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Abstract

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Keywords

Bankruptcy reorganization

CORPORATE REORGANIZATION AND STRATEGIC BEHAVIOUR: AN ECONOMIC ANALYSIS OF CANADIAN INSOLVENCY LAW AND RECENT PROPOSALS FOR REFORM

BY J.J. QUINN*

Upon a debtor's bankruptcy, creditors act opportunistically towards the disposition of the debtor's assets. J.J. Quinn discusses Part III of the Canadian Bankruptcy Act and recent proposals for reform using an economic analysis of creditors' behaviour

I. INTRODUCTION

This paper analyzes the provisions of Part III of the Canadian *Bankruptcy Act*¹ (hereinafter the Act) which regulate the reorganization of insolvent corporations. These rules provide a framework for the creditors' collective decision concerning the disposition of their insolvent debtor's assets and establish a procedure for judicial review of reorganization bargains to ensure that certain standards of fairness imposed by the Act are respected. The paper argues that the Act's regulatory scheme can be plausibly explained as a set of rules designed to impose limits on strategic behaviour among the creditors. The rationale for legal control of opportunistic behaviour developed in this paper is derived from an economic analysis of the insolvency process. The paper also briefly considers non-economic rationales for regulating strategic behaviour.

The first part of the paper attempts to explain existing insolvency law as a relatively sophisticated apparatus for limiting the economic costs of creditor opportunism in large corporate failures. The paper identifies those bargaining situations in which creditors are most likely to behave strategically and attempts to assess the private and social costs of creditor opportunism in insolvency negotiations. Most of the existing literature has focused on the problem of controlling strategic

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¹ R.S.C. 1970, c.B-3.

behaviour by debtors. Most studies on the law and economics of corporate reorganization have concluded that it would be economically efficient to make it more difficult for insolvent firms to reorganize. This paper argues that many legal strategies which have the consequence of discouraging corporate reorganization may not improve the efficiency of the insolvency process because they are likely to impose substantial transactions costs on the creditors as a collectivity. The implications of shifting the analytic focus to strategic behaviour by creditors are traced through a discussion of the most recent, but unsuccessful, attempt at comprehensive reform of Canadian bankruptcy and insolvency law, Bill C-17,² which expired on the order paper prior to the federal election of 1984. Other reform ideas are drawn from U.S. law and recent proposals advanced in the Cork Report on English insolvency legislation.³ Finally, the paper argues that some proposed alternatives are clearly superior to others, at least in respect to their likely impact on economic efficiency.

II. RATIONALE FOR REGULATION

A. Introduction

When a firm becomes insolvent, Canadian law provides rules and procedures for regulating creditors' decisions concerning the disposition of their debtor's property. Since the equity holders of a legally insolvent firm have, from a practical standpoint, exhausted the value of their investment, the firm's creditors become its *de facto* owners.⁴ When the creditors take control, either with the debtor's consent or through the invocation of the insolvency process, they face two basic collective decisions — one allocative and the other distributive.⁵ First, they must

² Bill C-17, *Insolvency Act*, 2d Sess., 32nd Parl., 1983-84.

³ Department of Trade & Industry, Review Committee on Insolvency Law & Practice, *Insolvency Law and Practice* (1982) Cmnd. 8558.

⁴ S.2 of the Act defines an "insolvent person" as "a person who is not bankrupt and who resides or carries on business in Canada, whose liabilities to creditors provable as claim under this Act amount to one thousand dollars, and either (a) who is for any reason unable to meet his obligations as they generally become due; (b) who has ceased paying his current obligations in the ordinary course of business as they generally become due; (c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due. Only an "insolvent person" may initiate a voluntary bankruptcy proceeding or make a proposal for an arrangement with his creditors. See also ss. 31 & 32.

⁵ One or more creditors may invoke the bankruptcy process when their debtor owes at least one thousand dollars and commits an "act of bankruptcy". S. 24 provides an exhaustive list of various "acts of bankruptcy" which include: (1) failing to pay debts as they become due; (2) transfer of property by debtor with intent to defeat or delay recovery by creditors; (3) allowing judgment debts to remain outstanding for more than two weeks after a writ of execution is issued;

reach a decision on the appropriate allocation of the firm's assets. Three general options are available to the creditors: (1) liquidation of the assets on a piecemeal basis; (2) sale of the firm as a going concern; or (3) reorganization of the firm's capital structure to permit its continuation as a going concern. Each of these three options may be achieved either by unanimous agreement of the creditors and their debtor, or by use of the statutory procedure. Combinations of these three strategies are also possible; for example, a division or subsidiary of the insolvent firm might be sold as a going concern, and the remainder of the firm reorganized or liquidated. As a collectivity, the creditors share a common interest in allocating the debtor's assets to their highest-valued use in order to maximize the resources available for the payment of their claims.

The second question confronting the creditors concerns the inter-creditor distribution of rights in the proceeds of liquidation or sale or, if the firm is reorganized, the new securities created by the debtor's recapitalization. In one sense, it is incorrect to characterize the insolvency bargain as distributional in nature. This is because bankruptcy law provides a precise and comprehensive distributional scheme that may only be varied by unanimous consent of all the creditors.⁶ Under this scheme, some creditors enjoy distributional priorities over others; these lexically ranked entitlements are created either by contract with the debtor or by the Act and allied legislation.⁷ If these entitlements could be perfectly and costlessly enforced, the insolvency bargain would involve only good faith differences in business judgment on the value-maximizing allocation of the debtor's property. However, since the protection afforded in the insolvency process is both imperfect and costly, there is always a chance that some creditors may seek to bargain for a share of the debtor's property that is in excess of their legal entitlement. Such opportunistic behaviour is possible when, for example, junior priority creditors can credibly threaten to block a value-maximizing reorganization of the debtor's business unless they are paid a portion of the seniors' rightful share. Conversely, the balance of strategic advantage may sometimes lie with the senior priority creditors whose claims would be fully satisfied by the expected proceeds of the debtor's liqui-

and (4) generally any conduct which indicates that the debtor is an "insolvent person" as defined by s.2.

⁶ Such an agreement or voluntary settlement is usually referred to as a "workout".

⁷ The Act, s. 107 (governing the "scheme of distribution" in bankruptcy proceedings) and s. 41(4) (providing that distributions to creditors under proposals for arrangement must respect the distributional scheme specified in s. 107); see also *Re Masivor Corporation and Rainville v. Dep. Minister of Revenue* (1979), 30 C.B.R. (N.S.) 179.

dation and who can therefore make highly credible threats to block a value-maximizing reorganization unless they receive a bribe from the juniors' rightful share. These rent-seeking strategies have one common feature which should be of paramount concern in the design of an efficiency-oriented bankruptcy law — and they both involve threats to block an efficient redeployment of the debtor's assets. An evaluation of the economic consequences of existing Canadian bankruptcy law turns primarily on how efficiently the regulatory scheme controls strategic behaviour in the insolvency bargain that must be struck by the firm's creditors.

Strategic behaviour arises from two basic sources of inter-creditor conflicts of interest. One source, referred to above, is the legal distribution scheme which accords some creditors' claims absolute priority over others. The absolute priority rule requires that claims of senior rank be fully satisfied before any distribution is made to junior claimants. The second source of conflict in the insolvency bargain arises when creditors of the same priority class have collateral relationships with the debtor. Trade creditors and employees, for example, stand to realize future gains if the enterprise is continued; they would lose a valuable source of prospective income if the decision is made to liquidate. In short, a creditor's collateral relationship may induce it to support a proposal for reorganization even though the expected value of its claim would be increased by liquidation.⁸ Many large suppliers and senior managers of the debtor may oppose a sale of the firm to third parties for the same reason — a fear that the new owners will seek new suppliers and managers.

When other creditors of the same priority class do not possess valuable collateral relationships with the debtor, intra-class conflicts may arise that lead to strategic behaviour. A dominant majority of creditors with collateral relationships may attempt to impose a reorganization on a dissenting minority even though a liquidation or sale as a going concern would increase the expected values of creditors' claims. Alternatively, a coalition of creditors without collateral relationships may form

⁸ Although trade creditors should be interested in maintaining their debtor-customer's viability, it can be argued that the average trade creditor is still ill-suited to provide a long-term financial commitment. The cost of converting a claim to a long-term interest through extensive negotiations, and the benefit of an immediate cash payment for its claim, may often outweigh the uncertain benefit to the trade creditor of increasing the long run viability of a single customer. In large corporate insolvencies, major long-term creditors — banks, institutional investors and public bondholders — would usually not expect the value of continuous, repeated dealings with the debtor to outweigh the benefit expected from allocating the debtor's assets to their highest-valued use. See Brudney, "The Bankruptcy Commission's Proposed Modifications of the Absolute Priority Rule" (1974) *Am. Bankruptcy L.J.* 305 at 326-28, which discusses Securities Exchange Commission studies on conflicts of interest between creditors in corporate reorganizations.

for the purpose of extracting a bribe from those who have a collateral stake in the debtor's survival. Such a coalition could threaten to block an efficient or value-maximizing reorganization unless they receive a side-payment in addition to their legal entitlement.

These examples of opportunities for strategic behaviour suggest a close parallel between the dynamics of the insolvency bargain and other types of collective choice processes. Voting in legislative bodies or large committees generates the same general problems of majority oppression and minority recalcitrance described above, and many of the legal instruments employed to control these problems have substantial heuristic value for an analysis of corporate insolvency law.⁹ From an efficiency standpoint, all collective choice processes are plagued by the difficulty, perhaps the practical impossibility, of separating or insulating allocative decisions from distributional concerns. This is the basic problem for an efficiency-oriented bankruptcy law and the objective of this part of the study is to describe and analyze the ways in which the distributional conflicts inherent in the insolvency bargain affect the allocation of resources. In other words, can the conditions be specified under which the incentives and opportunities for strategic behaviour in the insolvency negotiations might lead to the imposition of an inefficient reorganization, or the blocking of an efficient reorganization or sale as a going concern? An adequate answer to this question requires the formulation of a conceptual framework to describe the ways in which strategic behaviour can occur, and the probability of its occurrence in actual bargaining situations.

Two kinds of advantage-taking in the insolvency bargain can be distinguished. Inter-class advantage-taking involves attempts by one priority class to extract concessions from or impose costs on another class. As mentioned earlier,¹⁰ bankruptcy law creates a hierarchy of distributional classes, and this scheme generates conflicts of interest between creditor groups holding superior and inferior priorities. One of the ways in which bankruptcy law attempts to regulate this conflict is by requiring class voting on all important decisions concerning the allocation of the debtor's assets.¹¹ Each priority class must vote separately

⁹ See Mueller, *Public Choice* (1979) at 19-66 for an excellent summary of the mechanics of coalition formation in various voting situations.

¹⁰ See text accompanying *supra* note 7.

¹¹ S. 85 of the Act provides for class voting in bankruptcy proceedings and s. 36(2) authorizes class voting on proposals. The Act does not prescribe any criteria for defining classes of creditors, but it seems that the only plausible criterion would be the relative priority ranking of each creditor's claim. S. 290(3) of Bill C-17 indicates that priority status is the key criterion of class definition.

on any proposal for reorganization or sale as a going concern which preempts any attempt by one class to impose either of these decisions on another. The only threat that the members of one class can make to the members of another is that they will vote to block an efficient reorganization or sale, with the consequence that the debtor's assets will be liquidated (that is, sold on a piecemeal basis).

Intra-class advantage-taking, the second basic category of strategic behaviour in the insolvency bargain, can occur in one of two ways. A majority of the class may vote to impose an inefficient reorganization or sale on the minority, or at least credibly threaten to do so. Bankruptcy law attempts to police this sort of advantage-taking by requiring supra-majority approval for reorganization proposals.¹² A second type of intra-class opportunism takes the form of organizing a minimum blocking coalition — a minority group with enough votes to credibly threaten to put the debtor into liquidation unless they are paid a bribe from the proceeds of an efficient reorganization or sale. While Canadian law does impose some procedural requirements which deter minority hold-outs, it can be argued that the existing regulatory scheme is peculiarly susceptible to advantage-taking strategies which entail threats or actual attempts to block efficient reorganizations or going-concern sales.

To support an argument for a systematic bias, it is necessary to assess the relative likelihood that strategic behaviour will actually occur in each of the different types of advantage-taking situations described above. Hold-out strategies, in both the inter- and intra-class contexts, often involve threats to take action which may be as costly for the threateners as for those threatened. It may be rational to make and even carry out such threats in some negotiating situations, but it is also certain that such strategies are less likely to be employed than those which are disproportionately less costly for the threateners than the threatened.¹³ Other kinds of bargaining advantages may also be unequally distributed among priority classes or interest groups within classes. Information about the debtor's financial prospects and the value-maximizing allocation of its assets may be asymmetrically distributed among the creditors. One of the key functions of the bankruptcy trustee is to act as an impartial source of information and analy-

¹² S. 36 of the Act provides that the holders of at least 75% of the claims of each class must vote in favour of a proposal.

¹³ See, e.g., Linskild, McElwain & Wayner, "Cooperation and the Use of Coercion by Groups and Individuals" (1977) 21 J. Conflict Resolution 531. See also the discussion of the "Shapley value" in formal game theory in Abrams, *Foundations of Political Analysis* (1980) at 222-25.

sis for the creditors.¹⁴ Negotiating strategies will also be shaped by the size of each creditor's stake in the outcome. Creditors with large claims will be more likely to commit substantial resources to participation in insolvency negotiations. Creditors with small claims have less to lose from a non-value-maximizing allocation of the debtor's assets, and this fact will enhance the credibility of their hold-out threats.

The number of creditors in each priority class, and in distinct interest groups within a class, is also an important determinant of bargaining strength. Groups with few members will enjoy substantial transaction cost advantages in organizing for concerted action in the negotiations.¹⁵ This is because of the cost advantages that small groups enjoy in reaching agreement on a common plan and in policing free-riding. The relative size of creditor groups exerts substantial influence on the outcomes of insolvency negotiations. Canadian corporate insolvency law weighs each creditor's voting power by the size of its claim and requires that the holders of seventy-five per cent in value of the total claims vote in favour of a proposed reorganization. This voting rule often permits one or two creditors with large claims to organize an effective blocking coalition.¹⁶ Very large groups of similarly situated creditors, such as holders of publicly-issued bonds or debentures, often agree to the appointment of common agents (for example, indenture trustees) to represent their interests in the event of insolvency.¹⁷ Loan syndication agreements among banks and other large institutional investors also attempt to deal with the "large numbers" problem through the appointment of bargaining agents and by provisions authorizing a majority of the creditors to bind the entire group in insolvency negotiations.¹⁸

Large commercial banks and institutional investors may derive substantial advantages from their roles as "repeat-players" in the insolvency process. Creditors who engage in repeated insolvency negotiations with one another will be deterred from exploiting opportunistic strategies for fear that they will be similarly exploited in future negotiations.¹⁹ The relatively small number of large commercial banks oper-

¹⁴ S. 13 of the Act requires the trustee to report to creditors concerning the current state of the bankrupt's affairs.

¹⁵ See Olson, *The Logic of Collective Action* (1971) at ch. 2 & 3.

¹⁶ See *supra* note 12.

¹⁷ See American Bar Foundation, *Commentaries on Model Debenture Indenture Provisions* (1971) at 220-222.

¹⁸ See, e.g., Blum & Kaplan, *Corporate Readjustments and Reorganizations* (1976) at 287-292.

¹⁹ For some experimental findings on the effect of repeat transactions, see Shapiro, "Effect of

ating in Canada increases the probability that bank creditors will repeatedly confront the same negotiating partners in large corporate insolvencies. Trade creditors and other "single-shot" participants in insolvency negotiations are more likely to be the victims of strategic behaviour because they cannot credibly threaten to retaliate in future dealings with the members of their priority class.

To summarize, the incidence of strategic behaviour in insolvency negotiations is determined by various structural factors which affect the relative bargaining power of the various priority classes and interest groups within those classes. Four factors are particularly relevant to an analysis of strategic behaviour in the bankruptcy process: (1) the number of repeat-players in a particular class or sub-group; (2) the relative size of stakes, including the stake in maintaining a valuable collateral relationship with the debtor, as between priority classes and also between sub-groups of classes; (3) the number of creditors in each class, and in each distinct interest group; and (4) the "threat advantage" of each class or sub-group, which is determined by the members' expected costs of actually carrying out threats to force an inefficient result in the negotiations.

B. *Economic Consequences of Strategic Behaviour*

An economic analysis of Canadian insolvency law requires an explicit normative framework for evaluating the economic consequences of its rules and procedures. This section of the paper explains how strategic behaviour in the insolvency bargain can impose avoidable costs on creditors and on third parties who lack any legal standing in the negotiations.

Strategic behaviour in the insolvency bargain can have adverse effects on both allocative efficiency and the technical efficiency of the credit market. The preceding section of the paper provided a description of the various ways in which creditor advantage-taking could lead to allocatively inefficient outcomes. The prospect of strategic behaviour in insolvency negotiations will also affect the terms of exchange in the capital market. For credit sellers, the delays and decreased recoveries resulting from advantage-taking by other creditors are a cost of doing business. Minority hold-outs may generate wasteful delays in the bargaining, even if an efficient allocation of the debtor's assets is ultimately chosen by the creditors. These delays may cause potentially via-

Expectations of Future Transaction on Reward Allocations in Dyads" (1975) 31 J. Personality & Soc. Psych. 873.

ble firms to deteriorate through loss of key customers and employees; the deadlocked negotiations may cause suppliers to form unduly pessimistic judgments concerning their customer's viability.²⁰ Moreover, substantial amounts of senior management time may be siphoned off by protracted bargaining, with the consequence that the debtor's operational problems lack the attention required to turn the firm around.

Allocatively inefficient dispositions of the debtor's assets also entail private losses to the creditors. Each creditor has an interest in minimizing strategic behaviour which decreases the amounts recovered from insolvent debtors and, assuming competitive credit markets, credit borrowers will share this concern since the costs of strategic behaviour will be reflected in interest rates.²¹ From a cost minimization standpoint, all participants in the credit market will favour some state intervention to control strategic behaviour in insolvency negotiations. This is because it is likely that strategic behaviour entails a negative-sum game for creditors as a collectivity — that creditors as a whole lose more than they gain from advantage-taking in insolvency negotiations.²² Each creditor might expect to obtain an occasional windfall if strategic behaviour is unregulated, but *all* creditors must bear the costs of delays, the costs of decreased recoveries and the direct costs of defensive strategies aimed at countering anticipated strategic advantage-taking by other creditors. Moreover, it can be argued that opportunistic behaviour will increase the variance in creditor recoveries, with the consequence that creditors will bear higher uncertainty costs if advantage-taking is unregulated.²³

The efficiency rationale for state regulation of the insolvency bargain also depends on a second assumption about transactions costs in the credit market — that it would be too costly to hold an *ex ante* meeting of all a debtor's creditors to agree on appropriate controls for strategic behaviour.²⁴ A large firm's pool of creditors will change over

²⁰ Roe, "Bankruptcy and Debt: A New Model for Corporate Reorganization" (1983) 83 Colum. L. Rev. 527 at 529-30. Roe describes some recent U.S. corporate reorganizations in which delays attributable to stalemated negotiations led to the loss of customers and suppliers. These losses are deadweight costs to the extent that they could have been avoided if strategic behaviour had not delayed the insolvency negotiations. See also *Wall St. J.* (1 Apr. 1983) 4, which alleged that rivalries between Dome Petroleum's creditors stymied workout negotiations for nearly a year.

²¹ The extent to which these savings are passed on to consumers will depend on demand and supply elasticities in credit markets. See *e.g.*, Weston, "Some Economic Fundamentals for an Analysis of Bankruptcy" (1977) 41 *Law & Contemp. Probs.* 47.

²² Tom Jackson has pointed out that this situation presents a classic example of the "prisoner's dilemma" problem in formal game theory. Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain" (1982) 91 *Yale L. J.* 857 at 862. For a general non-technical description of game theory, see Williams, *The Compleat Strategist* (1966).

²³ Jackson, *ibid.*

²⁴ See Smith & Warner, "On Financial Contracting: An Analysis of Bond Covenants"

time so that the agreement would have to be renegotiated periodically. Moreover, non-consensual creditors, such as tort claimants, would have to be brought into the agreement. Since the creditors cannot be expected to negotiate this agreement, even though it would be in their joint interest, there may be an efficiency justification for legal regulation of the insolvency bargain.²⁵

Legal rules governing distributional priorities and collective decision-making procedures prescribe a minimum set of entitlements and safeguards for each creditor. The rules provide a normative framework or starting point for bargaining on the fate of the debtor's business. There usually are substantial cost savings to creditors from negotiating outside the legal framework because of the expense of complying with the formalities required by the Act; as a result, creditors normally attempt to achieve agreement without first invoking the formal process. All the direct costs of the legal process are borne by the creditors (and ultimately their debtors) in the form of fee charges, which have the status of a first priority claim against the debtor's unencumbered assets.²⁶ Many students of the legal process have also claimed that the notoriety of the formal procedure may stigmatize reorganized firms and increase their perceived riskiness in the eyes of investors, suppliers and customers.²⁷ These costs of the insolvency process, if they are in fact quantitatively significant, will also be borne by the creditors (the new owners of the reorganized firm). While the creditors as a group have an incentive to reach agreement outside the legal framework, the direct and indirect costs of the formal process can be viewed as the price which creditors pay for state protection from strategic behaviour. Under Canadian law, informal agreements or "workouts" require unanimous consent because any creditor with a claim of at least one thousand dollars can, in effect, veto the workout bargain by invoking the formal process.²⁸

A second efficiency justification for state regulation of the insolvency bargain concerns the effects of strategic behaviour on the adjustment or transition costs which usually accompany large corporate insol-

(1977) 7 J. Fin. Econ. 117 at 125-31; Whitel, "Public Policy Toward Bankruptcy: Me-First and Other Priority Rules" (1980) 11 Bell J. Econ. 550 at 556-62.

²⁵ See Jackson, *supra* note 22 at 867.

²⁶ Subsection 107(1)(b) of the Act.

²⁷ See, e.g., Coogan, Broude & Glatt, "Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills" (1975) 30 Bus. Law. 1149 at 1154-60; Krause, "Insolvent Debtor Adjustments Under Relevant State Court Statutes as Against Proceedings Under the Bankruptcy Act" (1957) 12 Bus. Law. 184 at 185.

²⁸ See *supra* note 5.

vencies. These costs are incurred by creditors who have collateral relationships with the insolvent firm, such as employees and suppliers, and by non-creditors who may be employees, customers, suppliers or residents of the community where the firm is located.²⁹ When a large firm becomes insolvent, each individual with a substantial pecuniary stake in the firm's future must decide whether some investment in shifting to a new job, a new customer or a new community is cost-justified. These investment decisions will be made under conditions of uncertainty and imperfect information.³⁰ It can be argued that individual assessments of the probability of the debtor's reorganization may be biased by delays arising from strategic behaviour in the negotiations. Third party observers of the bargaining may take at face value the hold-outs' protestations that the debtor's future looks dim and that their shares of the proposed reorganized enterprise would be too small to compensate for the risks attendant upon continuing the business. Substantial delay for no apparent purpose other than jockeying for position may bias the expectations of interested observers toward unjustified pessimism.³¹ A systematic bias in expectations would lead to mistaken investments in adjustment, and these errors by firms and individuals would result in the waste of productive resources as well as private losses. Moreover, when strategic behaviour leads to the frustration of a value-maximizing reorganization, all the adjustment costs incurred because of the debtor's liquidation are unnecessary from an efficiency standpoint and are a waste of resources.

Finally, state intervention to control creditor advantage-taking could be justified on distributive fairness grounds. The distributive effects of strategic behaviour in insolvency negotiations can be evaluated from two perspectives — from the standpoint of its impact on the creditors' relative shares in their debtor's property and its consequences for the welfare of non-creditors with substantial pecuniary stakes in the debtor's fate. First, the distribution of the debtor's assets among its creditors is prescribed by the Act.³² If one believes that the statutorily prescribed distribution scheme reflects social justice objectives distinct from efficiency objectives, then strategic behaviour aimed at subverting

²⁹ See Gunderson, Halpern & Quinn, *Economic Rationales for Bailouts and Technical Issues in Measuring the Costs and Benefits of Bailouts* (1984) at 109-39.

³⁰ For a discussion of the economic adjustment problems that result from corporate failure see, Trebilcock, *The Political Economy of Economic Adjustment: The Case of Declining Sectors* (1985) at chs. 1 & 2; see also Quinn & Trebilcock, "Compensation, Transition Costs and Regulatory Change" (1982) U.T.L.J. 117-32.

³¹ See *supra* note 20.

³² Act, s. 107.

that scheme should be prevented. For example, the distribution scheme provides employees with a limited priority over unsecured creditors. One plausible justification for this preferred treatment is that employees may have special difficulties in obtaining accurate information regarding their employer's financial situation.³³ Alternatively, it can be argued that employees deserve a distributional priority because they are likely to be less well off than other classes of claimants. Finally, it can be argued that minority hold-out behaviour is analogous to extortion and is morally censurable regardless of its consequences.³⁴

A second distributional rationale for regulation is that some of the adverse impacts from strategic behaviour will be borne by non-parties to the insolvency negotiations.³⁵ Employees, customers, suppliers and community residents may suffer substantial private losses if a value-maximizing reorganization is blocked as a result of strategic behaviour. However, a general public concern for the distributional effects of large firm insolvencies would justify a more extensive regulatory scheme than one designed exclusively to control opportunistic behaviour by creditors for efficiency reasons. In many large corporate insolvencies there will be direct conflicts between the efficiency and distributional goals of regulation. Intra-class advantage-taking may, for example, involve the imposition of a non-value-maximizing reorganization by a dominant majority. While the allocation of the debtor's property is inefficient, employees, customers, suppliers and community residents are permitted to escape, or at least postpone, the private losses they would have incurred in a liquidation. Regulatory intervention in this class of cases would require a judgment about the priority of the conflicting goals. When strategic behaviour takes the form of holding-out for a larger share by threatening to block an efficient reorganization, the efficiency and distributional goals of bankruptcy law should be roughly compatible. The rules designed to deter minority hold-outs should also reduce the number of large firm liquidations and the socially undesirable private losses which accompany them.

The argument so far is that *some form* of collectively imposed control is necessary to avoid the inefficiencies created by strategic behaviour in insolvency negotiations. Moreover, legal regulation of minority hold-out behaviour would seem to avoid private losses which are unrec-

³³ For a discussion of the problems likely to be encountered when employees are confronted with demands for wage concessions in order to stave off insolvency see, Harris, Lewis & Purvis, *Market Adjustment and Government Policy* (1984) at 186-211.

³⁴ See Nozick, "Coercion" in Morgenbesser, *et al.*, eds., *Philosophy, Science and Method* (1969) at 232-62.

³⁵ This view is reflected in the "cramdown" proposal in s. 120 of Bill C-17.

essary from an allocative efficiency standpoint. The next step in the argument should be to identify the optimal set of regulatory constraints on strategic behaviour by creditors. One way of proceeding might be to sketch out an array of feasible regulatory options, and then attempt to pick the best in light of certain evaluative criteria, such as efficiency, fairness and cost minimization. Rather than attempt an *a priori* specification of feasible options, it seems more economical to begin with an analysis of how existing Canadian law affects the incidence of strategic behaviour in insolvency negotiations. An assessment of the performance of the existing regulatory scheme should provide a framework for evaluating alternative forms of regulation, including the amendments proposed in Bill C-17.

III. LEGAL REGULATION OF STRATEGIC BEHAVIOUR

At least one-half of the "large firm" insolvencies in Canada are, by conservative estimate, resolved through workouts in which creditors agree unanimously to liquidate, or sell or reorganize their debtor's business.³⁶ Firms that become insolvent prefer to keep their financial difficulties a secret and, as a consequence, no data are available on the proportion of large firm insolvencies that result in workouts. When the workout negotiations break down, either the debtor or one or more of its creditors have legal standing to invoke the statutory process. The management of the debtor firm, the group which initiates more than eighty per cent of large firm bankruptcies, must choose between two distinct forms of legal proceedings. The debtor may apply for a straight bankruptcy proceeding which aims at a sale of the insolvent firm or liquidation of its assets as soon as possible. The alternative is to make a "proposal for arrangement" which is designed to continue the debtor's operations, either on a permanent basis after reorganization or on a short-term basis until the firm can be liquidated or sold.³⁷ While there are a few significant differences in the rules governing bankruptcies and proposals, both proceedings are designed to create a procedural frame-

³⁶ A "large firm insolvency" can be defined as the failure of a debtor firm with *assets* in excess of \$2 million. The number of formal proposals for arrangement under the Act by such large firms number on 3 or 4 per year on average. For an analysis of the data on Canadian insolvencies compiled by the Superintendent of Insurance see, Gunderson, Halpern & Quinn, *supra* note 29 at 30-35. Since workout agreements are not matters of public record, no statistical data on their incidence among large firms is available. Discussions with experienced insolvency practitioners indicated that at least one-half of large firm insolvencies result in informal workouts, rather than proposals under the existing statutory scheme. Interviews with Ronald McKinlay of Clarkson & Gordon (Toronto) and John Honsberger of Raymond & Honsberger (Toronto) in August, 1983.

³⁷ Act, Part III, subsections 32-46.

work for the creditors' collective decision on the allocation of their debtor's property. Many of the rules common to both proceedings can be plausibly explained as regulatory responses to the problem of creditor advantage-taking in insolvency negotiations. The following discussion identifies four general rules or principles of insolvency law which appear to constrain and deter strategic behaviour by creditors. The existing regulatory system's net impact on the incidence of creditor advantage-taking will be considered after the legal instruments are described.

A. *Judicially-Enforced Distribution Scheme*

The Act prescribes a conceptually precise and comprehensive distribution scheme for an insolvent debtor's property which cannot be altered by post-insolvency actions of creditors.³⁸ Moreover, pre-insolvency transfers to creditors in anticipation of default are voidable, with certain limited exceptions.³⁹ The statutorily prescribed distribution scheme is protected by an "automatic stay" provision which prohibits creditors from pursuing any litigation or private collection remedies against their debtor after the formal proceedings are initiated.⁴⁰ The major exception to the automatic stay rule under Canadian law is that creditors are not restrained from pursuing private or judicial methods for recovering their secured claims.⁴¹ This "exit option" for secured creditors will be discussed in the next section.

If the legal proceeding is a straight bankruptcy, the debtor's assets will be converted into cash or, in some cases, the securities of an acquiring firm. After the sale or sales, the trustee must distribute the proceeds in the following order: first are the secured creditors, whose claims have priority to the extent of the value of the collateral securing them; second are the preferred creditors — the federal and provincial governments, bankruptcy trustees and lawyers, municipal governments and other crown agents, and employees with claims for up to five hundred dollars for unpaid wages; third are the ordinary creditors, who share *pari passu* in whatever remains of the debtor's property after the secured and preferred claims are paid in full.⁴² Creditors may often be members of more than one class; for example, when a secured claim exceeds the value of its collateral, the claimant will usually file as an

³⁸ Act, subsection 107.

³⁹ Act, subsection 69-70 (defining voidable preferences).

⁴⁰ Act, subsection 49(1).

⁴¹ Act, subsection 49(2).

⁴² Act, subsection 107.

unsecured creditor for the balance due. In making these distributions, the trustee must observe the absolute priority rule or doctrine which requires that each priority class be paid in full, to the extent that available assets exist, before the next class is paid anything.

The identical scheme for inter-creditor distributions prevails in the proposal form of proceeding.⁴³ If a proposal for reorganization is accepted by the creditor, the trustee must distribute the new securities in the insolvent firm in exactly the same pattern as under straight bankruptcy — first the secured creditors who opt to participate, then the preferred creditors and, finally, the ordinary creditors in absolute priority. Much of the recent work⁴⁴ analyzing the efficiency properties of the statutory distribution scheme focuses on the question of whether according paramount status to secured claims is efficient. Most efficiency justifications for secured credit derive from arguments that some creditors enjoy cost advantages over others in monitoring their debtor's behaviour and enforcing their own claims.⁴⁵ Creditors who are burdened by relatively higher enforcement costs will therefore place a greater value on obtaining security than those creditors favoured with less costly methods for enforcing their debt contracts. These arguments are complex and interesting, but they need not be recounted here since this analysis of post-insolvency strategic behaviour is concerned with creditors' efforts to evade the distribution scheme which shaped the terms of their contracts with their common debtor.

There is very little work on the normative justifications for the priority status of preferred creditors.⁴⁶ Preferred claims are owed to governments (or their political sub-divisions) and employees. As indicated earlier, preferential treatment for employee claims could be justified on social welfare grounds, although it should be noted that the current preference is limited to five hundred dollars which is about one week's pay for the average industrial wage-earner in Canada.⁴⁷ The preference for government claims is more difficult to justify, especially since governments are armed with a broad array of statutory liens and other

⁴³ Act, subsections 41(4) & 46.

⁴⁴ See Jackson & Kronman, "Secured Financing and Priorities Among Creditors" (1979) 88 Yale L. J. 1143; Schwartz, "Security Interests and Bankruptcy Priorities: A Review of Current Theories" (1981) 10 J. Legal Studies 1.

⁴⁵ For an excellent and comprehensive review of the literature, see Schwartz, *ibid.*

⁴⁶ See Laskin, *et al.*, *Debtor and Creditor: Cases, Notes and Materials*, 2d ed. (1982) at 502ff; Dunlop, *Creditor-Debtor Law in Canada* (1981) at ch. 17.

⁴⁷ See Committee on Wage Protection in Matters of Bankruptcy and Insolvency, *Wage Protection in Matters of Bankruptcy and Insolvency* (1981) at 23-32.

special collection rights that private creditors lack.⁴⁸ Since the substantive content of the Act's priority scheme is not discussed in the next section, it should be noted that Bill C-17 proposed major changes in the priority assigned to both employee and government claims. Employee wage claims up to four thousand dollars would have been accorded a "super-priority" ranking ahead of secured creditors in the distribution scheme.⁴⁹ Most government claims would have been demoted to the status of unsecured debts.⁵⁰

Regardless of whether the Act's distribution scheme is efficient or not, if the scheme could be perfectly enforced in both bankruptcy and proposal proceedings, the problem of strategic behaviour in insolvency negotiations would cease to exist. All four of the regulatory measures discussed in this part of the paper — judicial review, exit option, supra-majority voting rules and the guillotine rule — can be viewed as instruments for protecting the distribution scheme from various forms of opportunistic behaviour by creditors. Perhaps the most significant of the four instruments is the requirement of judicial review for all bankruptcy distributions and for proposals that are approved by the required majorities of creditor classes. While judicial review aimed at ensuring that final distributions to creditors conform with the statutory standard is common to both forms of proceeding, there are some important legal and practical differences between the bankruptcy and proposal processes. First, the court has a statutory duty to review the substantive fairness of reorganization proposals and to refuse to approve proposals that "are not reasonable or are not calculated to benefit the general body of creditors" regardless of whether any creditor objects or not.⁵¹ A formal review of distributions in bankruptcy occurs only when a creditor files an objection with the court.⁵²

Second, as a practical matter, fairness review is much more straight-forward when the debtor's assets are converted into cash or marketable securities. As long as the sale or sales are *bona fide* arm's length transactions, the value of the debtor's property available for distribution is not in doubt. This is not the case in proposal proceedings when the debtor's business is to be continued indefinitely and creditors' claims must be paid in the new securities of the reorganized firm. Ac-

⁴⁸ For a review of the literature, see Bogart, "Statutory Claims and Personal Property Security Legislation: A Proposal" (1983) 8 Can. Bus. L.J. 129.

⁴⁹ Bill C-17, s. 265(4)(e).

⁵⁰ Bill C-17, s. 265(5)(a); but see s. 265(4)(i) (money collected on behalf of the Crown).

⁵¹ Act, subsection 41(2). See, e.g., *Ord, Wellington & Co.* (1968), 12 C.B.R. (N.S.) 89.

⁵² Act, subsection 123(6).

curate judgments about whether certain creditors are being taken advantage of, either by majority imposition of an exploitive plan or by minority holding-out, requires that the court assess the reasonableness of the creditors' respective bargaining positions. Since the value of the reorganized firm will be a matter of substantial uncertainty, even among professional analysts, there is a greater likelihood that significant departures from the statutory distribution scheme will go undetected when the court reviews proposals for reorganization.⁵³ Thus, a proposal may exaggerate the expected value of the reorganized firm in order to disguise the fact that a bribe is being paid to an opportunistic minority or that an oppressed minority is receiving less than its statutory entitlement.⁵⁴ All other factors aside, it seems certain that courts will make more errors, and more quantitatively significant errors, in evaluating the distributional consequences of reorganization proposals as opposed to pay-outs in bankruptcy proceedings. This does not necessarily mean that more advantage-taking will occur in proposal proceedings than in bankruptcy cases. If bribes are legal, and promises to make them enforceable, the opportunistic creditors would be indifferent between collecting an excessive dividend from the bankruptcy trustee or being paid in cash by the other creditors. It seems likely, however, that promises to pay bribes in these circumstances are void and unenforceable since they undermine the policies of the Act.⁵⁵ Moreover, bribes actually paid would probably be recoverable under some restitutionary theory, since the statutory distribution scheme is clearly designed to protect creditors from exactly this form of exploitation.⁵⁶ Therefore, creditors will have an incentive to disguise their advantage-taking and it will be relatively easier to do so in proposal proceedings.

The third, and probably most significant, difference between the characteristics of judicial review in the two forms of proceeding arises from certain limits on the court's power to control creditor negotiations on proposals. If a minimum blocking coalition holds out for a bribe and the bribe is not paid, they may carry out their threat to block the reorganization favoured by their fellow creditors. When threats of this kind

⁵³ In fact, the reported cases indicate that the courts are generally reluctant to pursue the questions of valuation in proposal proceedings. See, Houlden & Morawetz, *Bankruptcy Law of Canada* (1982) (current service) and Act, subsections 32-46.

⁵⁴ See Blum & Kaplan, "Valuation for Purposes of Reorganization" in *Corporate Readjustments and Reorganizations* (1976) at 292-354.

⁵⁵ See, e.g., Waddams, *The Law of Contracts* (1977) at 351-59.

⁵⁶ See McCamus, "Restitutionary Remedies" in *Law Society of Upper Canada Special Lectures* (1975) at 276-84.

are carried out and the insolvent firm is liquidated, the Act makes no provision for judicial intervention. The court's only remedial power is to nullify unfair insolvency bargains; it has no power to impose a reorganization bargain as a remedy for opportunistic holding-out. In fact, the Act provides that if the voting by creditors results in a rejection of the reorganization plan, the case is automatically transformed into a straight bankruptcy proceeding.⁵⁷ This provision of the Act is usually referred to as the "guillotine rule", and its implications for strategic behaviour will be considered in a subsequent section.

B. *Exit Option for Secured Creditors*

The policy of the Act is one of non-interference with secured creditors' contractual rights to enforce their security interests when their debtor defaults. Secured creditors may proceed with the realization of their security regardless of the initiation of either form of statutory process.⁵⁸ Secured claims are exempt from the Act's "automatic stay" rule, and a secured creditor may act virtually independently of any proposal accepted by other creditors, or of any bankruptcy trustee attempting sale of the insolvent firm as a going concern. If collateral is in the creditor's possession when either form of legal process is initiated, the trustee, as the common agent of all the creditors, has a right to require the secured creditor to declare the value of the collateral and to redeem the security by paying either the full amount of the secured claim or the value declared by the creditor, if it is less than the claim.⁵⁹ If the trustee disputes the creditor's valuation of the collateral, the only remedy is to demand a public sale of the property.⁶⁰ If the collateral is in the possession of the insolvent debtor or its trustee, a secured creditor may force the release of the collateral within fifteen days by filing a formal demand with the trustee.⁶¹ Finally, a secured creditor which either realizes on its security through a sale or reaches agreement with the trustee on the collateral's fair market value is also entitled to participate in both bankruptcy or proposal proceedings as an ordinary creditor to recover any deficiency between the value of the security and the amount of the claim.⁶²

The Act does provide for judicial intervention to stay the enforce-

⁵⁷ Act, subsection 39(1).

⁵⁸ Act, subsection 49(2).

⁵⁹ Act, subsection 99(3).

⁶⁰ Act, subsection 100(1).

⁶¹ Act, subsection 59(1).

⁶² Act, subsections 98(1) & 99(2).

ment of secured claims for up to six months, but the legislation fails to articulate any standard to govern the exercise of this discretionary power. The Act's "automatic stay" provision⁶³ directs that "a secured creditor may realize or otherwise deal with his security in the same manner as he would have been entitled to realize or deal with it if this section had not been passed, unless the court otherwise orders." Because of the absence of criteria to guide the bankruptcy court, it is not surprising that this power to stay secured creditors' enforcement actions has been invoked very rarely. Moreover, there is a federal statute⁶⁴ which confers limited powers on the courts to stay the enforcement of secured claims. This statute applies only to a company with an outstanding issue of secured or unsecured bonds, debentures, debenture stock or other evidence of indebtedness issued under a trust deed (or other instrument naming a trustee), where the proposed arrangement includes a compromise between the debtor and one or more bond or debenture holders. This statutory procedure is rarely used because of its restricted application and the fact that modern trust indentures usually preclude individual bond or debenture holders from pursuing their contractual remedies against the debtor without the trustee's consent.⁶⁵

The overall effect of this statutory scheme is to provide secured creditors with an "exit option" — a right to refuse to participate in either form of legal process. The secured creditor's right to stay out of formal proceedings provides strong protection from opportunistic behaviour by other creditors. A secured creditor cannot be forced, even by a seventy-five per cent vote of the debtor's other secured creditors, to participate in a reorganization or going-concern sale. Nor can a secured creditor be intimidated by minority hold-out threats and delaying tactics that increase the risk that the collateral will depreciate before its value can be realized. The exit option is not, however, equally attractive to all secured creditors. It will be most advantageous for *fully secured* creditors, claimants who would realize the full amount of their secured claim, plus their collection costs, from an immediate sale of the collateral.⁶⁶ Since creditors cannot recover any amount greater than their full claim in the formal process, a fully secured creditor will probably be indifferent between immediate realization of its security and participation in either bankruptcy or proposal proceedings. Moreover, if

⁶³ Act, s. 49(2).

⁶⁴ *The Companies Creditors Arrangements Act*, R.S.C. 1970, c.36.

⁶⁵ See, e.g., Dept. of Consumer & Corporate Affairs, Report of the Study Committee on Bankruptcy & Insolvency Legislation, *Bankruptcy and Insolvency* (1970) at 19-21.

⁶⁶ The mortgage, indenture or security agreement will usually contain express provisions that pass on to the debtor a secured party's expenses of collection.

there is any substantial risk of depreciation in the value of the collateral, the fully secured creditor will prefer immediate realization. This incentive for immediate foreclosure upon default will be diminished if the creditor is also uncertain about whether the debt is, in fact, fully secured or whether the current market value of the collateral has been over-estimated. On the other hand, secured creditors who believe their security interest to be worth substantially less than the face amount of their claims will have a strong incentive to cooperate with unsecured creditors in bringing about a value-maximizing reorganization or going-concern sale.

The secured creditor's exit option is a dilemma inherent in most legal instruments for the control of strategic behaviour in insolvency negotiations. While the exit option deters some types of opportunistic behaviour rather well, it also enhances the bargaining power of fully secured creditors who may threaten to remove key operating assets unless they receive a bribe. Whether or not the exit option does lead to a net decrease in the social costs of strategic behaviour is a question which has aroused recent controversy. Several Canadian commentators have criticized the exit option because it permits "irresponsible creditors to pull the plug" on firms with favourable economic prospects.⁶⁷ A legal expert has stated that, as a consequence of the exit option, "the secured creditor is normally able to extract preferential terms of repayment as he has no incentive to cooperate with the trustee in attempting to run the business to maximize realization of the bankrupt's estate for the benefit of general creditors."⁶⁸ The Canadian commentators have failed, however, to provide any estimate of the frequency of *successful holding-out* for bribes by secured creditors. This information is essential to an evaluation of the efficiency consequences of the exit option.

In a recent article, Tom Jackson argues that extortion attempts by fully secured creditors are unlikely to be successful and that many threats to exit will in fact be carried out, with the consequence that a substantial number of value-maximizing reorganizations and going-concern sales will be blocked by the exit option.⁶⁹ He also argues that in large firm insolvencies, which usually entail large numbers of creditors, it will be very costly for the creditors to reach agreement on the payment of a bribe to fully secured creditors who threaten to exit with

⁶⁷ See the Dept. of Consumer & Corporate Affairs, *Background Papers for the Bankruptcy and Insolvency Bill* (1979) at 22-24; Fortin, "Creditor Protection in Canadian Bankruptcy: A Banker's Dream" (1985) 90 *Comm. L.J.* 53-59.

⁶⁸ Coburn, "The Position of Retail and Wholesale Financiers as Secured Creditors Under the Proposed Bankruptcy Act" (1979-80) 4 *Can. Bus. L.J.* 348 at 350.

⁶⁹ Jackson, *supra* note 22 at 865.

key assets.⁷⁰ It would be equally costly, he argues, for the creditors to act collectively and repurchase the assets at a forced public sale. Some of the transaction costs will arise from free rider problems in securing *pro rata* contributions from the large number of creditors involved. Other costs will arise from the bilateral monopoly nature of the bargaining between the fully secured hold-out and the other creditors. For these reasons, Jackson concludes that “*ex post* deals capable of preserving the debtor’s going-concern value, while possible, would not be very likely in a large number of cases.”⁷¹ He therefore concludes that, on efficiency grounds, mandatory inclusion of secured creditors in the formal process is preferable to the exit option.

To assess this argument against the exit option, it is necessary to consider the risks of exploitation for fully secured creditors under a mandatory inclusion regime. Under Jackson’s preferred scheme, secured creditors would be required to leave their collateral in the debtor’s custody and to vote as members of their class on the appropriate disposition of their debtor’s assets. Fully secured creditors will not be intimidated by threats of other creditors to block a value-maximizing reorganization or going-concern sale since, by assumption, they would receive full payment of their claims in an immediate liquidation. However, fully secured creditors would be vulnerable to extortion threats by coalitions of non-fully secured creditors having the voting power to force a continuation of the debtor’s business that would reduce the expected value of the claims of the former below what would be received in a liquidation. This form of advantage-taking is also likely to lead to complex, costly and potentially intractable negotiations to resolve the fate of the debtor’s business, but it can be argued plausibly that these costs will be less than those attendant upon holding-out by fully secured creditors with an exit option. First, majority exploitation requires the organization of a fairly large number of secured creditors (the holders of seventy-five per cent of the secured claims), and the high transaction costs of forming such a coalition suggests that this type of strategic behaviour will occur less frequently than holding-out by fully secured creditors.⁷² Second, the threat to force a non-value-maximizing allocation of the debtor’s assets will be costly for the members of the strategic coalition to carry out; their own claims will decrease in value, along with those of fully secured creditors, if the threat is implemented. Threats to block an efficient reorganization or going-

⁷⁰ *Ibid.* at 869.

⁷¹ *Ibid.* at 865.

⁷² See *infra* for a description of the voting rules.

concern sale can be carried out by fully secured creditors at zero cost. Finally, if a strategic coalition did succeed in organizing to threaten fully secured creditors, it can be argued that an allocatively inefficient result would nevertheless be unlikely because it would be relatively easy for the targets of the threat to bargain collectively to pay the bribe. Fully secured creditors will invariably be few in number and thus able to avoid the high transaction costs and free rider problems that burden more numerous creditor groups.⁷³

In summary, the efficiency claim for a mandatory inclusion rule is supported by some plausible arguments that suggest it would deter a more costly form of strategic behaviour — holding-out by fully secured creditors — than the opportunistic conduct it would facilitate — majority exploitation by secured creditors. However, a complete evaluation of the comparative merits of mandatory inclusion and the exit option also requires some consideration of the voting rules and how they shape incentives for strategic behaviour. First, the current voting rules may encourage majority exploitation of fully secured creditors; these incentives need to be taken into account in assessing the relative efficiency of a mandatory inclusion rule. Second, the impact of the voting rules on the bargaining power of fully secured creditors is also an important factor in analyzing the probable consequences of repealing the exit option. As will be explained in the next section, fully secured creditors holding relatively large claims may be in a highly advantageous position to make hold-out threats regardless of whether they have a legal right to exit or not because creditor(s) holding one quarter of the total value of all secured claims can block any proposal.

C. *Weighted Voting by Priority Class and Supra-Majority Voting*

The creditors' collective decision on the appropriate allocation of their debtor's property is taken by voting. The voting procedure specified by the Act is basically the same for both forms of legal proceeding. The bankruptcy or proposal trustee is required to provide creditors with a "statement of affairs" concerning the debtor's business in advance of the vote.⁷⁴ The trustee is also obliged to provide, to any creditor who makes a specific request, additional factual information pertaining to the value of the debtor's assets or liabilities.⁷⁵ Creditors may vote on the proposal in person or by proxy letter; the trustee tallies the votes

⁷³ For a general discussion of strategies designed to overcome the free-rider problem, see Hardin, *Collective Action* (1983) at ch. 3.

⁷⁴ Act, subsection 32(5).

⁷⁵ Act, subsection 13(9).

and announces the result at a formal creditors' meeting. Voting rights are determined by the face value of each creditor's claim. Under the statutory formula, a creditor is basically entitled to a vote for every claim of one thousand dollars, although creditors whose individual claims are less than one thousand dollars are also permitted to vote.⁷⁶ Each priority class is entitled to vote separately in both bankruptcy and proposal proceedings.⁷⁷ In the bankruptcy form of proceeding, the question confronting the creditors is whether the debtor's business will be liquidated or sold as a going concern. Either allocation requires the support of a simple majority of the votes of each participating class, which means that creditors holding at least fifty-one per cent of the total claims of each class must agree to any disposition of the debtor's property.⁷⁸

In the proposal form of proceeding, the question confronting the creditors is whether the insolvent firm should be reorganized and operated as a going concern by the creditors. If a proposal fails to win the approval of all participating classes, the proceeding is automatically transformed into a straight bankruptcy and a second vote is conducted on whether the firm should be liquidated or sold as a going concern.⁷⁹ The adoption of a proposal for reorganization requires the affirmative vote of a simple majority of the creditors eligible to vote in each priority class and the support of creditors holding at least seventy-five per cent of the total claims of each class.⁸⁰

The voting rule for proposals has four components: (1) voting by priority class; (2) voting rights are allocated on the basis of the value of each creditor's claim; (3) a simple majority of the creditors in each class must approve the proposal; and (4) seventy-five per cent of the votes in each class must be cast in favour of the proposal. To identify the purposes of these rules, it is useful to begin with some specification of the concrete circumstances most likely to generate strategic behaviour in the voting process. At first glance, the supra-majority voting requirement for the approval of proposals seems puzzling from the standpoint of allocative efficiency since the rule creates a clear bias in favour of liquidation or sale of the debtor's business. Perhaps it can be argued, however, that certain features of proposal proceedings create relatively higher risks of majority exploitation and that this asymmetry

⁷⁶ Act, subsection 93.

⁷⁷ Act, ss. 36 & 85.

⁷⁸ Act, s. 93.

⁷⁹ Act, subsection 39(1).

⁸⁰ Act, ss. 2 & 36.

in opportunities for advantage-taking provides an efficiency rationale for the allocative bias imparted by the supra-majority approval requirement.

Two kinds of inter-creditor conflicts of interest are the most likely sources of strong incentives for opportunism. First, strategic conflicts may arise when groups of creditors possessing valuable collateral relationships with the debtor co-exist with other groups of creditors lacking such relational interests. Second, there is the risk that creditors with relatively small claims may attempt to exploit creditors with large claims. Since aversion to risk is partly a function of the amount at stake, creditor preferences will be influenced by the relative size of their respective claims. Small claim creditors might be willing to support reorganization proposals involving substantial financial risk (that is, with a high variance in anticipated returns) if they could, in effect, compel a minority of large claim creditors to put up most of the capital. Moreover, since small claim creditors have much less to lose from an inefficient disposition of the debtor's property (that is, their individual losses would be comparatively light), they have a stronger incentive to attempt to organize a blocking coalition in order to extract a bribe from large claim creditors.

Conflicts of interest due to the existence of unequal stakes among creditors are regulated by two components of the voting procedure. First, the provisions for class voting can be justified by the fact that senior priority creditors are likely to have substantially larger stakes in the debtor's property than junior priority creditors. The unequal stakes problem between priority classes is a result of the Act's absolute priority distribution scheme. If junior classes could compel senior classes to participate in an arrangement without their consent, the existence of unequal stakes between classes would often provide a strong incentive for juniors to attempt to impose a non-value-maximizing allocation on seniors. In short, class voting operates to check inter-class advantage-taking animated by the presence of unequal stakes. Second, the weighting feature of the voting rules can be explained as a constraint on intra-class advantage-taking caused by the presence of unequal stakes among creditors in the same priority class. If voting power were allocated on a one vote per creditor basis, it would be less costly for small claim creditors to organize minimum winning or blocking coalitions for the purpose of extorting bribes from large claim creditors. By weighing voting power by reference to the size of each creditor's claim, the present rule discourages the formation of majority coalitions of small claim creditors animated by a desire to "gamble with other people's money". The weighting rule also deters the organization of minimum blocking coalitions.

tions designed to extort payoffs from large claim creditors who have relatively more to lose from an inefficient disposition of the debtor's assets.

While the Act's weighted voting rule is an effective instrument for policing the problem of unequal stakes within classes of unsecured and preferred creditors, it is of limited use in regulating similar conflicts among classes of secured creditors. This deficiency in the weighted voting rule arises because the Act allocates voting power by reference to the face amount of a creditor's claim, *not* the claim's current market value.⁸¹ Since unsecured creditors receive a *pro rata* share of the debtor's unpledged assets, the economic value of each claim is a direct function of its face value: if the insolvent firm owes one hundred dollars in unsecured claims, ten dollars of which is owed to creditor A, creditor A is entitled to ten per cent of the firm's unpledged assets. In contrast, the economic value of a secured claim is determined by the current market value of the underlying security. If the secured claimant is *fully* secured, the economic value and face value of the claim are identical. In many cases, however, the assets comprising the security may be worth much less than the face value of the secured claim. Since voting power is determined by the face value, not the economic value, of each secured creditor's claim, the Act's weighting rule may encourage secured creditors to behave strategically. The rule creates an incentive for organizing coalitions of secured creditors holding relatively small claims, but backed by substantial voting power, for the purpose of extorting bribes from or imposing uncompensated risks on secured creditors holding large claims. It is uncertain whether this deficiency in the Act's vote weighting scheme is inefficient. In order to ensure an accurate alignment between the size of each creditor's real stake and its voting power, it would be necessary to conduct an expert valuation of claims when disputes arose among secured creditors. It would be costly to hold such valuation proceedings and it is not clear that the economic gain from deterring strategic behaviour arising from unequal stakes would justify incurring those costs. If it paid to hold valuation proceedings before votes were taken, creditors would already have discovered this source of cost savings and put it into practice. On the other hand, the absence of a valuation practice might be attributable to impediments to the voluntary organization of creditors after an insolvency occurs and, in particular, to their likely difficulties in agreeing on cost-sharing arrangements.

⁸¹ Act, s. 93.

The third component of the Act's voting rules is the requirement that seventy-five per cent of the votes in each class must be cast in the affirmative in order for a proposal to succeed. From the standpoint of deterring strategic behaviour, a requirement of supra-majority consent can be viewed as incorporating the basic empirical judgment that the costs arising from majority imposition of inefficient plans must outweigh the costs arising when efficient plans are blocked by opportunistic minorities. In other words, the supra-majority voting rule embodies the practical assumption that the dynamics of coalition formation in insolvency negotiations favour exploitive majorities over opportunistic minorities. In terms of the unequal stakes motive for strategic behaviour, there does not seem to be much support for this empirical judgment. For preferred and unsecured creditors, weighted voting operates to impose significant obstacles to the organization of small claim creditor coalitions. In the case of secured creditors, there is no reason to believe that the supra-majority requirement compensates for the deficiency in the weighted voting rule. Secured creditors holding relatively small stakes in a proposal would seem to face the same costs in organizing a hold-out coalition as they would incur in forming a majority group to impose a plan on members of their class with large claims. Nor is there any factual basis for concluding that payoffs to exploitive majorities will be, on average, greater than the bribes paid to hold-out groups. In short, there does not appear to be any plausible reason for rationalizing the supra-majority voting rule in terms of the problem of unequal stakes.

An alternative justification for the supra-majority rule focuses on the incentives for opportunism created by the presence of collateral relationships. One objection to this argument is the claim that the incentives arising from collateral relationships with the debtor may exert a fairly negligible influence on creditor behaviour. Although trade creditors should be interested in preserving their debtor-customer's business, the cost of converting a claim to a long term financial commitment through extensive negotiations, and the more tangible benefit of an immediate cash payment, may often outweigh the uncertain gain to the trade creditor from increasing the financial viability of a single customer.⁸² Moreover, many of the creditors in large corporate insolvencies will be banks, public bondholders and other institutional lenders. These types of creditors will usually not expect the value of continuous, repeated dealings with the debtor to outweigh the expected gain from

⁸² See Roe, *supra* note 23 at 542-44; Brudney, *supra* note 8 at 328-32.

allocating the debtor's assets to their highest-valued use. In spite of these considerations, the incentives generated by collateral relationships all pull in the direction of an inefficient continuation of the debtor's business. Creditors with collateral relationships would have no interest in organizing blocking coalitions. Therefore, the risk of majority exploitation as a result of collateral relations outweighs the negligible (zero) risk of minority holding-out; this is precisely the state of affairs which provides an efficiency rationale for the supra-majority voting rule.

The fourth component of the Act's voting rules is the requirement that a simple majority of each class of creditors (that is, each person or firm receives one vote) must vote in favour of the plan of reorganization. It should be noted that the only kind of voting in straight bankruptcy proceedings is by weighted votes. There is no rational justification for this additional voting procedure in proposal cases. Not only does allocating voting power on any basis other than the size of a creditor's stake seem arbitrary and unfair, there is some evidence that this dual voting requirement in proposal proceedings, in effect, allows creditors holding small claims to sell their votes to the proponents of the reorganization plan.

Several recent successful proposals have provided for payment in full of all claims up to two thousand dollars. It may be efficient to pay off small creditors in full if the costs of administering their participation in the reorganization are likely to exceed the face value of their claims. On the other hand, it is difficult to believe that the costs of reorganization, at least the costs attributable to those with small claims, would amount to two thousand dollars per creditor. Perhaps a more likely explanation for this solicitude on behalf of small creditors is that they have relatively little to lose from immediate liquidation while the proponents of reorganization stand to suffer large losses. The dual voting rule — seventy-five per cent of the claims and a simple majority of the creditors — provides small creditors with a powerful weapon for extorting more than their statutorily-prescribed share of the debtor's property. An examination of creditor lists in two recent successful proposal cases seems to confirm this concern for strategic behaviour by small claim creditors.⁸³ In both cases, the amount of the cash payoff seemed to be determined by the median value of creditors' claims. In other words, the payments were designed to secure the support of a simple majority of the creditors, and not to reflect some minimum

⁸³ *In re the proposal of AM International Inc.*, Toronto, 3 Sept. 1982 (Clarkson Co. Ltd.); *In re the proposal of Wilanour Resources Ltd.*, Toronto, 14 Apr. 1983 (Clarkson Co. Ltd.).

amount of administrative expense that it would be cheaper to avoid.

D. *Guillotine Rule*

While the Act reflects a legislative preoccupation with the protection of minority interests, one unusual provision of the statute seems to be specifically designed to deter holding-out by minorities. This is the "guillotine rule" which provides that if a reorganization proposal fails to win the required seventy-five per cent approval, the creditors' meeting is automatically transformed into a straight bankruptcy proceeding.⁸⁴ The effect of this rule is to permit an immediate vote on whether the debtor's business should be liquidated or sold as a going concern — outcomes which require only fifty-one per cent support from each participating class. The general effect of the guillotine rule is to increase the down-side risk of holding-out; once the vote is taken, there is no subsequent opportunity to avert an inefficient allocation. When implementing a hold-out threat that would be costly to the members of a minority coalition because their claims would be worth less if the debtor's business is liquidated or sold, the guillotine rule should reduce the incidence of strategic behaviour. When the execution of the threat involves only negligible costs to the threatener, as in the case of fully secured creditors, the guillotine rule would not exert any significant deterrent effect.

IV. BILL C-17 AND OTHER PROPOSALS FOR REFORM

The current bankruptcy and insolvency legislation dates back to 1949; the proposal provisions of Part III of the Act have their roots in English statutes of the last century.⁸⁵ A full review of federal bankruptcy and insolvency legislation was undertaken in February, 1966.⁸⁶ During the past decade, a series of bills has been introduced, studied and amended but none has been enacted. The most recent version of the proposed legislation was contained in Bill C-17, which received second reading on May 9, 1984, before it expired in the Standing Committee on Finance, Trade and Economic Affairs. The Mulroney government has announced its intention to introduce a comprehensive bill on bankruptcy and insolvency, but no draft proposals have yet been made

⁸⁴ Act, subsection 39(1).

⁸⁵ For a discussion of the English legislation on which the existing Canadian law is based see Wright, "Corporate Insolvency: An Analysis of English and Canadian Corporate Salvage Reform Proposals" (1985) 35 *Int'l & Comp. L.Q.* 24 at 27-31.

⁸⁶ For the result of this review see, *Report of the Sutcliff Committee on Bankruptcy and Insolvency*, *supra* note 64.

public. Bill C-17 incorporated several substantial changes in the rules governing proposals, which the draft legislation referred to as “commercial arrangements”. This third part of the paper briefly discusses the changes that the Bill proposed in the three basic elements of the regulatory scheme analyzed earlier — judicial review, the exit option for secured creditors and the voting rules. The draft legislation is vulnerable to the criticism that its provisions lacked any coherent rationale for the regulation of insolvency negotiations, and this basic deficiency resulted in major gaps in the Bill’s proposed reforms. The final part prescribes certain reforms designed to fill the gaps in Bill C-17’s regulatory scheme for corporate reorganizations.

A. *Judicial Review and “Cramdown”*

Sections 120-124 of the Bill proposed that bankruptcy court judges be authorized to formulate proposals for arrangement and impose them on creditors, regardless of whether the creditors vote by the required margins to accept them or not. This judicial discretion to “cramdown” a plan, as it is referred to in the United States, would be subject to two conditions: (1) the debts of the debtor initiating the proceeding must exceed one million dollars; and (2) the court is directed, in formulating the imposed plan, to consider the interests of all affected parties — creditors, employees, suppliers and the debtor’s community. The Bill provided judges with no guidance on how these considerations are to be factored into their decisions. It did, however, authorize bankruptcy judges to impose arrangements which depart from the absolute priority rule of distribution in cases where such an outcome would be “just and equitable to the creditors generally”.⁸⁷ Can this “cramdown” proposal be justified by the argument that judicial review could be expanded to control hold-out behaviour more effectively than the existing rules? I believe this argument fails on a closer examination of the direct and indirect costs that are likely to arise from employing broad judicial discretion to control opportunism.

Two basic approaches to regulating insolvency negotiations can be usefully distinguished. The first depends on timely intervention by some external reviewer, either a judge or other regulatory official. The second relies on passive restraints imposed through procedural rules designed to strike an optimal balance between the expected costs of strategic behaviour and the direct and indirect costs generated by the rules themselves. The main problem with the first approach is that it

⁸⁷ Bill C-17, s. 106(2), s. 120(2) & (3).

depends on the ability of public officials to identify cases of strategic behaviour reliably. Unreasonable or extortionate demands in insolvency negotiations will usually not be easily recognizable. Was the dissenting creditors' refusal attributable to a good faith difference of opinion concerning the expected value of the reorganized firm, or was it motivated by a desire to obtain more than their rightful share of the debtor's property? The true motives of dissenting creditors can, of course, only be inferred from the objective circumstances of the negotiations; hold-outs have no incentive to declare or admit that the debtor's business would be worth more if reorganized, and that their opposition is animated by a desire to be bought off by the other creditors.

This general problem of characterizing the motives of dissenting creditors by reference to the reasonableness of their demands in the negotiations forces the external observer to focus on expert opinions concerning the expected values of the debtor's assets in their alternative uses. Since there will usually be a range of plausible expected values for a reorganized firm, any regulatory response which depends on an external assessment of the reasonableness of minority demands will either be of limited effectiveness or prone to a high rate of erroneous intervention. In short, the "cramdown" provision is susceptible to the criticism that it is likely to generate indirect costs that may exceed, or at least cancel out, its beneficial contributions to the control of creditor opportunism.

B. *Exit Option*

The present statutory scheme gives secured creditors a right to refuse to participate in either proposal or bankruptcy proceedings. The Bill proposed a minor encroachment on the secured creditor's exit option. Debtors were entitled to file a "notice of intention" to file a proposal for arrangement.⁸⁸ The filing of such a notice with the administrator imposed a moratorium on all legal proceedings and private enforcement actions by all creditors, including secured creditors, for a ten day period. An extension of this automatic stay beyond ten days was to be granted by the court;⁸⁹ the Bill failed to provide any statement of the factors or circumstances that were to be considered by the court in deciding whether the ten day stay would be extended. The drafters' comments and committee testimony suggest that the proposal for the short automatic stay was motivated by administrative consider-

⁸⁸ Bill C-17, s. 101(1).

⁸⁹ Bill C-17, s. 101(2).

ations, primarily to provide the trustee with more time to formulate a plan when large corporate debtors teeter on the brink of insolvency.⁹⁰

The analysis of the exit option in an earlier part of this paper suggested that strategic behaviour is most likely to be a serious impediment to an efficient resolution of the creditors' collective choice problem when two conditions are satisfied. First, there must be major creditors with quite different levels of exposure to default risk, at least one of whom has relatively little to lose from immediate liquidation. Second, there must be a fairly large number of diverse creditors involved in the negotiations. When these conditions exist, there is a risk that bargaining costs and free-rider problems may block a value-maximizing reorganization of an insolvent firm.

Under existing law, this risk seems most likely to eventuate in a wasteful liquidation when a fully secured creditor removes key assets from a failing firm. The secured creditors' decision to "pull the plug" may be motivated by legitimate concerns about the debtor's viability and the protection of its own security; on the other hand, the decision may be a tacit or explicit attempt to extort a bribe from other creditors whose claims would be worth more if the debtor's business were continued rather than liquidated. As Jackson has argued, the targets of the extortion may often fail to agree on a method for allocating the cost of paying the bribe among themselves, and the insolvent firm will be wound up. Moreover, strategic behaviour may lead to wasteful delays in the bargaining, even if the efficient allocation of the debtor's assets is ultimately chosen by the creditors.

As argued earlier, the efficiency claim for a mandatory inclusion rule for secured creditors is supported by plausible arguments that the requirement that all creditors participate would avoid a more costly form of strategic behaviour (holding-out by fully secured creditors) than the opportunistic conduct which mandatory inclusion would facilitate (majority exploitation within the secured creditor class).

The overall risk of strategic behaviour among secured creditors is likely to increase as a function of at least two important variables: the number of secured creditors participating in the negotiations and the proportion of "repeat" as opposed to "one shot" players among the secured creditors. As the legal and administrative costs of obtaining security fall, and the number of large institutional and trade creditors who customarily take security increases, the incidence of strategic be-

⁹⁰ Government of Canada, Standing Committee on Finance, Trade and Economic Affairs, "Minutes of Proceedings and Evidence Respecting Bill C-17" in *Hansard* (28 May 1984) at 21:18-22.

haviour by secured creditors is also likely to increase because of the opportunities for coalition formation that arise in more numerous creditor groups.⁹¹ Moreover, the recent entry of foreign commercial lenders into the Canadian market increases the diversity of creditors participating in insolvency negotiations and reduces the deterrent effect of repeat bargaining.⁹² Because of these recent commercial developments, the main target for reform should be the secured creditor's exit option. The United States has employed a mandatory inclusion rule for secured creditors for more than fifty years.⁹³ Recent proposals for the reform of British corporate insolvency law would subject secured creditors to an automatic stay on the enforcement of their claims for up to six months.⁹⁴ While the British reforms would not require that secured creditors participate in reorganization arrangements, the proposed automatic stay rule would create an incentive for them to do so.

C. *Voting Rules*

Bill C-17 would have effected two changes in the existing rules governing voting on commercial arrangements. While the proposed legislation would have left the rules requiring class voting and weighted voting unchanged, the other two components of the existing voting scheme would have been substantially modified. First, the rule requiring a simple majority of the creditors of each class to consent to a proposal would be repealed.⁹⁵ As argued earlier, this would be a desirable reform because there is no good reason for undermining the weighted voting system with the additional requirement that a majority of the creditors consent. Moreover, in most large corporate insolvencies a simple majority of unsecured creditors are very likely to be the holders of relatively small claims, and small claim creditors have a comparatively stronger incentive to hold out for a bribe than large claim holders.

The second change in the voting rules proposed by Bill C-17 was to lower the supra-majority margin from seventy-five per cent to sixty-six

⁹¹ For an analysis of the cost-reducing consequences of recent reforms in personal property security rules in the United States see, Schwartz, *supra* note 44 at 28-30.

⁹² For a general discussion of these changes in federal banking regulation see, LaBrosse, "Canada's New Banking Law" (1982) 131 *The Banker* at 37-41.

⁹³ For an excellent analysis of the U.S. legislation regulating the reorganization of insolvent corporations see, White, "Bankruptcy Costs and the New Bankruptcy Code" (1983) 38 *J. Fin.* 477-91.

⁹⁴ Dept. of Trade & Industry, "A Revised Framework for Insolvency Law in England and Wales" (1984) Cmnd. 9175 at 49-53.

⁹⁵ Bill C-17, s. 290(5).

and two-thirds per cent of the claims of each class.⁹⁶ It was argued earlier that the only plausible rationale for the supra-majority rule is the asymmetrical incentives for strategic behaviour that arise from the presence of collateral relationships with the debtor. In short, collateral relations create incentives for majority exploitation and the supra-majority rule operates to neutralize those incentives. This proposed reduction in the level of protection accorded minority interests could be supported by some of the arguments made earlier about why the risks of opportunism arising from collateral relationships will often be negligible. On the other hand, it is also uncertain whether an eight point reduction in the supra-majority margin will have any significant impact on proposal proceedings. The comparative evidence is also mixed on this point. For example, United States law requires that the holders of sixty-six and two-thirds per cent of the claims of each priority class must vote in favour of reorganization,⁹⁷ while in West Germany eighty per cent support is required in order to effect a valid reorganization.⁹⁸ It is probably fair to say that there is no strong case for reducing the margin of creditor support required for reorganization by the present rule.

V. CONCLUSIONS

The main argument of this paper derives from the premise that strategic behaviour in insolvency negotiations is a particular case of the "prisoners' dilemma" of formal game theory. In the well-known game, the two prisoners are trapped by their inability to make credible commitments not to testify against one another and, as a result, opportunistic behaviour (that is, implicating one's co-conspirator) becomes the dominant or preferred strategy for both. The creditors of a large corporate debtor are trapped, in an analogous sense, by the high transaction costs of making credible *ex ante* commitments not to behave opportunistically in the event of their debtor's insolvency. If the creditors as a group lose more than they gain from advantage-taking in insolvency situations, then one rationale for government regulation is to impose an *efficient* set of rules to control strategic behaviour — that set of rules

⁹⁶ Bill C-17, s. 112(3).

⁹⁷ For an excellent discussion of the U.S. regulatory scheme for corporate reorganizations see, White, "Bankruptcy Liquidation and Reorganization" in Logue, ed., *Handbook of Modern Finance*, vol.35 (1984) at 20-42.

⁹⁸ Gessner, *et al.*, "Three Functions of Bankruptcy Law: The West German Case" (1977) 12 *Law & Soc.* 499 at 536-39. For a brief summary of recent proposals for reform of West German legislation see, "Canada Not Alone in Facing Bankruptcy Law Reform", *Globe & Mail* (12 March 1984) at B7.

which the creditors would have contracted for had the transaction costs been lower. A second rationale for state intervention is that strategic behaviour among creditors may block or delay reorganization and, as a consequence, impose avoidable losses on employees, customers and community residents.

Bill C-17's proposed reforms did not provide a coherent response to either rationale for regulation. From an economic efficiency standpoint, the Bill's proposal for court-imposed arrangements which depart from the absolute priority rule was simply illogical without a general rule that secured creditors will be required to participate in such reorganizations. Since secured claims customarily account for about three-quarters of an insolvent corporation's net assets, few corporate debtors could be reorganized as going concerns without the cooperation of most of the secured creditors. Moreover, as a mechanism for controlling creditor opportunism, the Bill's cramdown proposal was vulnerable to the criticism that it would have increased the incidence of strategic behaviour by the debtor's managers and shareholders. In comparison with other claimants, the managers and shareholders of an insolvent firm have a lot to gain, and the least to lose, from the continued operation of the business. This is why most of the law and economics literature analyzing the reorganization of insolvent firms has focused on the problem of preventing management from blocking efficient or value-maximizing liquidations and sales. Bill C-17 would have allowed the shareholders to petition the bankruptcy court to impose an arrangement on dissenting creditors when a reorganization would be "just and equitable" with regard not only to the creditors' interests, but also those of employees, suppliers, customers and community residents. Since the Bill failed to articulate any objective standards or criteria to assist judges in balancing these competing interests, shareholders and their managers would have been encouraged to seek cramdown relief as a routine strategy in insolvency negotiations. Finally, the Bill's cramdown power would have burdened bankruptcy judges with decisions concerning the valuation of the debtor's business that they are no better equipped to handle than the creditors and their expert advisors. In short, there is no reason to believe that the courts would have succeeded in achieving efficient outcomes any more frequently than would the creditors bargaining without the threat of affirmative judicial intervention.

From the standpoint of distributive fairness, the Bill's cramdown proposal was objectionable because the bankruptcy court is not the appropriate institution for dealing with the private losses of employees, suppliers and community residents. When the majority of creditors oppose the continuation of the debtor's business, a court-imposed arrange-

ment constitutes a forced redistribution of wealth from the creditors to those groups (such as workers and community residents) who would suffer the most from the firm's closure. If creditor property rights are undermined in this way, creditors will demand higher interest rates or lend on more restrictive conditions. Therefore, the costs of these judicially-imposed redistributions will ultimately be borne, for the most part, by commercial borrowers and the consumers of the goods and services they produce. If wealth transfers to displaced employees and dependent communities are desirable on social justice grounds, they should be effected through direct subsidies enacted by Parliament. Unlike bankruptcy judges, elected representatives can be held accountable for ensuring that workers and communities receive the public assistance which they may require when large corporations fail.

The main target of future reform should be to constrain secured creditors' rights to pursue their contractual remedies against a defaulting firm while refusing to participate in proposed arrangements that would continue the debtor's operations. The analysis of the exit option presented earlier indicated that holding-out by secured creditors is most likely to impede an efficient reorganization when two general conditions occur contemporaneously. When insolvency negotiations involve a relatively large number of creditors and these creditors are exposed to different degrees of financial risk depending on whether the debtor's business is liquidated or continued, the incentives for strategic behaviour that result from these bargaining conditions create a serious danger of creditor opportunism. As a rough approximation of these bargaining conditions, the presence of three or four secured creditors with comparatively substantial claims (that is, at least ten per cent of total secured claims) might be employed as a statutory rule of thumb to identify those insolvencies where the risk of strategic behaviour is highest. In these high risk cases, secured creditors should be deprived of the exit option conferred by the present Act; they should be required to participate in any arrangement approved by the necessary majority of secured creditors. If this reform is adopted, there would be no reason to alter the existing rules governing judicial review of proposed arrangements for reorganization. Therefore, bankruptcy judges should continue to review only those proposals for arrangement that are approved by an affirmative vote of all creditor classes; the sole purpose of such judicial scrutiny should be to ensure that they conform with the absolute priority rule of distribution.

Bill C-17's proposed changes in the voting rules governing creditor approvals of arrangements would have achieved one clearly desirable improvement in the existing statutory scheme. The present rule which

requires a simple majority of each creditor class to approve an arrangement is both unfair and inefficient for the reasons discussed earlier.⁹⁹ The repeal of the "one creditor-one vote" rule proposed by Bill C-17 should be incorporated in future legislative reforms. The overall impact of the Bill's other proposal concerning the voting rules — the reduction of the supra-majority approval requirement from seventy-five per cent to sixty-six and two-thirds per cent is more difficult to evaluate. As indicated earlier, the supra-majority voting rule deters strategic behaviour animated by the presence of collateral relationships between some of the creditors and the insolvent firm.¹⁰⁰ An eight point reduction in the required margin of approval would make minority groups somewhat more vulnerable to the risk of majority exploitation through the imposition of an inefficient arrangement continuing the debtor's business. Such a change would also make it more difficult for minority groups to exploit the other members of their class by voting against value-maximizing arrangements to continue operations. In short, an appraisal of the likely consequences of the proposed change turns on an empirical judgment concerning the most potent source of strategic conflict in insolvency negotiations. If the conflicts arising from unequal stakes are the primary cause of creditor opportunism, then a reduction in the supra-majority approval margin would be desirable on efficiency grounds. On the other hand, if conflicts arising from collateral relationships are the main source of strategic behaviour, then a cut in the protection afforded to minorities by the supra-majority voting rule would increase the frequency of inefficient outcomes. Since the empirical basis for making this comparative judgment does not exist, there is no reason to believe that a reduction in the present seventy-five per cent approval requirement will improve the chances of an efficient outcome in insolvency negotiations.

⁹⁹ See *infra* text.

¹⁰⁰ See *infra* text.