

# Reflections on English Law Schemes of Arrangement in Distress and Proposals for Reform

by

SARAH PATERSON\*

*The English scheme of arrangement process has, in many ways, proved a reliable friend to distressed companies and their majority finance creditors in the decade following the financial crisis. However, experience of using the scheme process to achieve a debt restructuring has highlighted a number of areas where it could be improved for the present, or to make it more adaptable in the future. This article was written at a time when the Insolvency Service had launched a review of the corporate insolvency framework in the UK (and published many of the responses which it has received to the consultation), and the European Commission had published a proposal for a new Directive setting minimum harmonisation standards for restructuring law. Both the consultation and the proposal have significant implications for the reform agenda, and the Government has published its response to the UK consultation just as this article is going to press. This paper focuses on the introduction of a preliminary moratorium as a gateway to restructuring efforts, the crucial question of how to value the enterprise if a cram down mechanism is introduced and the role of the insolvency practitioner in the scheme context.*

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\* Associate Professor of Law at the London School of Economics and Political Science. An earlier version of this paper was presented at the CLC Harris Manchester NUS Schemes of Arrangement Conference on 12 January 2017. The author is grateful to Jay Westbrook, John Armour and other participants at the conference for comments. The author is also grateful to Janis Sarra for comments. The usual disclaimers apply.

*Introduction*

Much of my recent work has focused on the way in which the English law scheme of arrangement procedure can be used to break deadlocked negotiations when a majority of the financial creditors wish to restructure the debts of a large, financially distressed company, but a minority are not willing to accept the debt restructuring plan. This has been a particular issue around the globe after the financial crisis, not least because financial innovation in the last couple of decades has resulted in a good deal more complexity in capital structures and in a more diverse group of creditors (who must be co-ordinated) on the one hand, and a much better understanding of the benefits of deleveraging a distressed balance sheet in anticipation of better times ahead on the other. The English scheme of arrangement process has, in many ways, proved a reliable friend to distressed companies and their majority finance creditors in the crisis. However, experience of using the scheme process to achieve a debt restructuring during the crisis has highlighted a number of areas where it could be improved for the present, or to make it more adaptable in the future. In my work I have analysed (in greater and lesser levels of detail) why the scheme process has worked tolerably well without a moratorium, but reasons why we may nonetheless wish to provide for a moratorium going forwards,<sup>1</sup> why we may wish to provide for cram down between classes of creditors within a scheme and how we should approach questions of fairness in allocating proceeds of the debt restructuring,<sup>2</sup> and whether there should be a role for the insolvency practitioner in the scheme of arrangement procedure.<sup>3</sup> This article was written at a time when the Insolvency Service had launched a review of the corporate insolvency framework in the UK (and had published many of the responses which it has received to the consultation),<sup>4</sup> and the European Commission had published a proposal for a new Directive setting minimum harmonisation standards for restructuring law.<sup>5</sup> The Government has published its

1 S. Paterson, 'Rethinking the Role of Corporate Bankruptcy Theory in the Twenty-first Century' (2016) 36(4) OJLS 697.

2 S. Paterson, 'Debt Restructuring and Notions of Fairness' (2017) 80(4) MLR 600.

3 S. Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards' (2014) 14(2) JCLS 333.

4 Available at <https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework>.

5 European Commission Proposal for a Directive on Preventative Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures (henceforth the "European Commission proposal").

response to the review just as this article is going to press.<sup>6</sup> Both the response to the consultation and the proposal go beyond reform of schemes of arrangement, but both have significant implications for them. The purpose of this paper is to set some of my previous work firmly in the context of my response to the consultation and my reaction to the proposal, and to consider further some of the points which I noted in previous work but left for another day which are relevant to that enquiry.

### *The Scheme of Arrangement Procedure*

English insolvency law has no single gateway through which a distressed company must pass before its debts are restructured, its business and assets sold as a going concern or its assets sold on a break-up basis. Instead, this choice is largely left to the directors and (in some circumstances) the creditors. There are currently 7 relevant procedures:

- Scheme of arrangement
- Company voluntary arrangement (CVA)
- Administration
- Fixed charge receivership
- Where a relevant exception applies in the Enterprise Act 2002, administrative receivership
- Creditors' voluntary liquidation
- Compulsory liquidation

Schemes of Arrangement are found in the Companies Act 2006.<sup>7</sup> Indeed, the fact that they exist outside insolvency legislation is thought to be one of their great strengths, given that the value destructive nature of insolvency proceedings is better understood in modern markets. Thus, even in the US where there has been a long tradition of using legal procedure to restructure corporate debts, fewer chapter 11 cases begin without any kind of negotiated plan than would have been the case in the 1980s and 1990s, and pre-negotiated restruc-

6 Insolvency and Corporate Governance Government Response 26 August 2018 (henceforth the "Government Response").

7 Part 26 sections 895–901.

turings, pre-packaged plans and pre-arranged sales of assets now dominate chapter 11 practice.<sup>8</sup>

An English scheme of arrangement may be proposed to achieve a ‘compromise or arrangement’ between a company and its creditors. Compromise presupposes some sort of dispute,<sup>9</sup> but ‘arrangement’ is interpreted broadly and does not require something analogous to a compromise.<sup>10</sup> Ultimately, all that is needed is some element of ‘give and take’ so that a creditor is not being asked simply to give something up and get nothing in return.<sup>11</sup> Thus schemes have been used to implement not only debt restructurings with which this paper is primarily concerned (such as debt-for-equity and debt-for-debt swaps) but also to amend existing debt arrangements to loosen covenants, extend maturities or even to implement a moratorium whilst a restructuring is agreed.

There will ordinarily be a pre-procedural phase in which the debt restructuring is negotiated. The specific issue which the scheme process is designed to address in a financial restructuring is the unanimous or very high consent thresholds ordinarily mandated in the loan agreement or bond documentation for many of the actions which are required to implement the debt restructuring plan. By contrast, the scheme of arrangement requires a vote of 75% by value and a majority in number of the members of each scheme class. Sometimes the scheme will merely be ‘threatened’ so that creditors will decide they may as well agree out-of-court (and sometimes worse terms are threatened if it proves necessary to proceed by way of a scheme). But in other cases, once the debt restructuring has been agreed by a sufficient majority to enable it to be implemented via a scheme of arrangement if there is still a hold-out minority the scheme process is commenced. The classic formulation for a scheme class is that it must be ‘confined to those persons whose rights are not so dissimilar to make it impossible for them to consult together with a view to their common interest.’<sup>12</sup> However, as creditors vote in class and the requisite majorities must be achieved in each of them, the courts are mindful of the need to avoid a proliferation of classes. In particular, they have emphasised the need to focus on rights (both rights which are to be released or varied under the scheme and the new rights to be granted under it) rather than interests. Thus questions of whether some creditors are

8 See, for example, D. Baird and R. Rasmussen, ‘Chapter 11 at Twilight’ (2003) 56 *Stan. L. Rev.* 673, 674–675.

9 *Sneath v Valley Gold Ltd* [1893] 1 Ch 477.

10 *Re Guardian Assurance Co Ltd* [1917] 1 Ch 431.

11 *Re NFU Development Trust Ltd* [1972] 1 WLR 1548; *Re Uniq plc* [2011] EWCH 749 (Ch).

12 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573.

influenced in voting by the fact that they have entered into a lock-up agreement to support the scheme,<sup>13</sup> or that they have received a modest consent fee,<sup>14</sup> have tended to go to the question of interests (which is relevant later in the process) and not rights (which is relevant in the early stages).

The first procedural step is to send out a letter setting out the scheme timetable and the classification of classes for voting on the scheme. The scheme then proceeds in a number of clearly defined stages. First, a ‘permission to convene’ hearing is held at which creditors may appear to argue that the composition of the classes is unfair,<sup>15</sup> or to raise issues with the manner in which the class meetings are proposed to be held, but ‘emphatically not ... to consider the merits and fairness of the scheme’.<sup>16</sup> The scheme document is circulated, together with an explanatory statement. The scheme meetings are then held, at which the requisite majorities must be achieved in each class. Assuming that the majorities are achieved, a further court hearing is held, at which the court must be satisfied that the ‘arrangement is such as an intelligent and honest man acting in respect of his own interest might reasonably approve’,<sup>17</sup> before sanctioning it. The court will ordinarily be of the view that ‘if the creditors are acting on sufficient information and with time to consider what they are about, and have acted honestly, they are ... much better judges of what is to their commercial advantage than the Court can be.’<sup>18</sup> But the court will be alive to claims that a creditor who has been left out of the scheme should have been included within it,<sup>19</sup> or that a creditor who has been included in the scheme has been treated too favourably, or that creditors have been ‘unfairly coerced by a majority within their class in terms of having been corralled by people whose rights appear similar but whose objects and interests were poles apart.’<sup>20</sup> Even if no-one appears at the sanction hearing to challenge the scheme, the court will consider it carefully before sanctioning it. Once the scheme has been sanctioned, and the court order filed at Companies House, it is very difficult to challenge the scheme, other than in the case of a fraud which affected the result.<sup>21</sup>

13 *Telewest Communications plc* [2004] BCC 356; *McCarthy & Stone plc, McCarthy and Stone (Developments) Limited* [2009] EWHC 712 (Ch); *Metrovacesa SA* [2011] EWHC 1014 (Ch).

14 *Re DX Holdings Ltd* [2010] EWHC 1513 (Ch); *Seat Pagine Gialle Spa* [2012] EWHC 686.

15 *Re Sovereign Marine* [2007] 1 BCLC 238.

16 *Re Telewest Communications plc (No 1)* [2004] BCC 342.

17 *Re National Bank Limited* [1966] 1 AER 1006.

18 *Re English, Scottish and Australian Chartered Bank* [1893] 3 Ch 385, at 409.

19 *MyTravel* [2004] EWCA Civ 1734; *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch).

20 *Primacom Holding GmbH* [2011] EWHC 3746 (Ch), at para 49..

21 *Fletcher v RAC* (1999) 96(II) L.S.G. 69.

Thus, although the scheme is relatively procedurally heavy for a small or medium sized enterprise, it is relatively ‘light touch’ for a large company with a complex capital structure when compared with other debt restructuring procedures around the world. It has proved adaptable (in terms of scope) and predictable (in terms of outcome) in the crisis, and has influenced discussion around reform of chapter 11 in the US, and around corporate restructuring reform in Europe. However, its great strength has proved to be in cases which are what we might call ‘largely consensual’; cases where the majority of financial creditors coalesce around a debt restructuring plan and where it has been possible to reach an accommodation with the equity, so that only a relatively small number of (sometimes unidentified) hold-out creditors remain.

Although English lawyers have developed a method of ‘twinning’ the scheme of arrangement with a pre-packaged administration where an entire class does not agree to the restructuring plan, as we shall see this is a much less elegant solution and has not been extensively tested. Some of the (unanticipated) developments in the finance market in the wake of government policy after the crisis have been the development of increasingly complex capital structures refinancing many leveraged situations,<sup>22</sup> the return of collateralised loan obligations,<sup>23</sup> the growth in high yield bond issues and the development of what is known as the ‘Term Loan B Market’ in which lenders trade financial covenant protection for (small) improvements in yield.<sup>24</sup> There is a concern that some or all of these innovations may mean that restructuring situations in the next slow-down in the finance cycle will not be amenable to the quasi-consensual approach which has dominated post 2008. In other words, the concern arises that we do not have a debt restructuring procedure equal to a more contentious fight. In particular, concerns have been voiced about the absence of a moratorium, and the requirement that majorities be achieved in each class before the scheme can be implemented.

Secondly, the crisis has, for the most part, been a finance crisis for large business. Unusual monetary policy conditions have meant that interest rates have stayed staggeringly low, and for the most part trading conditions recovered relatively rapidly after the worst of the crisis (although growth remains sluggish). This has meant that, in the large company space, financial liabilities

22 S. Paterson, ‘The Adaptive Capacity of Markets and Convergence in Law: UK High Yield Issuers, US Investors and Insolvency Law’ (2015) 78(3) MLR 431.

23 S&P Global RatingsDirect *Leveraged Finance: Borrower-friendly Credit Conditions Endure as the European Leveraged Finance Market Shrugs Off Brexit Uncertainty* 8 August, 2016, p.5.

24 White & Case *A Brave New World for International Leveraged Debt* (Debtwire Xtract Research 2016).

have typically been sufficient to absorb losses, so that almost all debt restructuring cases have involved only financial creditors and the scheme of arrangement (and the jurisprudence which has developed through the crisis) has proved equal to this task. There are concerns, however, about how well-adapted the scheme of arrangement would be to deal with a large company debt restructuring which implicated trade creditors as well as financial creditors.

Finally, there has not been a significant incentive to prefer sale in the market (causing losses to trade creditors) over a debt restructuring which leaves trade creditors untroubled, given the absence of many traditional bidders in the market. We cannot rule out that third party sale (and trade creditor loss) may return as a more viable alternative in the future. None of these points is developed expressly in the Insolvency Service consultation or the Government response, but it is suggested that they have influenced the concerns in the market which are reflected within it and the development of the European Commission proposal. This paper will now turn to the first issue: the absence of a moratorium.

### *Moratorium*

In my earlier work, I have unpicked why schemes of arrangement have operated pretty well during the financial crisis notwithstanding that they do not offer a statutory moratorium and notwithstanding the fact that bankruptcy theory tells us that a moratorium is essential to prevent creditors from taking individual enforcement action to ‘grab’ assets before the restructuring can be implemented.<sup>25</sup> In that work I drew a (controversial) line between restructuring situations, in which the market sees potential in restructuring the business, and an insolvency situation in which finance creditors are no longer willing to support the business.<sup>26</sup> The details of that distinction need not detain us here, but the relevance for this account is the analysis of the moratorium and the scheme of arrangement. I sought to show how an active distressed debt trading market in large company situations provided an alternative route for lenders

25 TH Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements and the Creditors’ Bargain’ (1982) 91(5) Yale LJ 857; TH Jackson, ‘Translating Assets and Liabilities to the Bankruptcy Forum’ (1985) 14(1) JLS 73; TH Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986); TH Jackson, RE Scott, T Eisenburg and M Roe, ‘On the Nature of Bankruptcy: An Essay in Bankruptcy Sharing and the Creditors’ Bargain’ (1989) 75(2) Va L Rev 155.

26 S. Paterson, ‘Rethinking the Role of Corporate Bankruptcy Theory in the Twenty-first Century’ (2016) 36(4) OJLS 697.

who do not wish to support the situation, so that those who are not willing to support a restructuring trade out, and those who are willing to support a restructuring trade in. I examined the incentives of financial creditors (other than distressed debt traders) who did not choose to sell, and did not find a significant incentive to prefer enforcement.<sup>27</sup> And I highlighted the role which modern financing documentation plays in providing contractual moratorium protection against enforcement. Overall, I concluded that we could explain why the scheme of arrangement has managed quite well without a statutory moratorium. We might also add to this the willingness of the English courts, in appropriate cases, to exercise their case management powers to create moratorium protection when a scheme of arrangement is well-advanced, commands wide support and appears to be in the interests of creditors;<sup>28</sup> the ability of debtors to commit lenders sufficient to block enforcement action to a stay in the lock-up agreements signed as part of the restructuring negotiations; and the possibility of using the scheme of arrangement procedure itself to create an interim moratorium.

However, I also raised several notes of caution. First, I highlighted just how crucial an active distressed debt market is to the analysis. At present, there appears to be an active and healthy distressed debt market in the UK, but we cannot be assured that it will be there for ever. Things change rapidly in modern financial markets. In the 1990s there was a deep and active market for providing so called debtor-in-possession financing to companies in chapter 11. However, a combination of reform to secured transaction law in the US, changes to practice in chapter 11 and significant regulatory changes, have led to the rapid decline of that market.<sup>29</sup> In the same way, we cannot be assured that the distressed debt market will be a permanent feature, or that it will always function in the same way. Moreover, as mentioned above, there has been a growth in access to the high yield bond market and so-called Term Loan B financing. Neither of these typically provides detailed maintenance financial covenants, so that it may be more challenging to bring the borrower to the table to negotiate and there may not be a long runway in which creditors can trade in and out before something must be done. Situations may become inherently more hostile. This may necessitate stronger tactics, such as threatening to cease to make interest payments until a restructuring has been agreed. Yet these tactics will also implicate difficult questions of directors' duties unless statutory endorsement of a payment moratorium is available. And finally the crisis may take a different form, necessitating compromise of trade credit as

27 Ibid., 714–715.

28 *Sea Assets Ltd v PT Garuda Indonesia; Bluecrest Mercantile NV v Vietnam Shipbuilding Industry Group* [2013] EWHC 1146 (Comm).

29 ABI Commission Report into Reform of chapter 11 at 75 fn 296.



well as financial liabilities, so that new incentives for another class of creditor to grab assets are introduced.

For all of these reasons I am not averse to providing for a voluntary moratorium in the scheme of arrangement process. Both the Government response and the European Commission proposal advance something rather different: a new preliminary procedure which would act as a gateway to restructuring or insolvency procedures. The preliminary moratorium idea clearly raises wider questions outside the scope of this paper. But insofar as it relates to the scheme of arrangement procedure a number of observations may be made.

First, difficult questions arise over timing. The original Insolvency Service proposal was for a moratorium of three months, extendable with the consent of all of the secured creditors and a majority of unsecured creditors, whilst the European Commission proposal is for a moratorium of four months, extendable with the consent of judicial or administrative authority.<sup>30</sup> Respondents to the Insolvency Service consultation raised concerns both that 3 months is too long (if it also stays the hand of trade creditors, for example) and too short (in order to negotiate a complex debt restructuring), and raised concerns about the extension mechanics. The Government response concludes that the new moratorium should be for 28 days, extendable, in certain circumstances, for a further 28 days. Creditor consent would be needed to extend beyond this 56 day period. Perhaps more importantly from a macro-perspective, it was not clear in the Insolvency Service consultation whether the new moratorium would be optional or compulsory. I strongly suggested, in my response, that the moratorium should be optional. We are already aware, from experience of the company voluntary arrangement procedure in the UK that distressed companies may be wary about announcing moratorium protection because this will draw unwanted publicity to a delicate situation. A number of respondents also raised this point, and the Government response confirms the optional approach.

Secondly, there are difficult questions on scope. The Insolvency Service proposal was not entirely clear as to the scope of the moratorium, but the Government response confirms that it will be broadly based on the moratorium which is currently available in an English law administration. This imposes a moratorium on creditors' rights to pursue a winding up, enforce security or repossess goods under hire purchase, conditional sale, chattel leasing or retention of title agreements, re-enter premises as landlord or pursue legal process against the company (including legal proceedings, execution, distress or diligence).<sup>31</sup> The European Commission proposal is more developed, and suggests that the

30 Article 6 of the European Commission proposal.

31 Insolvency Act 1986 Sch B1 para 43.

stay of enforcement could be general (affecting all creditors) or targeted towards individual creditors.<sup>32</sup> This is a point I return to below.

At present the moratorium in administration does not generally prevent the exercise of contractual termination rights,<sup>33</sup> although certain utility and IT suppliers can be required to supply provided the insolvency office holder is willing to offer a personal guarantee.<sup>34</sup> However, the company may have many other suppliers who are not utility or IT suppliers but who are nonetheless critical to the business. If this is the case, the administrator is able to pay the supplier's pre-administration debts as a 'ransom' creditor,<sup>35</sup> but this gives rise to two issues. The first is that payment alone may not induce the supplier to continue to supply. The second is that it enables the supplier to exploit its ransom position to gain preferential treatment compared with other, non-ransom unsecured creditors.

The Insolvency Service consultation proposed a mechanism for expanding the definition of suppliers who would have limited ability to terminate within the moratorium where they provide 'essential' supplies, foreshadowing the suggestion in the European Commission proposal that Member States should at least prevent termination of essential supplies such as gas, electricity, water, telecoms and card payment services but may choose to go further.<sup>36</sup> Even where a scheme of arrangement is only proposed amongst financial creditors, the rights of counterparties to terminate contracts may still be relevant, because contracts may contain termination rights which are triggered when a scheme is proposed and so, in principle at least, this seems like a good idea. In the US, typically contractual provisions that permit a party to terminate or modify what is known as an executory contract (essentially a contract which has not been fully performed) by virtue of the counterparty's insolvency or bankruptcy filing are unenforceable.<sup>37</sup> The debtor is then able to decide whether to assume or reject the contract,<sup>38</sup> and will often use the threat of rejecting the

32 European Commission proposal Recital (19) and Article 6.

33 *Re Olympia & York Canary Wharf Ltd* [1993] BCC 154.

34 Section 233 Insolvency Act 1986 and The Insolvency (Protection of Essential Supplies) Order 2015.

35 The analysis is moderately complex but relies on the ability to terminate contracts in administration (*Re Olympia & York Canary Wharf Ltd* [1993] BCC 154), Insolvency Act 1986 Sch. B1 para. 66 which permits an administrator to make a payment other than in accordance with the normal rules of distribution where 'he thinks it is likely to assist the achievement of the purpose of the administration' and Insolvency Act 1986 Sch 1 para 13 which empowers the administrator to make 'any payment which is necessary or incidental to the performance of his functions'.

36 European Commission proposal Recital (21) and Article 7(4).

37 11 U.S.C § 365(e).

38 11 U.S.C § 365.

contract to obtain (or attempt to obtain) concessions from suppliers and other parties. Similarly, Canadian courts have drawn on their discretionary powers, in making a stay order pursuant to the Canadian Companies' Creditors Arrangement Act (CCAA),<sup>39</sup> to prevent a creditor from terminating an executory contract with the debtor. In *Doman Industries Ltd* Mr. Justice David Tysoe of the British Columbia Supreme Court also found that the court has similar jurisdiction to grant a permanent stay surviving restructuring of the debtor company in respect of events of default or breaches occurring prior to the restructuring.<sup>40</sup> The Government has indicated, in its response to the Insolvency Service proposals, that it no longer intends to require the designation of essential supplies by a debtor company. Instead, the Government plans to legislate to prohibit the enforcement of termination clauses by most suppliers in contracts for the supply of goods and services where the termination clause is triggered by entry into a formal insolvency procedure, the pre-insolvency moratorium already discussed or the restructuring plan procedure discussed below. The proposal raises many questions and issues, but for our purposes it also directly implicates classic concerns for fairness (for non-consequentialists), economic concerns of negative ripple effects (for consequentialists) and wider questions about the effect of such interventions on entrepreneurialism.

In my previous work, I have challenged the idea of fairness as an intuitive concept, adopting Amartya Sen's challenge not to 'give our unscrutinised instincts an unconditional final say.'<sup>41</sup> In particular, as we shall see later, I have distinguished between fairness concerns where parties are of unequal bargaining power and sophistication, and where parties are of equal bargaining power and sophistication but have struck different bargains. As I say, this point will be developed in due course. But for the moment the point is made that staying the hand of small suppliers during attempts to rescue large businesses immediately gives rise to a fairness concern. Furthermore, many respondents to the consultation pointed out the potential for negative ripple effects if suppliers who were forced to supply struggled to secure their own supplies, or lost the protection of credit insurance and were ultimately left unpaid. At the most macro level, we may worry that this reluctance to protect the freedom of contract of small suppliers may have an impact on entrepreneurialism gener-

39 Companies' Creditors Arrangement Act R.S.C. 1985, c. C-36, as amended.

40 *Doman Industries Ltd, Re* (2003), 2003 Carswell BC 538, [2003] BCJ No. 562 (B.C. S. C. [In Chambers]), analysed in J. Sarra, *Rescue! The Companies' Creditors Arrangement Act* 2<sup>nd</sup> edition (Thomson Reuters Canada Limited 2013), 60–61..

41 A. Sen, *The Idea of Justice* (Penguin Books), 51.

ally.<sup>42</sup> Finally, respondents also referred to the relative ease with which some suppliers may be able to avoid entering into the sorts of long-term contracts which would be caught by the new provision. There is some evidence of this in the US. Whilst creditors who are bound by long-term contracts may be obliged to supply,<sup>43</sup> there is evidence in the US literature of many suppliers avoiding these sorts of arrangements through their contracting arrangements and demanding much the same priority treatment as a ‘critical vendor’ in bankruptcy as we are familiar with in England.<sup>44</sup>

It is in part for these reasons that I suggested that the scope of the moratorium should not be fixed. I suggested instead that a menu of options should be available, such as a no termination provision, a stay of certain classes of creditor, a stay of all creditors and stays of other proceedings. The benefit of this approach, from the debtor company’s perspective, is that it would be able to restrict or expand the moratorium to the matters which it considered needed to be covered, but it would also enable the independent court to scrutinise the fairness of the moratorium proposal. Further inspiration might be drawn here from the Canadian CCAA. In the first edition of her leading text, Janis Sarra describes the CCAA as providing, ‘a court-supervised process to facilitate the negotiation of compromises and arrangements where companies are experiencing financial distress, in order to allow them to devise a survival strategy that is acceptable to all their creditors.’<sup>45</sup> The first stage of the CCAA process is ordinarily to obtain an initial order and an initial stay, but a stay is not an essential component of CCAA proceedings, and the court will be alive to suggestions that the CCAA application is merely an effort by the debtor to avoid its obligations to its creditors, or to suggestions that creditors have lost all confidence in management.<sup>46</sup> Crucially, for our purposes, the court has discretion not only as to whether or not to order a stay, but also as to the scope of the stay. I suggested that this sort of flexibility is welcomed because the point at issue may vary from case to case. In some circumstances, the important issue may be restricting the triggering of cross default clauses or staying dissenting creditors, whilst maintaining (to the maximum extent possible) the functioning of the debtor company in a business as usual manner, whilst in

42 See, for example, A. Greenspan, *The Age of Turbulence: Adventures in a New World* (Allen Lane 2007), p. 15 ‘The spreading of a commercial rule of law and especially the protection of the rights to property has fostered a worldwide entrepreneurial stirring’.

43 11 U.S.C. § 362.

44 M.J. Roe and F. Tang, ‘Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors’ Bargain’ (2013) 99 Va. L. Rev. 1254-1257.

45 J. Sarra, *Rescue! The Companies’ Creditors Arrangement Act*, 1<sup>st</sup> edition (Thomson Reuters Canada Limited 2007), 1.

46 J. Sarra, *Rescue! The Companies’ Creditors Arrangement Act*, 2<sup>nd</sup> edition (Thomson Reuters Canada Limited 2013), 55–58.

others it may be crucial to mandate continued supply. One issue which has arisen is what Professor Sarra describes as ‘the problem of overreach’;<sup>47</sup> ever-more complex draft orders designed to cater for every eventuality but often required in a short time frame and with little notice to creditors. She describes efforts by the profession to draft model orders, which appear to have gone some way towards mitigating this problem. We may also wish to draw further inspiration from regimes which entitle the debtor to “turn off” termination rights in contracts in other group companies to the extent they arise solely as a result of the restructuring of the finance or parent company.

For the moment, however, and as already described, the Government response envisages a less-flexible moratorium based on the existing moratorium in administration. This may be, in part, because the Government response confirms that the moratorium will be obtained by paper filing only with the courts, unless a creditor launches a challenge to the stay. The European Commission proposal is not altogether clear, referring to judicial or administrative authorities, but also referring to a stay being ‘ordered’,<sup>48</sup> and providing that the stay should not be granted when creditors are unfairly prejudiced setting out detailed factors which the judicial or administrative authorities may take into account in establishing unfair prejudice.<sup>49</sup> It will be clear from this discussion that, although I am generally in favour of reducing the court’s role to an administrative filing function where possible, I can see considerable benefit in an initial hearing at which the moratorium is sought. One such advantage is that this would facilitate a flexible structure of the sort already described. Another is that it would mitigate some of the disadvantages which many respondents noted in their replies to the Insolvency Service consultation of putting all the work in disputing the moratorium on the creditor, who may be poorly resourced and not particularly literate in the insolvency system. Of course, it only provides some small remedy for these effects, not least because there will be limitations on notice to creditors. Yet it does at least provide a forum in which concerns can fairly easily be aired by the judge.

47 J. Sarra, *Rescue! The Companies’ Creditors Arrangement Act*, 2<sup>nd</sup> edition (Thomson Reuters Canada Limited 2013), 85–87..

48 European Commission proposal Article 6(2).

49 European Commission proposal Article 6. These are whether the stay would preserve the overall value of the estate, whether the debtor acts in bad faith or with the intention of causing prejudice and whether the debtor generally acts against the legitimate expectations of the general body of creditors and, in the case of a single creditor or class of creditors whether their claims would be made substantially worse-off as a result of the stay than if the stay was not granted or if the creditor is put more at a disadvantage than other creditors in a similar position.

The European Commission proposal suggests that the stay should be lifted when creditors are unfairly prejudiced, referring to the factors identified above. In the Government response the UK Government confirms that it plans to take a similar legislative approach as seen in administration as it considers, for the most part, that the same principles will apply in a case of a creditor applying to court to have a moratorium lifted.<sup>50</sup> In English insolvency law the approach to the lifting of the moratorium in administration is relatively well-developed in case law:

- Would lifting the stay impede the administration?
- If it would, and the applicant is a secured creditor, the property rights of the secured creditor will be balanced against the rights of the other creditors (giving weight to the proprietary interest)
- If it would, and the applicant is an unsecured creditor seeking leave to enforce a contract, would the court have granted an injunction or an order for specific performance if the company were not in administration and, if the court would have done so, would enforcement frustrate the administration?
- Where the claim is purely monetary, the stay will rarely be lifted

In its recent report, the ABI Commission recommended that an unsecured creditor should be permitted to compel performance of its contract ‘if the court determines, after notice and a hearing, that the harm to the non-debtor party resulting from the trustee’s non-performance significantly outweighs the benefit to the estate derived from such non-performance’ (see page 116). This would seem to be similar to the English approach. For secured creditors, the US position is more complex and depends, in part, on the type of security which the creditor has been granted.

### *Cram down*

Schemes of arrangement have been used in the financial crisis to swap the debt of highly leveraged businesses, which is typically secured (so that the company voluntary arrangement or CVA route is not available), into equity. Although it is possible to cram a scheme of arrangement onto minority creditors within a class, it is not possible to cram a scheme of arrangement onto a dissenting class. English common lawyers have overcome this challenge by “twinning” the scheme of arrangement with a pre-packaged administration sale of the business

50 Insolvency and Corporate Governance Government Response 26 August 2018, 49.

and assets to a new company, stranding creditors in the dissenting class in a shell company with no assets.<sup>51</sup> Although this has proved a workable solution, it undoubtedly uses the pre-packaged administration sale in a way which was not envisaged by the legislature, and the Insolvency Service has suggested that cram down between classes is something which should now be specifically addressed. The European Commission proposal also sets out a plan for what it calls cross-class cram down. I agree that it is time to address the way in which English law permits imposition of a debt-for-equity swap in a large corporate situation on a dissenting class.

The first option would be to reform the scheme of arrangement procedure itself to permit such a cram down. This gives rise to the following considerations:

- As mentioned above, schemes of arrangement are currently found in the Companies Act 2006. This is one of the procedure's great strengths because it reduces stigma and increases certainty (as review provisions of insolvency law relating to avoidance of transactions, directors' duties and the like are not engaged). Some jurisdictions have concluded that it would be inappropriate to allow cram down of a scheme on a dissenting class outside insolvency legislation. However, in other jurisdictions it may be possible to cram a scheme down on a class within a corporate law scheme. Further research would be beneficial here.
- If there is an imperative for recognition for the purposes of the World Bank Rankings, a cram down outside insolvency legislation may not be eligible for ranking purposes.
- We may want to give some thought as to whether the new cram down provisions can be adapted for use with other insolvency procedures.

Overall, this would suggest that one way forward might be a new procedure, based on the scheme of arrangement, but located in the Insolvency Act 1986 and permitting a debt-for-equity swap to be crammed down on a dissenting class. The Government response confirms that a new restructuring plan procedure is envisaged with no qualifying financial conditions. This raises the question of how the new restructuring plan procedure will interact with the existing options. For example:

- It is suggested that a mechanism should be incorporated to convert a scheme of arrangement (in the Companies Act 2006) into the new struc-

51 For a fuller description see S.Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards' (2014) 14(2) JCLS 333.

turing plan procedure. There is already precedent for this in the mechanisms in English law which permit conversion from of a company voluntary liquidation into a compulsory liquidation. There is also precedent in Canada, where two different insolvency regimes sit alongside each other for the purposes of achieving a debt restructuring (the CCAA, already discussed, and the proposal provisions of the Bankruptcy and Insolvency Act),<sup>52</sup> and provision is made to allow a proceeding to be converted from one statute to another under certain conditions.

- Should a scheme of arrangement “twinned” with a pre-packaged administration be prohibited if it is merely an attempt to avoid the requirements of the new restructuring plan procedure (as is currently the case for a *sub rosa* chapter 11 plan)?
- Should the review provisions of insolvency law relating to avoidance of transactions, directors’ duties and the like be engaged in the restructuring plan procedure?

One further consequence of the lack of a formal cram down procedure in English law, and the pragmatic use of the scheme of arrangement coupled with the pre-packaged administration to fill that gap, is that there has been no legislative debate as to the appropriate valuation standard which should be used when a plan is imposed on financial creditors. Uncertainty creates issues for financial creditors, who are unable to price the risk of default if they do not know which valuation standard will be applied to determine whether they are in the money or out of the money, and valuation is a thorny issue. The Insolvency Service consultation document appeared to suggest that a minimum standard is adopted (no creditor worse off than in liquidation), leaving it to the courts to decide whether some other standard should be applied in a particular case. There were a wide variety of responses on this issue, but I, and many other respondents, considered that this is not a matter which should be left to develop through the courts, and that if a cram down provision is to be introduced we must determine which valuation standard we wish to adopt when a plan of reorganisation is imposed on dissenting creditors. The complicated choices around valuation standard were not addressed in the Insolvency Service consultation document, but the Government response concludes that valuation should be determined by reference to the next best alternative for creditors if the

52 *Bankruptcy and Insolvency Act*, RSC 1985, c. B-3, as amended (*BIA*). It is also possible to implement a restructuring in Canada under the Canadian Business Corporations Act (CBCA) R.S.C. 1985 c. C-44 as amended. For a discussion see Sarra, *Rescue! The Companies’ Creditors Arrangement Act*, 2<sup>nd</sup> edition (Thomson Reuters Canada Limited 2013) at 12, 36–46.



restructuring plan was not to be agreed.<sup>53</sup> This contrasts with the European Commission proposal, which appears to largely adopt the approach in chapter 11. It is, then, necessary to consider the two broad approaches to the valuation question currently adopted in corporate debt restructuring in order to evaluate the relative merit of the different valuation standards.<sup>54</sup>

### Counterfactual approach

The counterfactual approach is the approach traditionally adopted by English law.

In short, it requires the court to consider whether creditors are worse off in the proposed restructuring than they would be if the restructuring did not go ahead. This is sometimes described as the liquidation standard, but in fact it is more nuanced than that label would suggest. In the *MyTravel* case, the counterfactual was a liquidation of the business, because there was evidence that if the restructuring did not go ahead the Civil Aviation Authority would revoke *MyTravel's* operating licence so that it would not be able to continue to operate as a going concern.<sup>55</sup> However, these facts are unusual and generally the counterfactual will be a going concern sale of the company's business and assets by an administrator.

Even where a going concern valuation is adopted, there are nonetheless criticisms of the English approach which concentrates on the market price for the business at the time of the restructuring. Both procedural and substantive criticisms are raised. Insofar as procedure is concerned, the counterfactual value is often established by a short bidding process for the company's business and assets, but in many cases this may not be a real auction process because bidders are unwilling to commit to it if they suspect the process is merely a means to establish a price to benchmark a restructuring, rather than a genuine sale process. Moreover, if senior lenders are confident that they are in the money on the counterfactual basis, they have little incentive to reach a negotiated settlement and may prefer resorting rapidly to the legal process.

There are also a number of substantive issues. Restructurings often occur when either the market is depressed, or the particular sector in which the seller

53 Insolvency and Corporate Governance Government Response 26 August 2018, 74.

54 For more detail see S.Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards' (2014) 14(2) JCLS 333; S. Paterson, 'Rethinking the Role of Corporate Bankruptcy Theory in the Twenty-first Century' (2016) 36(4) OJLS 697.

55 *Re MyTravel Group Plc* [2004] EWCA Civ 1734; [2005] 2 BCLC 123.

operates is distressed, so that trade buyers in the same sector lack financing to make a bid, or there may be a shortage of bid financing generally, or potential buyers may simply be conserving their reserves. Moreover, the sale agreement will often be drafted on insolvency terms, in other words, without any representations and warranties, indemnities etc. For both these reasons the price may be lower than the price which would be obtained for the business in a more normal market on more normal arms' length terms. Thus, if the business is valued on this basis, senior creditors may take the lion's share of the equity in a debt-for-equity swap, but as the market and the business recovers, may subsequently recover more than they were owed.

### The bargaining and litigation approach

As a result, a different approach is used in US bankruptcy in chapter 11, sometimes referred to as the bargaining and litigation approach.<sup>56</sup> Here, each creditor class retains its own expert to value the business and assets of the company using standard valuation methodology such as comparable transaction pricing, discounted cash flow (or DCF) and leveraged buyout pricing. If the parties do not reach agreement, there may be a valuation hearing in the chapter 11 process which the bankruptcy judge will arbitrate.

There are several advantages to this approach. The first is that it is arguably fairer because it does more to prevent the situation in which senior creditors grab a significant proportion of the equity when the market is depressed. Secondly, we may prefer this approach if the money which is at stake in junior tranches of the capital structure has been invested by pension funds, insurance funds etc. so that it is money which belongs to us all. Thirdly, we may prefer it if it increases the availability of credit or reduces its cost. Fourthly, we may prefer it if we consider it will do more to attract international investors to UK debt structures. Finally, this approach may do more to incentivise a negotiated settlement because all parties fear the litigation risk and expense inherent in a court valuation fight. In other words, senior creditors may be incentivised to give something to junior classes to effectively buy out any ability which they have to hold up implementation of the plan of reorganisation by forcing the matter into a contentious court hearing.

However, the US approach also has serious disadvantages. First, out-of-the-money creditors may fear the valuation fight less than senior creditors (having less to lose) and thus capture returns which they ought properly not to be

56 D.G. Baird and D.S. Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2006) 115(8) *The Yale Law Journal* 1930.

entitled to. Secondly, negotiations can become very protracted, costing significant amounts and delaying rehabilitation of the company. Finally, the approach is very subjective so that the result is somewhat unpredictable, and the judge hearing the valuation dispute may, as Judge James Peck has put it, feel gamed. Thus it is the subject of much debate in the US at the moment, with some practitioners arguing for the UK approach or, at least, a different approach.

### Options approach

The issue has recently been considered in the US as part of the American Bankruptcy Institute (ABI) Commission on Reform of Chapter 11. Specifically, the Commission considered whether some variant of the so-called options approach should be adopted. Several US academics have advanced the idea of the options approach, in which out-of-the money creditors would receive an option with a strike price equal to the debt ranking ahead of them and a defined exercise period, which could be traded in the market and which would assume a higher value if the business recovered rapidly following the debt restructuring.<sup>57</sup> The ABI Commission report uses options pricing methodology as a starting point in order to determine whether creditors who are out-of-the money today should receive some consideration in the restructuring. However, the author's impression is that the idea has not been greeted with much enthusiasm in the market, the idea is not reflected in either of the consultations under consideration and it would seem to add to, rather than reduce, complexity. Accordingly, it is not discussed in more detail here.

### Determining a way forward

There is little detailed analysis on the issue in the Insolvency Service consultation and Government response, and none in the European Commission proposal. Yet the choice between these two broad approaches is not to be taken lightly. The first point which requires consideration is the argument around which approach is fairer. In a recent paper, I have suggested that we need to be careful about how we think about fairness in the context of debt restructuring involving

57 L. Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101(4) Harv. L. Rev. 775; P. Aghion, O. Hart and J. Moore, 'The Economics of Bankruptcy Reform' (1992) 8(3) J. Law Econ. Org. 523; O. Hart, *Firms, Contracts and Financial Services* (Oxford University Press 1995); L. Bebchuk, 'Using Options to Divide Value in Corporate Bankruptcy' (2000) 44(4) Eur Econ Rev 829.

large, sophisticated creditors.<sup>58</sup> The paper divides fairness concerns into two, broad groups comprising what I have called issues of substantive fairness and issues of procedural fairness. Drawing on a wide range of literature from diverse fields such as moral and political philosophy, biological sciences, psychology, organisation theory, group theory and economics I sought to build an analytical framework to assess fairness concerns in small and medium sized debt restructurings (which do not implicate the scheme of arrangement procedure and so are relevant for this account in only one small way which will become apparent in a moment), and a large corporate restructuring in which debt restructuring proceeds were allocated based on the English counterfactual approach and without a US-style valuation battle. My principal categories of substantive fairness were the principle of equal treatment for equally situated creditors (dealt with in the scheme of arrangement procedure by careful class classification and the other procedural safeguards), the principle of deservingness (getting one's due), the principle of consent or responsibility for outcomes, the principle of legitimate expectation, the principle that losses should not fall on those least able to bear them and what Mark Warren calls a 'pathological form of fairness',<sup>59</sup> the desire to see the party who has done us wrong suffer. Insofar as procedural fairness is concerned, I focused on voice for those affected by the decision in the process, lack of bias and protection against abuse of power. Working carefully through each of these categories, I sought to show that they are each of greater concern in small and medium sized debt restructuring, where the creditors have very different levels of bargaining power and sophistication, than in the large corporate debt restructuring where the original investment decision was made by a sophisticated creditor with access to professional advice and the full range of investment opportunities available to him. There is neither space nor time to cover that separate paper here, and interested readers are directed towards it. For the moment, the point is made that we must be very careful about the precise 'fairness' concern which guides us in balancing the different policy objectives.

Even if the differential fairness analysis is disputed, it is not at all clear that the primary method of valuation in US chapter 11, the discounted cash flow, is to be preferred as intrinsically fairer. In a recent paper, Arturo Cifuentes briefly tracks the history of the discounted cash flow method applied to valuation.<sup>60</sup> He points us to Joel Dean's work in the 1950s in developing the

58 S. Paterson, 'Debt Restructuring and Notions of Fairness' (2017) 80(4) MLR 600.

59 M.E. Warren, 'Democracy and the Everyday Origins of Fairness' in J.P. Sarra (ed) *An Exploration of Fairness: Interdisciplinary Inquiries in Law, Science and the Humanities* (Canada: Carswell, 2013).

60 A. Cifuentes, 'The Discounted Cash Flow (DCF) Method Applied to Valuation: Too Many Uncomfortable Truths' available at SSRN: <https://ssrn.com/abstract=2845341> or <http://dx.doi.org/10.2139/ssrn.2845341>.

DCF approach by analogy with bond valuation as the right tool for valuing financial assets.<sup>61</sup> However, he shows how (absent issuer credit risk) the future cash flows of a bond are well-defined. Of course, when we are considering a business, cash flows are inherently uncertain. As Cifuentes puts it, ‘... the probabilistic distribution of cash flows is not bounded: we can get more, or we can get less than expected. The distribution is two-sided. There is upside and downside potential.’<sup>62</sup> He also points to the problems of estimating the correct discount rate using the weighted average cost of capital (which is ‘feasible, at best, for firms that have publicly traded debt and equity’<sup>63</sup>), and the use of a single discount rate to two cash flows with different risk profiles. Overall, Cifuentes argues that the DCF ‘attempts to transform a problem which is probabilistic in nature (cash flows are uncertain) into a deterministic problem by appealing to the “right” discount rate’<sup>64</sup> (reminiscent of attempts by one set of financial advisers in a well-known English case to use Monte Carlo simulation methodology precisely to aim at characterising the problem probabilistically – an attempt which met with very great disfavour from the judge).<sup>65</sup> The important point here is that this unease with the use of DCF methodology is not being raised specifically in the context of corporate bankruptcy. In another recent paper, Michael Simkovic has shown how concerns such as these are causing US bankruptcy courts to consider moving away from DCF and comparable transaction methodology to newer methods based on market prices.<sup>66</sup> He goes so far as to call this a ‘time of transition between methods of financial analysis’,<sup>67</sup> as courts look for newer corporate finance methods which can be ‘more objective, less susceptible to hindsight bias, harder to manipulate, and less expensive to implement.’<sup>68</sup> In the context of debt restructuring in chapter 11 he concludes, ‘the rise of 363 sales is driven in part by preferences for market valuations through a judicially supervised auction process rather than purely judicial valuations.’<sup>69</sup> There is, therefore, a risk that we turn

61 J. Dean, *Capital Budgeting* (Columbia University Press, 1951).

62 A. Cifuentes, ‘The Discounted Cash Flow (DCF) Method Applied to Valuation: Too Many Uncomfortable Truths’ available at SSRN: <https://ssrn.com/abstract=2845341> or <http://dx.doi.org/10.2139/ssrn.2845341>.

63 *Ibid.*

64 *Ibid.*

65 *Re Bluebrook [2009] EWHC 2114 (Ch)*.

66 M. Simkovic, ‘The Evolution of Valuation in Bankruptcy’ (2017) 91 *Am. Bankr. L. J.* 299.

67 *Ibid.*, 300.

68 *Ibid.*, 304.

69 *Ibid.*, 304, citing D.G. Baird and R. Rasmussen, ‘The End of Bankruptcy’ (2002) 55 *Stan. L. Rev.* 751, 758, 785–88, 789; D.A. Skeel Jr., ‘The Nature and Effect of Corporate Voting in chapter 11 Reorganisation Cases’ (1992) 78 *Va. L. Rev.* 461–533, 496–98; J. Berge, ‘An Efficiency Model of Section 363(b) Sales’ (2006) 92 *Va. L. Rev.* 1639–1685,

towards DCF and comparable valuation methodology just as the US turns away from it.

Even if one points to the fact that much of the money involved is pension fund and insurance money and belongs to us all, it is not at all clear that the DCF and comparable transaction methodology (with all its inherent subjectivity and somewhat vague application) produces a 'fairer' outcome. Simkovic points to the cost of the exercise which can be vast. Valuation is crucial to many different aspects of the US chapter 11 process, and Simkovic tells us that in the Caesars Entertainment case the financial advisers sought approval for over \$17 million for financial analysis. It is clear that this goes far beyond the work which we are concerned with in the present context, but it does give an indication of the risks of increasing the role of professional advisers in the process. It is also the case that even if junior creditors or shareholders are successful in lobbying for a stake in the restructuring proceeds through the DCF and comparable transaction valuation exercise, the amount which they will receive will often be pretty small.

In the 'fairness' piece, I noted that we might still be concerned if our choice of valuation methodology had an impact on the availability and cost of credit in the primary market. This brings us to the vexed issue of the relationship between debt restructuring law and the availability and cost of credit. Legal scholarship often states that insolvency law has an influence on both, but also often as an intuition and without much empirical support. This is, of course, because the investment decision is influenced by so many factors that it is almost impossible to isolate restructuring law's contribution (if any). But it is arguably crucial to our decision on the choice between valuation standards in cram down. At the outset, two broad intuitions present themselves. The first is that senior lenders may be more willing to permit subordinated borrowing if restructuring law protects their rights. But the second is that junior lenders may only be prepared to lend if their position is protected on default. Against a normative concern for the availability and cost of capital, these two intuitions may lead us towards some sort of balance between senior and junior creditor rights after the US model. However, my research suggests a somewhat different answer.

In my work in 2012 I found important differences in the capital structures of leveraged debt deals in the UK and in the US.<sup>70</sup> I pointed to the fact that in

1644, 1671; H.R. Miller and S.Y. Waisman, 'Is chapter 11 Bankrupt?' (2005) 47 B.C. L. Rev. 129, 172-73; J.M. LoPucki and J.W. Doherty, 'Bankruptcy Fire Sales' (2007) 106 Mich. L. Rev.; J.J. White, 'Bankruptcy Noir' (2008) 106 Mich. L. Rev. 691-719; 691-92.

70 S. Paterson, 'The Adaptive Capacity of Markets and Convergence in Law: UK High Yield Issuers, US Investors and Insolvency Law' (2015) 78(3) MLR 431.

the US high yield bonds were typically part of what we might call a ‘traditional’ structure, in which the high yield bond is subordinated to a senior secured loan with a revolving credit facility, whilst in the UK issuers were increasingly combining loan and bond debt in the secured part of the deal structure. The purpose of the article was to consider the consequences of capital structure for pressure for change in valuation approach (which I return to below), but I wondered in passing whether the comparatively less favourable conditions for junior bondholders in the UK also contributed to the differences in capital structure. However, evidence in the market since then suggests that corporate restructuring law (and anticipated recovery return on default) does not have had much to do with it. Instead, the availability of (cheaper) all senior deals appear to be a function of conditions in the leveraged finance market. In their European Leveraged Loan Chart Book 2016, Fitch point out that ‘Structures with senior secured notes sitting alongside senior loans saw an increase in leverage between 2011-2012 and 2013-14 whilst pricing declined driven by investor’s “search for yield”’ but that ‘In 2015, few leveraged buyouts have seen senior secured notes together with senior loans and leverage has declined whilst pricing has increased, as risk appetite for new HY-funded LBOs fell amid increasing volatility. The number of refinancings has reduced in 2015 but deals have seen further increases in leverage and pricing pressure as borrowers took advantage of existing investor bases. High-yield notes increasingly became an unsecured/subordinated instrument in 2013-2014, helping borrowers increase financial leverage.’<sup>71</sup> This is echoed by S&P who state, ‘Looking at the deal structures that we track on a quarterly basis ..., there is an increase in “traditional” structures – a senior secured loan with an accompanying revolving credit facility – in the first quarter of 2016, when deal execution in the bond market was difficult. When the bond market reopened in the second quarter, issuers began to structure all-bond transactions, as well as combine loan and bond debt in the senior secured part of the deal structure.’<sup>72</sup> It seems, then, that market conditions, and not restructuring law, are driving capital structure decisions – it’s the market, stupid!

Fitch’s Country-Specific Treatment of Recovery Ratings provides some interesting colour for this analysis.<sup>73</sup> Fitch’s recovery analysis methodology applies restructuring analysis to the rating notches of debt instruments. Most of this methodology is not jurisdiction sensitive. The key country-specific treatment

71 *European Leveraged Loan Chart Book – 2Q2016* FitchRatings July 2016, 19–20.

72 *Leveraged Finance: Borrower-Friendly Credit Conditions Endure as the European Leveraged Finance Market Shrugs off Brexit Uncertainty* 8 August, 2016 S&P Global Ratings.

73 FitchRatings *Country Specific Treatment of Recovery Ratings* 18 October 2016.

of recovery ratings appears to be the ‘soft caps’ to instrument ratings for a particular jurisdiction. Countries have been separated into groupings of the world’s jurisdictions based on Philip Wood’s *Maps of World Financial Law* and each legal group has been assigned a cap.<sup>74</sup> Jurisdictions have then been ranked according to the World Bank’s Distance to Frontier (DTF) data with specific cut-off points for each jurisdictional group. There are four groups: Group A can be rated up to ‘RR1’; Group B can be rated up to ‘RR2’; Group C can be rated up to ‘RR3’ and Group D can be rated up to ‘RR4’. But here is the crucial point. Group A, which comprises ‘Jurisdictions that generally support the priority of claims on bankruptcy and display other features that are deemed to be generally creditor-friendly, including generally reliable enforceability’ so that ‘the legal and political environment provides no cap to RRs’<sup>75</sup> includes the UK, USA, Germany, Netherlands, Australia and Japan. In other words, even where differences in corporate restructuring law between jurisdictions are taken into account for the purposes of assessing the recovery rates of debt when it is issued in the primary market, only broad differences seem to go to the analysis and not specific differences such as valuation methodology.

At first sight, empirical work in the finance literature appears to undermine this broad ‘country bucket’ approach to corporate restructuring and insolvency law, but a closer examination may support it. Davydenko and Franks find fascinating evidence of banks adjusting their lending and reorganisation practices to mitigate what they term ‘costly aspects of bankruptcy law’.<sup>76</sup> However, crucially their research focuses on lending by domestic banks to small and medium sized enterprises. We would expect to find domestic banks lending to this riskier group of borrowers with detailed knowledge of (and perhaps bias for) their home jurisdiction approaching their credit decision in a different way from lenders in large, complex, international capital structures, particularly as commercial banks have extensive teams which specialise in screening and monitoring business debtors and legal teams with detailed knowledge of the domestic legal regime.<sup>77</sup> This is heightened by the fact that Davydenko and Franks focused on secured lending, comparing collateral demands in France and Germany with collateral demands in England in the era of ‘administrative receivership’ when a small group of domestic banks was able

74 P. Wood, *Maps of World Financial Law* (Sweet & Maxwell 2008).

75 FitchRatings *Country Specific Treatment of Recovery Ratings* 18 October 2016.

76 S. Davydenko and J. Franks, ‘Do Bankruptcy Codes Matter?’ (2008) *The Journal of Finance* Issue 2 April 2008, 565.

77 J. Armour, A. Menezes, M. Uttamchandani and K. Van Zwieten, ‘How Do Creditor Rights Matter for Debt Finance? A Review of Empirical Evidence’ in F. Dahan (ed) *Research Handbook on Secured Financing in Commercial Transactions* (Cheltenham: Edward Elgar Publishing 2015).



to rely on careful monitoring and extra-judicial enforcement of secured credit covering all or substantially all of the firm's assets on default.<sup>78</sup> The credit assessment for a fund investing in a complex, international capital structure is likely to be very different: monitoring is costly; investors are numerous and dispersed; and the fund lacks the portfolio management and restructuring resources of a large European domestic bank and may actively trade debt positions in the secondary market across its portfolio.<sup>79</sup> Considered from this perspective this gives rise to a new intuition: that whilst domestic banks may pay relatively closer attention to the detail of the corporate restructuring and insolvency legal regime (particularly when advancing secured credit to SMEs), funds and other investors who more habitually invest in junior debt are more likely to take a generalised approach to the legal environment closer to the 'general legal ethos' identified by Fitch.

In this context, Becker and Stromberg consider an event study around a change in the duties of directors in Delaware when a company is financially distressed which was favourable to creditors.<sup>80</sup> They find that leverage did increase but 'by a relatively small amount.'<sup>81</sup> They also suggest that the decision was followed by longer maturities and less use of covenants,<sup>82</sup> but found the reduction in covenants primarily in firms closer to distress.<sup>83</sup> Crucially, they do not find any evidence of a change in interest cost.<sup>84</sup> In other words, the change in law does not seem to have been significant enough to change the overall way in which investors viewed corporate restructuring and insolvency law risk. Rodano, Serrano-Velarde and Tarantino study the effects of Italian bankruptcy law reform of 2005-2006 on the cost of loan financing.<sup>85</sup> Fascinatingly, and perhaps counter-intuitively, they find that the introduction of a reorganisation (or restructuring) procedure actually increased the interest rates in loan financing. In other words, the reform was sufficiently significant to change the way in which investors viewed corporate restructuring and insolvency law in Italy, but changed it in a negative way. On closer inspection, this is entirely consistent with the 'country bucket' approach. There appears to be weak confidence

78 See J. Armour and S. Frisby, 'Rethinking Receivership' (2001) 21 OJLS 73.

79 See, for example, T.Cox, D. Malone and M. Sinjakli, 'Investing in Distressed Debt in Europe: an Overview' in I. B. Aldana (ed) *Investing in Distressed Debt in Europe* (Globe Law and Business Ltd 2016), 18.

80 B. Becker and P. Stromberg, 'Fiduciary Duties and Equity-debtholder Conflicts' (2012) 25(6) Rev. Financ. Stud. 1931.

81 Ibid., 1953.

82 Ibid., 1955.

83 Ibid., 1956.

84 Ibid., 1954.

85 G. Rodano, N. Serrano-Velarde and E. Tarantino, 'The Casual Effect of Bankruptcy Law on the Cost of Finance' available at <http://ssrn.com/abstract=1967485>.

in Italian insitutions in corporate restructuring and insolvency, whilst the new regime prescribed that the debtor should be the sole party entitled to open the procedure and put forward the restructuring plan, provided the debtor with a powerful automatic stay against creditor actions during plan development and provided the courts with the ability to impose a plan in the face of creditor dissent in certain circumstances. This appears to have exacerbated creditor concerns about the overall Italian corporate restructuring and insolvency law environment, so that ‘worse repayment incentives outweigh efficiency gains from greater creditor coordination.’<sup>86</sup>

Recent work in an entirely different area also supports this ‘country bucket’ analysis, and reinforces the idea that whether a change in law has an impact, and whether that impact is positive or negative, depends not only on the substantive change itself but also on how it interacts with the pre-existing perception of the general legal environment by investors. Hans Christensen, Luzi Hail and Christian Leuz have examined the capital-markets effects of changes in securities regulation in the EU aimed at reducing market abuse and increasing transparency.<sup>87</sup> They find that the reforms increased market liquidity but that the effects were stronger in countries already perceived as having stricter securities regulation so that ‘countries with initially weaker regulation do not catch up with stronger countries, and that countries diverge more upon harmonising regulation.’<sup>88</sup> Two factors appear to be particularly important. First, the pre-existing market conditions reflect ‘insitutional, market, and political forces (or constraints) that are still at play when the new rules are introduced.’<sup>89</sup> Secondly, ‘a country’s past track record with respect to implementing regulation is likely to be revealing about its political will to put in place regulation that induces (or curbs) socially (un)desirable behaviour.’<sup>90</sup> Of course, this has far-reaching implications for the European restructuring harmonisation proposal outside the scope of this paper (including that the effect of incorporating stronger moratorium protection in England, which is generally perceived to be a creditor-friendly regime, may be less significant than the effect of incorporating it in other EU Member States’ insolvency regimes where creditors have less confidence in the overall legal environment). For the moment, the point is that what may matter most for the availability and cost of

86 *Ibid.*, 17.

87 H.B. Christensen, L. Hail and C. Leuz, ‘Capital-Markets Effects of Securities Regulation: Prior Conditions, Implementation, and Enforcement’ Chicago Booth Research Paper No. 12–04. Available at SSRN: <https://ssrn.com/abstract=1745105> or <http://dx.doi.org/10.2139/ssrn.1745105>.

88 *Ibid.*, 1.

89 *Ibid.*, 11.

90 *Ibid.*, 11.

credit in complex capital structures for large firms (of the sort likely to resort to the scheme of arrangement procedure) is not the detail of the corporate restructuring and insolvency regime, but rather the general perception of the legal environment, and that the impact which a reform has on availability and cost of credit in a particular jurisdiction will depend, in part, on how it changes that perception. Given English courts' generally credit market-friendly approach, and the deep and expert pool of lawyers working in this area in London, it is suggested here that a decision to retain the traditional European counterfactual approach in determining the allocation of restructuring proceeds is unlikely to cause capital to flow out of English cases, at least in firms some distance from default.

Nonetheless, let us suppose, for the moment, that all of the detail of restructuring law *does* matter for the availability and cost of junior debt and shareholder equity. We should still ask whether we care. One of the issues highlighted during the financial crisis was that banks and other financial institutions had been able to borrow too cheaply because of an assumption in the market that governments would not allow them to fail.<sup>91</sup> This was objectionable in part because it proved to be correct; governments around the world stepped in to use taxpayers' money to restore banks' balance sheets. Thus part of the regulatory response after the crisis has been designed to ensure that the industry will henceforth bear the costs of its mistakes, so that financial institution debt must be re-priced to reflect this. But it is also an acknowledgment of the broader role which mispriced debt played in the crisis. Many bankruptcy scholars have highlighted the role which insolvency law plays in the availability and cost of credit in the market for debt for healthy companies.<sup>92</sup> Yet this is normally described in only one direction: if insolvency law is not sufficiently (secured) creditor friendly, sources of finance may diminish or pricing may go up. The financial crisis showed us that we do not necessarily want a limitless supply of cheap money. Indeed, it highlighted the risks of distress if there is too much leverage in the system, the 'zombie company' problem caused by debt overhang and the risk if investors make assumptions about the liquidity and depth of the secondary market (so that the investment model assumes that the investor will be able to trade out should the need arise). At the time of writing, growing leverage (and aggressively borrower friendly terms) are causing renewed anxiety amongst regulators, with the ECB publishing an exposure draft setting out regulatory guidelines consistent with US leveraged lending

91 A. Admati and M. Hellwig, *The Bankers' New Clothes* (Princeton and Oxford: Princeton University Press, 2013), 89; C.M. Reinhart and K.S. Rogoff *This Time is Different: Eight Centuries of Financial Folly* (Princeton and Oxford: Princeton University Press 2011), 145.

92 D. Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108(3) *The Yale Law Journal* 573.

guidelines.<sup>93</sup> We may not mind if we have a restructuring law which is predictable and capable of comparatively rapid and cheap execution, but which causes some price increase for risky junior debt to compensate pension funds and insurance companies adequately, or if some companies are unable to leverage their equity to the same extent because they are regarded as too risky. Indeed, it may be that that is just how it should be.

Of course, all of this assumes that large corporate debt restructurings continue much as they have evolved post-crisis: debt-for-debt or debt-for-equity swaps to deleverage the balance sheet (sometimes accompanied by an injection of new money) such that the financial liabilities are sufficient to absorb the losses. I noted at the outset that we cannot be assured of this trajectory, and that different ‘fairness’ considerations arise where trade credit is implicated. Although, therefore, I am broadly in favour of the best alternative available to the company in determining value, there may need to be a caveat to deal with future developments. I return to this point at the end of the paper.

The final point made in favour of a US approach to the valuation question is that the very unpredictability of the valuation dispute encourages bargaining. Where this bargaining takes place in the context of the cost and complexity of a pending chapter 11 dispute, it is not immediately obvious that it delivers the usual benefits of a consensual deal in terms of speed and reduced cost. But setting that to one side, creating an environment in which rational actors are incentivised to bargain, so that any hold-out problem is reduced to the maximum extent possible must be a good thing, particularly if we focus on some of our concerns for procedural fairness. This takes us to our final issue: whether some sort of mediator should be introduced into the process.

### *The Mediator*

One question raised during the ABI deliberations on chapter 11 is whether some sort of independent mediator could be appointed to help mediate valuation fights between the parties and, potentially, to assist the bankruptcy judge, and the European Commission proposal suggests that Member States may require the appointment of a practitioner in the field of restructuring where the debtor is granted a general stay of enforcement actions or where the restructuring plan needs to be confirmed by a judicial or administrative authority by

93 European Central Bank, *Draft Guidance on Leveraged Transactions* 23 November 2016, available at: [https://www.bankingsupervision.europa.eu/legalframework/public-cons/pdf/leveraged\\_transactions/leveraged\\_transactions\\_guidance.en.pdf?fbdb5fffb4-daff043052e8a056d620b](https://www.bankingsupervision.europa.eu/legalframework/public-cons/pdf/leveraged_transactions/leveraged_transactions_guidance.en.pdf?fbdb5fffb4-daff043052e8a056d620b).

means of a cross-class cram down.<sup>94</sup> This is an idea which I have written about in the UK context,<sup>95</sup> where there is already a party well-positioned to take this role, in the shape of the insolvency practitioner. In my work, I have focused on the fact that in most cases the company will be arguing in favour of the restructuring on the basis that it produces a better result for creditors as a whole than the best available alternative option, which will often be an administration sale of the business and assets as a going concern. But for this analysis to withstand scrutiny, the administrator-in-waiting must be convinced of the case for moving to a sale transaction if the debt restructuring fails. This is because paragraph 3(1)(a) of Schedule B1 to the Insolvency Act 1986 mandates a rescue of the company as the first purpose of the administration unless the administrator thinks that is not reasonably practicable and he acts in the best interests of creditors, in which case he can move down the hierarchy of purposes to a going concern sale.

In my earlier work I noted that paragraph 3 is a difficult paragraph, which has been described by Armour and Mokal as ‘almost Delphic in its complexity.’<sup>96</sup> But in my analysis I argued that the difficulties with the construction of the hierarchy do not entitle the senior class to hold the administrator to ransom, and refuse the debt restructuring plan, where the administrator considers (weighing the interests of the different classes and the expected recovery in an administration) that another, fairer scheme is available and the question is the allocation of the debt and equity rather than strategic decisions such as who to sell the business to.<sup>97</sup> I therefore suggested that the Insolvency Practitioner should have a role in a cram down scheme.

There has been some considerable scepticism about the IP as a neutral gatekeeper in English insolvency law. It is suggested here that this scepticism has arisen in part because of the historically close relationship between IPs and the clearing banks which dominated the financial landscape in the UK. However, this landscape has fundamentally changed, and there may be a role for an IP if a new cram down provision is introduced. Indeed (although this would require considerable thought) one solution to mediate between the rather blunt application of the counterfactual valuation standard and the problems inherent in moving towards the US valuation approach may be to provide the IP with a role in deciding on the “fairness” of the restructuring plan, given not only the apparent value in current market conditions, but also the forecasts for the

94 European Commission proposal Article 5.

95 S.Paterson, ‘Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards’ (2014) 14(2) JCLS 333.

96 J. Armour and R. Mokal, ‘Reforming Governance of Corporate Rescue: The Enterprise Act 2002’ (2003) 1 Lloyds Maritime and Commercial Law Quarterly 28,41.

97 *Ibid.*, 37 n 64.

business. This could be bolstered by enhanced regulation setting out how the IP should approach the valuation mediation role, new legal rights which creditors could have to make representations to her, and new challenge rights against the IP's decision-making (perhaps not pitched as high as the current thresholds to challenge IPs). Indeed, some inspiration could be taken from the field of takeovers and the role of the independent adviser. Reform of this type would be limited, however, to large corporate situations using the scheme of arrangement or proposed restructuring plan procedure and it would be important for IPs willingness to take on the role that any challenge to the IP's opinion is dealt with before sanction of the scheme.

Further inspiration might also be drawn once again from the Canadian CCAA process (and a number of respondents highlighted this in their response to the Insolvency Service consultation). If a stay is ordered in CCAA proceedings, a monitor is appointed (and the court has discretion to order the appointment of a monitor in other cases). Crucially, the court has discretion 'to direct the monitor to perform duties such as acting as liaison with the creditors and giving an opinion on the debtor corporation's ability to meet the requirements of a revised business plan.'<sup>98</sup> Like the English law administrator, the monitor is an officer of the court who can provide a dual function as the court's officer in holding the ring in commercial discussions between the stakeholders and in reporting to the court. But unlike the English law administrator, she does not replace the company's directors and the company's governance structure continues through the process. Janis Sarra notes, 'Monitors increasingly navigate the debtor company through the complexity of the CCAA process, providing business judgment, negotiation skills and financial advice. The monitor can act as mediator or facilitator, bringing the parties together in an effort to build consensus on a viable going forward business plan.'<sup>99</sup> In developing this role for the monitor the Canadian courts have consistently emphasised the need for the monitor to act independently, and their repeated emphasis on this point appears to have been crucial in the perception of market players and trust in the monitor role.<sup>100</sup>

The Government response concludes that where a preliminary moratorium is in place a Monitor should be appointed who should, for the moment, be a regulated insolvency practitioner. However, the response also envisages a relatively limited role for the Monitor and that there would be no Supervisor or similar office holder in the new restructuring plan procedure. Interestingly, a relatively detailed response to the consultation was submitted by the judges

98 J. Sarra, *Rescue! The Companies' Creditors Arrangement Act*, 2<sup>nd</sup> ed. (Thomson Reuters Canada Limited 2013), 32.

99 *Ibid.*, 571.

100 *Ibid.*, 571, 574–579.

of the Chancery Division of the High Court. The Chancery Judges pointed to the role of the monitor under the Canadian CCAA. But they also expressed some concern about a move towards US-style valuation fights in cram down saying, ‘the existing arrangements have the great benefit that in general the most contentious question (valuation of the business, from which proceeds the constitution of the classes who are “in the money” and those who are “out of the money”’) depends crucially upon the commercial judgment of the administrator supporting the pre-pack administration (against whom disgruntled creditors have a right of recourse) and not upon the judge. Notwithstanding that the proposal is that the new restructuring plan procedure would adopt the best alternative available approach, it is suggested here that we may still want to consider whether a role for the insolvency practitioner as officer of the court and mediator and facilitator of the restructuring plan should be built into any new cram down procedure.

### *Conclusion*

Overall, then, I am persuaded of the wisdom of providing for a moratorium at least in an ‘insolvent’ scheme of arrangement, not because it is widely needed at the moment, but to assist in more hostile situations and to future proof the scheme against market changes. I support the decision in the Government response to make the moratorium optional, but continue to be attracted by the ‘menu approach’ adopted in the European Commission proposal, which enables both the company and the court to flex the scope of the moratorium to deal with the particular issues of the case. I also support the ability to ‘switch off’ termination events, although suspect that the devil will be in the detail of this development. To this end, the extensive jurisprudence in US chapter 11, and the experience of the Canadian CCAA may continue to provide helpful guidance.

On balance, I am in favour of valuing the company on the basis of the best available option in a cross-class cram down procedure, but I accept that different ‘fairness’ considerations may arise if future cycles do not involve the compromise of claims amongst highly sophisticated financial creditors, but also implicate trade. To this end, the UK Government response confirms that the court will retain an absolute discretion whether or not to confirm a restructuring plan on just and equitable grounds.

Finally, I am of the view that there would be benefit in building incentives to bargain into the process and in assisting the court in determining whether the commercial aspects of whatever test is settled upon have been met. To this end, and notwithstanding the UK Government response, I think there is a role for developing the insolvency practitioner as an officer of the court during a restructuring plan process, to facilitate negotiation and to report to the court.