LSE LAW POLICY BRIEFING SERIES

Insolvency Law, Restructuring Law and Modern Financial Markets

Sarah Paterson

POLICY BRIEFING 8 | 2015

LSE Law

Insolvency Law, Restructuring Law and Modern Financial Markets

The finance market has undergone rapid change in developed Western economies in the last decade. In much of Europe the concentrated finance market in which a small group of banks controlled the flow of finance to large and small companies has given way to a dispersed creditor economy. In both Europe and the US there has been an explosion of secured credit and the market for buying and selling debt of distressed companies has matured so that those holding the debt of a financially distressed company will, in many cases, not be the lenders who originally advanced the funds.

In the US, the American Bankruptcy Institute launched a commission to study reform of Chapter 11 in light of these new market dynamics which reported shortly before Christmas 2014 (http://commission.abi.org/). Across much of Europe, reform is underway or under consideration. In England the flexibility of the common law has enabled lawyers to adapt procedures designed for a different finance market to accommodate the needs of the new one, so that the case for reform has not been pressing. However, given the momentum for reform elsewhere, we should pause to consider how well these pragmatic adaptations work for modern financial markets. Moreover, the European Commission has issued a recommendation on a new approach to business failure and insolvency which encourages member states to put in place effective restructuring mechanisms. English law does not meet all of the Commission's suggestions and we should consider whether the points of difference are based on sound policy judgments, or merely a reluctance to reset a mind-set fixed in a different era. We can then be an effective part of the wider European debate.

ISSUES FOR RESTRUCTURING LAW

Choice between sale and restructuring

First, we must decide whether there is an explicit role for the law in steering creditor choice between restructuring the company on the one hand or selling its business and assets to a third party on the other. Historically, notwithstanding some law on the books which might have been used to influence this choice, English law in action has taken a benign approach, largely leaving it to creditors to decide whether the company should continue in operation or whether it should be allowed to fail. US bankruptcy law has been more interventionist and it is an explicit policy objective of Chapter 11 to steer the parties towards a restructuring of the company rather than a sale of its business. This is achieved by handing management significant veto rights on the assumption that management will favour a restructuring and the retention of their jobs. Until very recently these differences of approach had seemed to become less acute, as reform of the Uniform Commercial Code in the US made it easier for a senior secured class with security over all of the assets to emerge. This security interest enables the creditors to lay down conditions for access to cash to finance the Chapter 11 case, enabling them to control decision-making. However, the recent report and recommendations from the ABI make a number of suggestions which appear to reaffirm a role for the law of corporate distress in steering the choice between restructuring and insolvency, reaffirming the traditionally different philosophical approach between England and the US.

I suggest that the question of whether the law should steer the choice between restructuring and sale remains live for small and medium sized companies and is an issue which we should debate in that context. The ABI Commission has made specific recommendations for a restructuring regime for small and medium sized enterprises and I suggest that we also consider SMEs as a special case. However, in a recent working paper, Rethinking the Law of Corporate Distress in the Twenty-First Century, (http://papers.ssrn.com/sol3/papers.cfm?abstract _id=2526677) I argue that the distressed debt market has solved the issue for large and larger mid-cap companies. This is because the distressed debt market exists to maximise profit rather than minimise loss. Thus it seeks to identify cases in which the value of the company if it continues to operate will be greater than its value if the business is sold at the time of the restructuring, and provides an exit mechanism for senior creditors who would otherwise have preferred sale of the business, buying their debt ahead of any debt for equity swap.

Allocation of value in a restructuring

The distressed debt market does not solve the problem of deciding who should get what in the ensuing exchange of debt for (usually unlisted) securities. In Europe this has traditionally been dealt with by benchmarking the equity which creditors receive against the amount they would have got if the business and assets had been sold instead – in other words, checking that creditors would not have been better off in insolvency. However, if the market is depressed the market price at the time of the restructuring may be lower than it would have been if the business had been sold at a later date so that the creditors who do receive an equity allocation may make a substantial profit if they sell the business after the market has recovered. In the US this problem is solved by the 'bargaining and litigation' approach. The parties are left to negotiate value using traditional valuation techniques such as discounted cash flow, comparable pricing and private equity valuation methodology. If the parties cannot agree, the bankruptcy judge will make a determination. However, this approach is highly subjective and leads to concerns of increased time, cost, delay, arbitrary allocation of value and, possibly, increased pricing for senior secured credit.

Some US scholars have proposed an alternative 'options approach' to solve the problems with both the auction approach and the bargaining and litigation approach. In the options approach the capital structure is reset so that those creditors who have debt covered by the value of the business at the time of the restructuring receive equity (so-called 'in-the-money' creditors), and all others receive an option with a strike price equal to the claims ranking ahead of them. The ABI Commission proposals do not adopt this approach (which might lead to some rather unwieldy capital structures) but do propose using a hypothetical option structure and options pricing methodology to determine whether junior creditors should receive anything in the new bargain. Interestingly, the proposals do not dedicate much time to the question of whether, where junior creditors do receive an allocation, it should be after senior creditors have recovered their original investment, or whether senior creditors should receive a premium to reflect their new risk.

I suggest a three stage approach for the UK. First, there is an empirical question as to the consequences of the different approaches for the pricing of senior secured credit, the depth and strength of the debt markets (particularly as the UK becomes less bank-dominated) and for equity financing. Once we have the answer to the empirical questions, we can decide which valuation approach we prefer. Elsewhere I have argued that this preferred valuation approach should then be clearly spelt out in regulation for insolvency practitioners so that they can be clear when it is legitimate to cut junior stakeholders out and when they should receive some value. We may also decide that reforms are needed to our legal procedures in order to reflect the chosen approach, including the extent of court involvement and the conditions for access to the procedures.

Should a restructuring moratorium be available?

English law has apparently operated without too much difficulty in the Great Recession without a moratorium in the legal procedures used to implement large restructurings. The usual argument for a moratorium in distress is that it reduces the incentive for individual creditors to take action to sell assets, breaking up the company and reducing value. I have argued (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2526677) that the distressed debt market has also resolved this issue in large restructurings by providing an alternative means of exit for creditors who would otherwise have enforced. However, I have argued that there may still be a case for a moratorium in restructuring in order to enable directors to suspend payments on debt during restructuring negotiations to encourage bargaining. Once again, different considerations apply for small and medium sized enterprises where the distressed debt market does not operate as effectively and I would suggest that the issues should be reviewed separately for each part of the market.

Financing a restructuring

Finally, the vexed question of whether a special regime is needed for finance raised during a restructuring case would benefit from a new appraisal. Here greater research into the role debtor in possession financing now plays in Chapter 11 would be beneficial. Traditionally, third party financiers have stood ready to provide DIP financing as a source of liquidity for the restructuring case. However, US commentators suggest a changing role for DIP financing, with distressed debt purchasers using the regime as a strategic tool to gain control. At the same time, we need to understand the extent to which conditions for access to cash collateral affect the financing needs of the debtor.

ISSUES FOR INSOLVENCY LAW

Thus far I have concentrated on the need to review how our restructuring regime operates in the twenty-first century. But I also suggest that it is time to consider whether our insolvency regime operates as effectively as it might to maximise sale proceeds where the creditors decide that they are no longer willing to remain invested and the distressed debt market identifies no restructuring surplus. This requires examination of many of the same issues but in a different context. For example, do we continue to see a role for the trading administration given the rise of the pre-packaged sale and, if we do, is our moratorium strong enough to promote sale of the business as a going concern? Is our finance regime fit for purpose? And, given the changing nature of commerce, is it time to change our approach to asset classes such as intellectual property rights, currently grounded in nineteenth century concepts of property and contract?

In short, it is time to consider whether the regime which we have pragmatically adapted for changing conditions is really the one which we want – or whether we need to put time and resource into a real reform effort.

Sarah Paterson
(Department of Law,
London School of Economics
and Political Science)

SARAH PATERSON

Sarah Paterson is an Assistant Professor of Law at the LSE where her research and teaching interests focus on corporate insolvency.

Before joining the LSE in September 2013 she was a partner with Slaughter and May in London specialising in corporate restructuring and insolvency.

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Law
The London School of Economics
and Political Science
Houghton Street
London WC2A 2AE