring law.

SIGNIFICANCE OF ADAPTATION FOR PROSPECTS OF CONVERGENCE IN VALUATION STANDARD

Determining the law governing the restructuring

The vast majority of recent Rule 144A high yield bond issues by UK issuers have been governed by US (normally New York) law. Issuers have understood this to be a requirement in order for the bonds to be tradable in the US debt capital markets.[101] One option might, therefore, be for the UK issuer to submit to a Chapter 11 process (or, at least, to threaten a Chapter 11 process as a contingency plan during negotiation). Its debt is, after all, governed by New York law and it is a principle of English private international law that the English courts will recognise a foreign discharge of a debt governed by the laws of that jurisdiction.[102] However, in order for this to provide a viable route, an UK issuer will need to be confident that the English courts will recognise the effects of the Chapter 11 plan given that its assets are likely to be located in the UK. The recent decision of the Supreme Court in *Rubin* v *Eurofinance* casts considerable doubt over this question.[103]

Rubin involved a scam perpetrated in the US by The Consumers Trust ("TCT"), established by the terms of an English law governed trust deed. The settlor of the trust was Eurofinance SA, a BVI

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[100] See also IFLR 2014 High Yield Report: UK at section 5 'Nowadays in most European high yield bond issuances, senior bonds rank *pari passu* with high yield creditors, whereas the revolving credit facility lenders and hedge counterparties benefit from a super priority status in the waterfall of enforcement proceeds' and C. Ruby, J, Thompson and M. Steinberg 'Intercreditor Agreements – Spot the Difference' International Financial Law Review February 2012

[101] C. Mallon and S. Waisman, *The Law and Practice of Restructuring* (Oxford University Press, 2011), 6.23

[102] A.V. Dicey, J.H.C. Morris, L. Collins and A. Briggs, *Dicey, Morris and Collins on the Conflict of Laws* (under the general editorship of Lord Collins of Mapesbury, P.C., L.L.D., L.L.M., F.B.A. with specialist editors) (London: Sweet & Maxwell/Thomson Reuters, fifteenth ed, 2012) Rule 219 ' … a discharge from any debt or liability under the bankruptcy law of a foreign country outside the United Kingdom is a discharge therefrom in England if, and only if, it is a discharge under the law applicable to the contract'. For a detailed discussion, see R Dicker QC 'Discharge of Debts by a Foreign Liquidation' 3-4 Digest July 2010, 2 available at www.southsquare.com/wp-content/uploads/2010/06/July-2010.pdf (last accessed 18 July 2014)

[103] *Rubin* v *Eurofinance SA* [2013] 1 A.C. 236

company wholly owned by Adrian Roman, who was resident in England. Receivers were appointed to TCT in England and the receivers petitioned for Chapter 11 relief in New York. Various avoidance actions were successfully brought against Adrian Roman and his brothers in the Chapter 11 proceedings and the receivers subsequently sought to enforce the orders against them in England.

The Supreme Court determined that it could not enforce the orders. In the leading judgment Lord Collins held that the rules for enforcement of a foreign judgment in insolvency proceedings did not depart from the ordinary conflicts of laws rules in English law. UNCITRAL'S Model Law on Cross-Border Insolvency, implemented in Great Britain in the Cross Border Insolvency Regulations 2006, was not designed to provide for the reciprocal enforcement of judgments and so the 2006 Regulations could not be used.[104] This left common law rules.[105] The judgment of the US Court was a judgment *in personam* and the defendants had not appeared in the proceedings and had not submitted to the jurisdiction. As a consequence, English law conflicts of laws rules for recognition of an *in personam* judgment by a foreign court had not been met and the orders of the US Courts could not be recognised. Furthermore, and significantly for the purposes of this article, in reaching this conclusion their Lordships held that the previous case of *Cambridge Gas*[106] had been wrongly decided by the Privy Council.

In *Cambridge Gas*, a group of insolvent Isle of Man companies were in Chapter 11 proceedings in the US. The Chapter 11 reorganisation plan involved an exchange of debt in certain of the group

[104] The Cross Border Insolvency Regulations 2006 provide for cooperation and coordination between British and foreign insolvency proceedings and for cooperation between insolvency practitioners in those proceedings. For an overview see Olivares-Caminal *et al* n 56 above, 210-229 and A. McKnight, *The Law of International Finance* (Oxford University Press, 2008), 290-295. However, in *Rubin* the Court decided that although the Chapter 11 proceedings fell within the ambit of the Cross Border Insolvency Regulations, they did not extend to the enforcement of judgments see *ibid*, [24] and [133] – [144]

[105] Two other methods exist under English law for assisting insolvency proceedings in other jurisdictions; section 426 of the Insolvency Act 1986 which provides a power to assist corporate as well as personal insolvency proceedings in countries specified in the Act and the EC Insolvency Regulation which applies to insolvency proceedings in respect of debtors with their centre of main interests (COMI) within the European Union (excluding Denmark) – see *ibid*, [25] and [26]. However, neither of these sources of jurisdiction is relevant in a case before the UK and the US courts.

[106] *Cambridge Gas Transportation Corporation* v *Official Committee of Unsecured Creditors of Navigator Holdings plc* [2007] 1 AC 508 PC

companies for shares in the ultimate holding company of the Group, Navigator, a company incorporated in the Isle of Man. A request was made by the US Bankruptcy Court to the Isle of Man court to give assistance by giving effect at common law to the Chapter 11 plan. A shareholder objected to the plan and confirmation order under which the existing shares were to be cancelled and new capital represented by that shareholding issued to a committee of creditors. It argued that the order of the New York Court confirming the plan was either a judgment *in rem* or a judgment *in personam* and that the conditions for recognition and enforcement of an *in rem* or *in personam* judgment had not been satisfied.

The Judicial Committee of the Privy Council had decided in *Cambridge Gas* that orders made in foreign insolvency proceedings are classified as neither judgments *in personam* nor judgments *in rem* for the purposes of recognition. Different principles governed recognition and enforcement of such orders.[107] The principle of 'universalism' required that wherever possible there should be a single insolvency proceeding in relation to an insolvent debtor which takes place in one jurisdiction and has one effect and that to this end, wherever possible, the English court should give assistance to such a foreign insolvency proceeding.[108] However, the English approach was one of 'modified' universalism. The court was able to give assistance to the extent that it would be consistent with justice and UK public policy to do so. In *Cambridge Gas* this appears to have found expression in the principle that the court could grant assistance wherever the domestic court could have achieved the same result in the case of a domestic insolvency – and the court concluded that the same result could have been achieved by a scheme under the Isle of Man Companies Act 1931.[109] Finally, Lord Hoffman had found in *Cambridge Gas* that it was no objection to the implementation of the plan in the Isle of Man that the shares in Navigator belonged to a person who was not a party to the

[107] *ibid* [13]-[15]
[108] *ibid* [21]-[22]
[109] *ibid* [24]

bankruptcy proceedings, as a shareholder was bound by the transactions into which the company had entered, including a Chapter 11 Plan,[110] an analysis for which there is some scholarly support.[111]

Lord Collins was certainly not persuaded on any of the grounds. In concluding that *Cambridge Gas* was wrongly decided he stated:

The Privy Council accepted (in view of the conclusion that there had been no submission to the jurisdiction of the court in New York) that Cambridge Gas was not subject to the personal jurisdiction of the US Bankruptcy Court. The property in question, namely the shares in Navigator, was situate in the Isle of Man and therefore also not subject to the in rem jurisdiction of the US Bankruptcy Court. There was therefore no basis for the recognition of the order of the US Bankruptcy Court in the Isle of Man.[112]

Much ink has been spilt on the blow dealt by *Rubin* to principles of universality for foreign insolvency proceedings in English law[113]. For present purposes, the consequences of the judgment for attempts

[110] *ibid* [26] 'a share is the measure of the shareholder's interest in the company: a bundle of rights against the company and the other shareholders. As against the outside world, that bundle of rights is an item of property, a chose in action. But as between the shareholder and the company itself, the shareholder's rights may be varied or extinguished by the mechanisms provided by the articles of association or the Companies Act … As a shareholder Cambridge is bound by the transactions into which the company has entered, including a plan under Chapter 11'.

[111] K. R. Handley, 'Cambridge Gas Rejected' (2013) 129 Law Quarterly Review 144, arguing, in addition, that the US order may have been binding on Cambridge Gas because it was aware of the proceedings and could therefore have intervened to protect its property. Adrian Briggs has also, at least latterly, suggested that where the company had submitted 'it would not be altogether surprising if the submission were effective as against the shareholders and stockholders held to be affected as such' A. Briggs, 'Recognition of Foreign Judgments: A Matter of Obligation' (2013) 129 Law Quarterly Review 87, n 75 (although this does not seem to have been his first reaction to the Cambridge Gas decision and in an earlier article, quoted by Lord Collins in *Rubin*, he seems to have arrived at a different conclusion - see A Briggs 'Private International Law' (2006) 77 BYIL 575, 581 'Where a shareholder subscribes for shares in a Manx company, he buys into a Manx club governed by Manx rules. It can be argued, for Lord Hoffman argues it, that he then becomes bound by everything which is done by and to the company, for he has no material existence to sue as a member of the company, and no independent property save as a member of the company … But if one takes the view that shares are choses in action, albeit complex ones, and are property, albeit moderately complex property, then their confiscation ought to be a matter for the courts of the place where the property is'. He went on to express the view, quoted by Lord Collins in *Rubin* at [53] that 'the decision in [*Cambridge Gas*] is wrong, for it requires a Manx court to give effect to a confiscation order made by a foreign court of property belonging to a person who was not subject to the personal jurisdiction of the foreign court').

[112] *Rubin* v *Eurofinance* SA n 103 above, [132]

[113] See, for example, B. Isaacs, 'What's Left of the Golden Thread? Modified Universalism after Rubin and the New Cap' (2012) Butterworths Journal of International Banking & Financial Law 675; G. McCormack, 'Universalism in Insolvency Proceedings and the Common Law' (2012) Oxford Journal of Legal Studies 325; F.

to recognise US Chapter 11 proceedings with respect to UK issuers are of considerable significance. Whilst it is possible to construe Rubin narrowly, and Rubin dealt with different conflicts of laws principles than those relating to a foreign discharge of a foreign-law governed debt, the judgment raises difficult questions where the Chapter 11 plan involves an exchange of debt into shares in a UK company. Absent an appeal all the way to the Supreme Court, it seems unlikely that an English court would recognise a Chapter 11 plan pursuant to which New York law governed debt was exchanged for shares in a company incorporated in England (or, indeed, in another jurisdiction outside the US), assuming that the shareholders did not consent to the plan. It is suggested, therefore, that US investors in securities issued by UK corporates will find that any debt-for-equity swap is likely to be concluded in the shadow of English insolvency law rather than (or as well as) in the shadow of Chapter 11 unless other adaptations to the Chapter 11 plan can be introduced and successfully defended.[114]

What does this mean for UK issuers of New York law governed high yield securities who find themselves embroiled in a contentious battle for equity post restructuring? The answer may be that it depends. In a highly leveraged but effectively '*pari*' structure (that is, all the bond debt ranks equally behind a small amount of revolving credit which is amply covered by the assets, or bank and bond debt ranks equally) we might expect to see the valuation debate move back from an inter-creditor debate to a debate between debt and equity. In this situation, the bondholders are collectively motivated to press for as low a value as possible in order to argue for the entire equity allocation. In this event, even US investors may be best advised to adopt the traditional English approach – focusing on the market price of the firm established by market testing rather than a

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Toube, 'Isolationism Revived: Foreign Restructurings Still Do Not Discharge Debts under English Contracts' (2011) Insolvency Intelligence 77

[114] For one such adaptation see A. Zacaroli QC and S. Dickson 'Recognition of Foreign Insolvency Restructuring Proceedings: Arcapita Bank' South Square Digest February 2014 available at http://www.southsquare.com/files/Digest-February-2014.pdf (last accessed 18 July 2014), suggesting a structure in which the assets of the company are sold to a newly incorporated company in exchange for fresh equity in the 'newco', leaving dissenters stranded in the old shell – a technique already used in the English market and discussed briefly below. But whether such a structure would gain the necessary recognition in light of the *Rubin* decision, and how it would fare in the US courts, remains to be seen.

more subjective valuation opinion approach. Thus, there might be expected to be little pressure from US bondholders for change – particularly if there are a significant number of restructurings in a generally depressed market. In contrast, if the restructuring implicates a traditional subordinated high yield bond issue, in which the bond is subordinated to a more sizeable portion of senior debt, we might expect to find bondholders in the junior piece pushing vigorously for an approach consistent with the approach adopted by the US courts and looking to subjective valuation opinions to support a residual interest in the company.

In this account, it is the number of investors entering the market and the capital structures which they invest in which determines whether there will be change in the law. In other words, a complex picture emerges of adaptation in the finance markets and sporadic change in the legal environment making it hard to predict the interaction between the two systems. This challenge is amply illustrated if one reviews Skeel's taxonomy for corporate governance in insolvency ('manager-displacing' and 'manager-driven')[115] and Armour, Skeel and Cheffins predictive piece on US and UK convergence in corporate governance in insolvency which was based upon it.[116] As Armour, Cheffins and Skeel predicted, the legal techniques used to achieve a restructuring in the UK today (a scheme of arrangement or a scheme of arrangement and a pre-packaged administration, discussed briefly below) avoid the true manager-displacing features of a full insolvency proceeding in the UK. Nonetheless, these techniques continue to afford senior secured creditors significant control rights. At the same time, the spectacular boom of US capital structures in which creditors have security over all or substantially all of the assets of the debtor and can dictate the course of a debt restructuring through the mechanism of the security arrangement, together with the rise of the market for distressed debt, has meant that practical, if not legal, control has passed to the secured creditors in the US.[117] As an English scholar, Gerard McCormack predicted, in many ways from a

[115] Skeel n 14 above

[116] Armour, Cheffins and Skeel n 15 above

[117] See, for example, DG Baird and RK Rasmussen, 'The End of Bankruptcy' (2002) 55 Stanford Law Review 751; DA Skeel Jr, 'Creditors' Ball: The New New Corporate Governance in Chapter 11' (2003-2004) 152 University of

governance perspective US and UK insolvency law have converged in the middle.[118] Indeed, if Skeel were writing today he might include a third category of insolvency regime, 'manager-implemented' and Armour, Cheffins and Skeel might observe US/UK convergence around this third way. For present purposes, the important point is that it is the adaptation in the US finance market to a legal environment which creditors regarded as persistently manager friendly which has upset the legal evolutionary account.

Thus, if a traditional subordinated high yield bond issue is to be restructured, investors are likely to press for change in the way in which valuation questions are approached, reinforcing other influences pressing for change. But if no change occurs and the legal rules appear fixed, the finance market may adapt itself to the more hostile legal environment. If these adaptations occur, then the legal system may experience negative pressure from the finance system, dampening other influences pressing for change. During the process of adaptation it is possible for the legal system to experience both positive pressure for change (from legacy structures) and negative pressure for change (from adapted structures) at the same time. In this situation it is extremely difficult to predict how the two systems will interact. This analysis is supported by the approach of the US courts to recognition of the restructuring of New York law governed debt by foreign courts.

Implications of seeking US recognition of an English court restructuring of high yield debt

A UK issuer restructuring New York law governed debt held by a number of US creditors through an English process is likely to wish to seek recognition of that restructuring in the US courts. This may be because it has assets within the jurisdiction which it wishes to protect but even in the absence of

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Pensylvania Law Review; D Baird and R Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 University of Pennsylvania Law Review 1209; H Miller 'Chapter 11 in Transition - From Boom to Bust and into the Future' (2007) 81 American Bankruptcy Law Journal, 375; KM Ayotte and ER Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 Journal of Legal Analysis, 511; 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

[118] G. McCormack, 'Control and Corporate Rescue–An Anglo-American Evaluation' (2007) 56(3) International and Comparative Law Quarterly, 515, 516

assets, the issuer is likely to wish to avoid subsequent legal challenge in the US which may result in judgment against it, or which may result in a judgment creditor seeking to enforce in other jurisdictions where the company does own assets.

To date the prognosis for obtaining recognition is encouraging. The US has implemented the UNCITRAL Model Law on Recognition of Foreign Insolvency Proceedings in Chapter 15 of the US Bankruptcy Code. Unlike England (which has also adopted the UNCITRAL Model Law but as an addition to its other sources of jurisdiction for recognition of foreign insolvency proceedings) Chapter 15 appears to be a single gateway entitling the US court to assist foreign insolvencies which take place in the 'COMI' or 'establishment' of the debtor.[119] Several foreign debtors have petitioned for, and been granted, Chapter 15 relief in relation to restructurings of New York law governed bonds by the English courts.[120] It is notable that all of these restructurings have involved schemes of arrangement and that none of them has been challenged by bondholders before the UK courts.

As discussed above, a US chapter 11 plan may be confirmed over the objection of a dissenting class if certain confirmation standards are met, including the best interests test and the absolute priority rule. If the plan is confirmed, it is 'crammed down' on the dissenting class. This power does not exist in an English law scheme of arrangement – in order to implement a restructuring without the consent of a dissenting class it is necessary to 'twin' the scheme of arrangement with a pre-packaged administration in order to strand the dissenting class in an empty corporate shell with no assets.[121] There is a paucity of current case law on this technique in England. Only two cases have come to court dealing directly with a challenge to the plan and introducing valuation evidence. One of these

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[119] See G. Moss 'Beyond the Sphinx – is Chapter 15 the Sole Gateway?' (2007) 20 Insolvency Intelligence 55
[120] See B. Davies and M. Glengarry 'WIND Hellas' in *European Debt Restructuring Handbook* K Asimacopoulos and J Bickle (eds) (London: Globe Law and Business, 2013), 173, *Magyar Telecom BV* [2013] EWHC 3800 (Ch) (in which an English scheme of arrangement comprising New York law governed bonds issued by a Dutch registered company gained recognition) and *In the matter of Zlomrex International Finance SA* [2013] EWHC 3866 (Ch) (in which an English scheme of arrangement comprising New York law governed bonds issued by a French registered company whose COMI had been moved to England and which was part of a group whose operational headquarters were in Poland gained recognition)
[121] For a more detailed description see Olivares-Caminal *et al*, n 56 above, 163-164

is not entirely on point as it related to a direct enforcement by a security trustee.[122] The other was touched on above and appears to have been an under-resourced and hastily assembled challenge.[123] Both cases show the English courts unwilling to shut the door completely on arguments that valuation evidence ought to be reviewed in assessing whether a senior class is receiving too good a deal under a restructuring plan.[124] If the number of US investors holding subordinated bonds issued by UK corporates increases significantly, then as we have seen it is possible that more challenges will arise to restructuring plans which seek to 'strand' bondholders but which are based solely on market price auction evidence as to the value of the business and which do not accommodate US-style valuation opinion evidence. As others have noted, the common law develops only as cases come to court and its development is highly dependent on the parties which argue these cases.[125] If the number of US holders of New York law governed subordinated high yield bonds issued by UK issuers increases, it might be anticipated either that plans will be developed and cases will be fought adopting a US approach by all sides or that more challenges to restructuring plans articulated in different terms will be launched.

If these sorts of challenges do arise, it is suggested that the desire for recognition of the plan by the US courts may lead issuers to prefer to prepare and argue cases in a way which the US courts will recognise from their domestic experience. This is because, although the Chapter 15 cases referred to above are encouraging, they are not a reason to be complacent that the US courts will automatically accord recognition for an English law restructuring where the issuer's COMI is in England. In the first place, in more contentious cases the US courts have focused on the primary purpose of Chapter 15 as protecting the assets of the issuer located in the US.[126] This reflects the

[122] *Saltri III Ltd v Mezzanine SA Sicar & Ors* [2012] EWHC 3025

[123] *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch); [2010] BCC 209; [2010] 1 BCLC 338

[124] *ibid*, [50]

[125] J. Armour and D. A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1730

[126] *In Drawbridge Special Opportunities Fund LP v Barnet (in re Barnet)* Case No 13-612 (2d Cir. Dec. 11, 2013) the United States Court of Appeal for the Second Circuit held that only a person with a domicile, residence, place of business or property in the US is eligible for Chapter 15 relief

drafting of the Model Law itself. Whilst in other cases the US courts have shown themselves willing not to concentrate on an asset requirement, it remains a potential route for the refusal of relief where the issuer has no assets in the US and is seeking Chapter 15 relief as a purely defensive measure to avoid expensive litigation in the US which it is required to defend (or to prevent orders of the US court which may be enforced against the issuer in other jurisdictions (besides England) where it does have assets).

Furthermore, in a number of recent cases the US courts have shown greater willingness to protect US creditors at the expense of the benefits for the case of recognising a foreign insolvency proceeding (and notwithstanding that the creditors have chosen to invest in a foreign issuer). Chapter 15 contains an exception which enables the court to deny relief on the basis that it would be contrary to public policy.[127] Although this is described as a 'narrow' exception, recent decisions show a willingness to rely on the public policy exception where the result in the restructuring would not be achieved in a Chapter 11 plan. Appeal courts have shown greater reluctance to expand the reach of the public policy exception but have relied on other provisions of Chapter 15 (section 1507 listing the factors for courts to consider in granting additional assistance and section 1522 requiring that the interests of creditors and its debtor be sufficiently protected) to much the same effect.[128] Two relatively recent cases focus on granting of relief where the foreign debtor's assets have been sold in the main insolvency proceeding – highly relevant if a restructuring in the UK is implemented via a pre-packaged administration sale. Whilst the cases of Elipda Memory and Fairfield Sentry suggest that the US court will reserve plenary review of the sale under section 363 of the US Bankruptcy Code to situations where the assets concerned are located in the US, certain statements made by the court in Fairfield Sentry, in distinguishing Elipda, suggest that there are other grounds

[127] Section 1506 of the US Bankruptcy Code
[128] *Vitro S.A.B. de C.V. v Ad Hoc Group of Vitro Noteholders*, et al 2012 WL 5935360, 11 (5th Cir 2012)

on which the US court may undertake a more extensive review.[129] A UK issuer restructuring a New York law governed bond is likely to wish to have the comfort of Chapter 15 relief but, equally, an application for relief which is denied may be more damaging than refraining from seeking relief at the outset. It is suggested that this is likely to cause an issuer in contested restructurings to wish to be able to present its case to the US court in a way which the court will recognise – encouraging a focus on valuation opinions as well as market price and in voting on the plan in a way which is consistent with voting on a Chapter 11 plan.

On the other hand, as already suggested, the position may be entirely different in a '*pari*' structure where the battleground is between bondholders and equity. In this case, the approach may turn on whether US investors are present only in the debt or in the debt and equity. In the former case, they are likely to be content with the traditional English law approach and, as we have seen, in non-contentious cases (where US investors have not opposed the grant of relief) the US courts have been quick and generous in granting the necessary orders. Where, on the other hand, US investors inhabit both the debt and the equity, similar considerations as to the approach of the US courts may apply.[130]

Position of directors of the issuer and the issuer's advisers

In the brief review of the literature on convergence in corporate governance at the start of this article, reference was made to Coffee's analysis of convergence through securities laws.[131] Whilst

[129] *In re Elpida Memory, Inc* Case No. 12-10947 (CSS), 2012 Bankr. LEXIS 5367 (Nov. 16,2012); *In re Fairfield Sentry Ltd*, 484 br 615, 622, both discussed in M Zerjal 'Sales of Foreign Debtor's Assets: Approval is not to be 'Rubber Stamped' by US Courts in Chapter 15' 10(5) International Corporate Rescue 2013

[130] It is also worth noting the alternative to Chapter 15 relief (assuming that a standalone Chapter 11 plan has not been filed for the reasons outlined above). The issuer may file a Chapter 11 plan in connection with a contemporaneous restructuring in its home jurisdiction. However, this offers no obvious advantage in terms of restructuring plan standards as the parallel proceedings will each need to be justified, presumably on the same grounds. Absent other relief which is required and which can only be granted in Chapter 11 proceedings, and given the increased cost and complexity of parallel proceedings, it seems likely that the majority of cases will continue to proceed as a Chapter 15 case in the US. One exception may be where a highly complex capital structure includes both borrowers incorporated in the US and borrowers incorporated in the UK – this is the case for the largest high yield bond issue to date and, if it ever falls to be restructured, is likely to require complex parallel proceedings

[131] JC Coffee n 9 above, 694

accessing US debt capital markets does not incorporate US securities laws explicitly relating to restructuring, and so Coffee's example of convergence through the regulatory contract is not strictly relevant for this account, US securities laws requirements in a Rule 144A offering could nonetheless provide another indirect driver for functional convergence. Coffee's work highlighted the significance of securities laws liability in deciding to access US equity capital markets and this liability question does remain relevant for UK issuers accessing US debt capital markets. Whilst Rule 144A offerings are exempt from US Securities Act registration, they continue to involve many of the features of US public offerings. In particular, issuers, underwriters and their controlling persons are potentially liable to purchasers of securities with respect to material misstatements and omissions in offering documents. Section 12(2) of The Securities Act 1933 applies to offers and sales of securities whether or not registered (and to Rule 144A offerings) and provides liability for untrue statements of material facts and omissions in offering documents for a seller of securities 'who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission ….': the so-called 'due diligence' defence of underwriters in securities litigation.[132] Rule 10b-5 under the Securities Exchange Act 1934 makes it unlawful, in connection with the purchase or sale of any security 'to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading'. The Supreme Court has held that 10b-5 liability arises only if the party charged has 'scienter' (which broadly includes intent to defraud, recklessness and similar standards).[133] This means that a party which engages in due-diligence type procedures, as well as seeking to rely on the due diligence defence for the purposes of section 12, should also be less vulnerable to a 10b-5 claim on the basis that its due diligence procedures are inconsistent with 'scienter'.

[132] The due diligence defence also applies to liability under section 11 of the Securities Act of 1933 which is only applicable to public offerings of securities and not Rule 144A offerings

[133] *Ernst v Ernst & Hochfelder* 425 US 185 (1976) cited in Alistair Alcock, 'Rise and Fall of Private Actions Under Rule 10b-5' (1998) Journal of Business Law 230

In order to address these due diligence concerns, the practice has developed in all public offerings of securities in the US, and in Rule 144A offerings, that the US underwriters will request Counsel involved in the transaction to provide disclosure opinions in connection with the offering. In general (and unlike practice in the English market where 'cross table' opinions are not typically provided in debt transactions) opinion letters will be sought from counsel for both the issuer and the underwriters. Although in some transactions underwriters will be willing to settle for only one letter it would be unusual (and 'off market') for the underwriter's counsel to give an opinion where the issuer's counsel does not give one. If only one letter is to be provided it is likely to be the issuer's counsel who is providing it rather than the underwriter's counsel.

Thus in any subsequent financial restructuring, the spectre of securities laws litigation haunts all those involved in the original offering for the issuer. In addition to federal securities laws, state securities laws and the common law may be engaged. Investors may be incentivised to bring securities laws litigation which can be targeted at deep pockets rather than the beleaguered issuer. In these circumstances, there may be a strong incentive for a UK issuer and its advisers, unfamiliar with the labyrinth of US securities laws litigation, to reach a consensual restructuring with its creditors, adopting a US-style approach to navigating a path to agreement. But how strongly this incentive operates may depend, again, on precisely where the US investors sit in the capital structure. In a '*pari*' bond structure an aggressive plan for bondholders to retain all of the equity may delight US investors. On the other hand, in a more traditional subordinated structure, US bondholders may react angrily to attempts to cut them off through a scheme and pre-packaged administration structure and may point to the terms of the securities offering document in maximising their leverage. In this event, investors in the high yield market are likely to reinforce other pressures for change.

OTHER INFLUENCES

In Part III, the pressure for change coming from the high yield market was described in terms of its effect on other influences in the market. The high yield market represents only one of a number of influences on the legal system. Even if the high yield market is well-adapted to the apparently fixed legal regime, other influences may nonetheless continue to press for change in the law. The problem of prediction does not just lie, therefore, in the complexities arising within the high yield market itself but also in identifying other influences which may destabilise the legal system.[134] A complete review of all the influences on the question of valuation in restructuring law is outside the scope of this article and, in any event, probably impossible without the benefit of a crystal ball or a good deal of luck or hindsight. But it is worth touching on a couple, at least by way of illustration. The first comes from the finance market itself.

Although the high yield market now represents an increasingly significant proportion of the English finance market, loan debt remains extremely important.[135] This is compounded by the speed with which the high yield market can shut down and the attractions for investors in financing loans rather than bonds.[136] As many of the so-called 'alternative lenders' have begun to provide loan finance through primary deals there is some evidence that the structure of highly leveraged loan facilities may also be changing. Just as high yield bond structures traditionally comprised some senior (lower priced) debt and some subordinated (high yield) debt, so a highly leveraged loan structure would traditionally comprise senior (lower priced) debt and subordinated (mezzanine or junior) debt at a higher interest rate. A new phenomenon has, however, made an appearance in the UK market – so called unitranche facilities.[137] Unitranche technology has existed in the US for some time but has

[134] This problem is well-known in chaos theory – the two-body problem was completely solved by Newton. However, the introduction of just one more gravitational object makes the problem considerably harder. For an admirably straightforward explanation see James Gleick, *Chaos: Making a New Science* (London: Vintage, 1998), 145

[135] See Bank of England quarterly publication 'Trends in Lending – April 2014' available at http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx (last accessed 18 July 2014)

[136] G.D. Chamblee and A.T. Jolie 'Converging Markets: Leveraged Syndicated Loans and High-Yield Bonds' (2005) 20(6) Commercial Lending Review, 7-16

[137] See, for example, 'Capital Thinking - Issue 3:Unitranche' available at http://www.grant-thornton.co.uk/en/Services/Corporate-Finance/Debt-Advisory/Capital-thinking/ (last accessed 18 July 2014)

only recently appeared in English deals. In a unitranche loan, the senior and junior debt is combined into a single facility which ranks *pari passu*, either at the top of the structure or, like the '*pari*' high yield bond structures, behind a relatively small revolving credit, capital expenditure or acquisition facility which is well-covered by available collateral. The borrower pays a single, blended interest rate for the unitranche facility which is higher than the rate which would have been paid for the senior piece but lower than the rate which would have been paid for the mezzanine piece. Unitranche lenders are likely to be entirely happy with an approach to valuation based on current market price for just the same reasons as were advanced for '*pari*' high yield bonds. The valuation fight might be expected to be between creditors and equity rather than an inter-creditor battle and the lenders are likely to prefer an argument which favours 'cutting off' the equity holders. Unitranche lenders and '*pari*' high yield bond investors are both likely to operate as influences dampening demands for a change in the English approach to valuation.

However, whilst unitranche facilities are appearing in the English market, the move to this structure in the loan markets is not as pronounced as the move to the senior secured structure in the high yield bond market.[138] Unlike investors in unitranche facilities, junior or so-called mezzanine lenders can be expected to continue to prefer a move to a US style approach to valuation, and the introduction of valuation opinions rather than a reliance on market price alone. Thus mezzanine lenders are likely to operate as an influence reinforcing other demands for change.

At the same time, there is continuing pressure for greater substantive harmonisation in insolvency law in Europe in general, and in financial restructuring in particular. The European Commission has released a recommendation for Member States to review pre-restructuring procedures in their jurisdiction. [139] The recommendation has no legal force but it does carry political weight. The

and J Thompson and C Ruby 'Global Trends in Leveraged Lending' 23-24 in *The International Comparative Legal Guide to Lending and Secured Finance 2014* (London: Global Legal Group, 2014)

[138] *ibid* 'Capital Thinking', 2 describing the market as 'embryonic'

[139] Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency available at http://ec.europa.eu/justice/civil/files/c_2014_1500_en.pdf (last accessed 18 July 2014)

Commission has asked Member States to enact appropriate measures within one year and has stated that it will review progress after 18 months in order to evaluate whether further measures are needed.[140] It might, therefore, be expected to be the first indication of where harmonisation efforts in this area could go. Interestingly, the Commission proposal includes a 'cram down' procedure – the ability for a court to impose a restructuring plan on a dissenting class – and sets out the minimum conditions for the court to provide its confirmation:

(a) the restructuring plan has been adopted in conditions which ensure the protection of the legitimate interests of creditors;

(b) the restructuring plan has been notified to all creditors likely to be affected by it;

(c) the restructuring plan does not reduce the rights of dissenting creditors below what they would reasonably be expected to receive in the absence of the restructuring, if the debtor's business was liquidated or sold as a going concern, as the case may be.[141]

Whilst it appears to be envisaged that creditors would have a right to be heard on the application,[142] the valuation approach adopted in the proposal also appears to be on all fours with the traditional English approach – provided the dissenting class receives no less than it would have received on a liquidation or a going concern sale (as the case may be) then the plan may proceed. Thus the indications from Europe would appear to be a negative influence for change and, at this stage at least, would appear to pull in the same direction as the structural adaptations in the high yield market.

CONCLUSION

[140] *ibid* 10, Section V (Supervision and reporting)
[141] *ibid* 8, paragraph 22
[142] For a description of the concept of 'legitimate interests' in a different context in EU law see H. Hofmann and A. Türk, *Legal Challenges in EU Administrative Law: Towards an Integrated Administration* (Cheltenham: Edward Elgar Publishing, 2009), 278-286

This brings the analysis back to the debate between *ex ante* and *ex post* convergence as a condition for access to foreign markets. The account here, in which investors pushed for structural change in what they perceived as the highly disadvantageous terms on offer in the UK and Europe when compared with the US, supports the view of those who have argued that it is the entrance of new players in the market pressing for change which drives reform. The short history of the failure to bring about legislative change reinforces the problems of path dependency and the lack of evolution through judicial decision highlights many of the problems with relying on case law to bring about reform which others have noted.

Yet this article also highlights the adaptive capacity of the finance market itself. Thus, provided certain minimum standards are met, the finance market is able structurally to adapt to the legal environment, where the legal environment remains resistant to change. Three states are identified: a state in which the high yield market is poorly adapted to the legal environment and reinforces other pressure for change, a state in which the high yield market is well-adapted to the apparently fixed legal environment and dampens other pressures for change and a state in which both legacy structures and adapted structures exist at the same time, potentially pulling in different directions.

The difficulty in predicting how the market will move between the three states, coupled with the difficulty of predicting how it will operate with other influences pushing for or against change, illustrate the impossibility of predicting accurately how the systems will evolve. Moreover, this article has investigated a very specific example of the relationship between the law and the finance market from two highly developed economies. It is difficult, therefore, to draw conclusions for the co-evolutionary account of law and finance markets more generally. Instead, a synthesis is attempted of existing theories and the significance of the adaptive capacity of finance markets explored in this article which, it is hoped, might prove a useful framework against which other examples from developed economies can be tested:

1. There needs to be a certain level of confidence in the legal institutions of a country for a market to begin to develop, but at this stage the detail of the legal system may be poorly understood by investors
2. As the market develops, cases will arise which will highlight differences in its operation from other legal regimes with which the investors are more familiar
3. If there are other compelling reasons to invest, this will not necessarily act as a complete brake on the development of the market but may give rise to positive efforts to bring about change in the law by (i) lobbying for legislative change (ii) litigation
4. How successful these efforts will be may depend on the extent to which (i) the legislature is receptive to the demands of these market actors (ii) cases come to court. This may depend, amongst other things, on the number of players in the market and whether other actors or influences are pulling in the same or a different direction
5. If the legal environment remains persistently hostile, capital structures may nonetheless adapt to the legal environment. If these structural adaptations occur they may reduce pressure or even act as a negative influence for change – depending on how well-adapted capital structure is to the legal environment
6. If new capital structures are well-adapted to the legal environment, the stability of the legal environment may depend on how wide spread the adaptations are and whether other influences are pulling in the same direction.

A fascinating question remains unanswered by the scope of this article. If the legal environment does remain resistant to change but adaptations occur in the finance market dampening pressure for change in law, the question arises as to whether these adaptations increase the cost of capital within the jurisdiction in which they occur. Ultimately, this is the heart of the 'does law matter?' debate. It is notoriously difficult to compare spreads on high yield bonds.[143] But it is hoped that a

[143] See B. Biais and F. Declerc 'European High-Yield Bond Markets: Transparency, Liquidity and Efficiency' 2007, research commissioned from the Centre for Economic Policy Research by the Association of British Insurers,

comparison between spreads on US second-lien structures and European *pari passu* senior secured structures might prove a promising area for future research.

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the City of London Corporation, the European High Yield Association, the International Capital Market Association, the Investment Management Association and the London Investment Banking Association