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THE LAW AND ECONOMICS OF ORDERLY AND EFFECTIVE INSOLVENCY

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for the degree of Doctor of Philosophy

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ABSTRACT

What is effective insolvency law? Effective insolvency laws play an important role in the health of an economy, and particularly upon the framework of investment decisions. Understanding how this works is particularly relevant during a period of financial crisis. International Monetary Fund and World Bank guidelines for “Orderly and Effective” insolvency laws were intended to encourage law reforms that would stimulate investment by improving returns to investors in the event of insolvency. The guidelines were strongly influenced by an efficiency approach to insolvency. This approach posits that absolute priority for secured creditors is allocatively efficient and therefore the best means to achieve maximum social welfare. The guidelines also drew heavily on the principles and practices of ‘creditor friendly’ English law, seen by some as a paragon of efficient insolvency. But how accurate is this appraisal of English law or the impact of efficient insolvency?

The Enterprise Act 2002 sought to develop a rescue culture by improving inclusivity and increasing distribution of both control and returns amongst stakeholders. Instead of reducing overall returns, as an efficiency model would suggest, research into insolvency outcomes suggests that the revised administration procedure may provide better returns to all groups of creditors, including secured creditors. This thesis uses empirical data to explore the limitations of an efficiency approach to insolvency, and explain why in a developed legal regime inclusivity improves returns by increasing the likelihood of effective rescue. The changes in English law are reflective of an increased private sector investment in informal workouts and a growing emphasis on reputational and relationship concerns. An element of redistribution and inclusivity will provide better global returns to investors than a slavish approach to secured creditor priority.

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CHAPTER 1: ORDERLY AND EFFECTIVE INSOLVENCY

REGIMES

What makes insolvency law effective? This question was explored by the World Bank and the International Monetary Fund in their guidelines for Orderly and Effective model laws, intended to encourage investment by promoting economic stability and thereby reducing the cost of credit. These models were strongly influenced by English Law. The effectiveness of English law was ascribed to the notion that it was a creditor friendly system, with a laissez-faire approach to private ordering, that provided strong creditor control in the form of predictable outcomes and hard and fast liquidation returns. This analysis in turn had clear links to the efficiency approach to insolvency law, made influential by scholars like Jackson, Baird and Rasmussen. The efficiency approach is predicated on the belief that absolute priority for secured creditors maximises both returns and social welfare, and that as such the only mandatory rules in an insolvency system should be those related to structure.

Both the Orderly and Effective model and English law itself clearly go beyond the merely structural. They include a variety of redistributive interventions from protection for workers to prescribed parts in floating charges. If the efficiency approach is correct, then these compromises will reduce returns to creditors and in turn welfare more generally. This thesis challenges that view by re-examining the notions of creditor friendliness, insolvency efficiency and how parties bargain in the shadow of the law. Rather than a low-cost hands-off approach, English law provides a forum for augmented negotiation. This offers stakeholders a wide range of options for seeking resolution along with professional specialist support that allows them to customise solutions according to their own needs and difficulties. The intuitively higher cost of this approach is compensated for by greater aggregate returns to

creditors, due to improved economic stability and likelihood of the business surviving. Whilst strong secured creditor rights and efficient realisation of those rights are an important part of effective insolvency, the principles of insolvency efficiency are not an ideal state against which any compromise inevitably reduces returns and general welfare. Insolvency law which adheres too slavishly to the principles of efficiency will be less effective, both globally and for secured creditors as a subset, than laws which take into account redistributive issues.

This thesis seeks to advance this argument and make an original contribution to the body of insolvency research in two stages. First, by combining and exploring the empirical insolvency outcomes research of scholars including Frisby, Walters, Armour, Mumford, and Katz, in order to get a clearer picture of how changes in the Enterprise Act have impacted upon creditor returns and what this says about the role of inclusivity and redistribution in insolvency law. This is then considered in the broader context of the cost of credit argument and the changing ways in which banks interact with distressed firms. Second, through an exploration of the behavioural impact of business failure, starting with a history of failure as a quasi-crime, continued in a new experiment to illustrate the impact of information in business failure on decision making, and then considering how lessons from mediation and reintegrative shaming can help improve insolvency outcomes.

This re-appraisal of the operation of English insolvency law is important because the recent financial crisis has raised serious questions about some widely applied principles of economic theory, in particular the fashion in which market pricing mechanisms operate and the extent and limits of consumer rationality. Market efficiency principles have proved pervasive in the economic analysis of insolvency law, but their application by legal theorists has on occasion proved one dimensional.

The danger is that lawyers and legislators continue to apply outmoded approaches to market theory just as they are being abandoned by economists, and in doing so ignore the qualities of our laws that are actually attractive to investors. Instead it should be accepted that stakeholder rationality cannot be presumed and that part of the service they require is assistance in achieving the best possible returns. Our growing understanding of the reality of decision making during business failure helps us to provide mechanisms that improve insolvency outcomes in accordance with creditor needs.

This thesis uses a variety of different methods, including quantitative and qualitative analysis, economic experiment and theory. It seeks to demonstrate alternative approaches to empirically testing the behavioural impact of insolvency law that may be more illuminating than simple reliance on basic market models. It also attempts to show that the common understanding of what makes English insolvency law Orderly and Effective is based upon misconceptions about how negotiations in the shadow of the law actually take place. It is hoped that these illustrations of method will in the future allow for more specific, targeted, empirical projects looking at bargaining by parties to insolvency.

As the research involves human participants it was subject to internal ethical review and meets the standards of the ESRC Research Ethics Framework.¹ For convenience “he” and “his” is used for all gendered pronouns where no specific gender is involved. Naturally this should not be taken to imply that women are any less capable than men of performing as judges, insolvency practitioners, bankers, bankrupts or economically-irrational creditors. Finally, unless otherwise noted, all translations from French into English are my own, as are any errors.

¹ Economics and Social Research Council (ESRC), *Research Ethics Framework*, found at http://www.esrc.ac.uk/ESRCInfoCentre/Images/ESRC_Re_Ethics_Frame_tcm6-11291.pdf (website) (Accessed 14th December 2007)

The rest of this chapter will introduce the key themes and terms of the thesis. First, the nature of insolvency and its role as a constitution of commerce is defined. Second, the IMF Orderly and Effective insolvency model is introduced as an effort to describe a virtuous insolvency law that will improve economic stability and productivity. Third, the strengths and weaknesses of insolvency efficiency theory are described. Finally, the two pillars of Orderly and Effective insolvency are defined as predictability and protection of value, clearly linked to the principles of insolvency efficiency.

1.1 WHAT IS INSOLVENCY?

Corporate Insolvency is defined in two ways: the inability to pay debts when they fall due (cash flow insolvency), or having liabilities that exceed assets (balance sheet insolvency).² Insolvency laws are

a series of legal rules and principles which determine, in the first instance, the extent of the corporate estate at the point of commencement of insolvency proceedings, in the second how it might be inflated, either by exploitation of existing corporate assets or through claw back of those disposed of prior to insolvency, and, finally, who, out of many claimants, is entitled to it and in what proportion.³

Insolvency law manages the settlement of debts from the insolvent personality. You will note in this definition that there is no requirement that the personality be extinguished. English law makes the distinction between insolvent enterprises and bankrupt individuals, where:

The ultimate objective of the bankruptcy process is to discharge the bankrupt from his liabilities, so that he can begin again with a clean slate, free from the burden of his debts, and thus rehabilitate himself into the community. The ultimate fate of a company in winding up is not discharge but dissolution, that is, the termination of its existence.⁴

This distinction between rehabilitating bankruptcy and terminal insolvency is occasionally unhelpful. It can give the impression that insolvency does not rehabilitate. Winding up and dissolution represent only one of many possible outcomes from insolvency proceedings, and a business may survive beyond the life of the company that housed it - achieving exactly the clean slate Goode reserves for the bankrupt. Insolvent does not mean unprofitable or unviable. It "does not in itself denote a lack of money or assets... what sets insolvency apart from poverty is

² Insolvency Act 1986, s123(1)(e) and s123(2)

³ Frisby S, "Insolvency Law and Insolvency Practice: Principles and Pragmatism Diverge?", *Current Legal Problems* 64(1) (2011) 349-397, p350

⁴ Goode R, *Commercial Law*, 3rd Ed, Penguin (London: 2004), p830

that the debtor has in some way spent or utilised the money of some other party rather than just spent his own.”⁵ This definition, that insolvency concerns the dissolution of another party’s assets, could be applied as easily to a bankrupt as an insolvent.

Indeed, most international literature uses the term “bankruptcy” interchangeably for both firms and individuals. But the difference is important. Insolvency law is principally about managing the relationship between creditor and debtor, where insolvency itself is by no means fatal to future profitable relations between the parties. The word “bankrupt”, however, is beset with social meaning and the implication of moral as well as financial failure. Adam Smith observed that “bankruptcy is perhaps the greatest and most humiliating calamity that can befall a man”⁶ and in Efrat’s work on bankruptcy stigma he observes that an appreciable number of people believe “bankruptcy is an acceptable reason for committing suicide.”⁷ The insolvency of a company “inevitably generates dismay and, in many cases, resentment, among a variety of stakeholders in the corporation.”⁸ This can spread far beyond immediate stakeholders:

failure may have wider implications. It may force customers and suppliers into insolvency; it may, in causing job losses, tear the heart out of the local community; in the case of a major bank or industrial company it may even affect the national economy, for example by undermining confidence or by removing a key player from the export market. The community at large may also have an interest in the continued performance of the company’s obligations in public law.⁹

⁵ Dennis V, *Insolvency Law Handbook*, 2nd Ed, Law Society (London: 2007), p1

⁶ Smith A, *Wealth of Nations*, Oxford University Press (Oxford: 2008), Book 2, Chapter 3, p204

⁷ Efrat R, “The Evolution of Bankruptcy Stigma”, *Theoretical Inquiries in Law* 7(2) (2006)365-393, p379 –referencing the National Opinion Research Center, General Social Survey 1972-2000 Cumulative Codebook, available at <http://webapp.icpsr.umich.edu/GSS/> (last visited Jan. 12, 2004) (reporting that 4.4% to 9.6% of the respondents find that bankruptcy filing is an acceptable reason to end one’s life).

⁸ Frisby S (2011), p350

⁹ Goode R, *Principles of Corporate Insolvency Law*, 4th ed, Sweet & Maxwell (London: 2011), p68

The emotional and psychological impact of business failure will be an important theme in this thesis because of its behavioural consequences. A creditor who is angry or upset is less likely to be able to correctly identify the best commercial outcome. A debtor for whom their business represents their life's work may pursue unrealistic rescue outcomes or be too ashamed to admit that their efforts have failed. These sentiments impact upon insolvency outcomes. If we value rational and impartial decision-making it is not too much of a leap to consider this impact as unwelcome.

Insolvency law emerges as a response to credit¹⁰ just as its importance stems from its role as the foundation of credit. It “necessarily arises from the extension of credit, for without credit there can be no debt.”¹¹ Debt is “a legally enforceable liability, whereby a party known as a debtor can be compelled to render what is due at the insistence of a party known as a creditor.”¹² It can be seen that those things which qualify as credit can be extremely broad, encompassing money, goods or services, be it a loan of cash or the arrangement for deferred payment. The most influential analysis of English insolvency law¹³, the Cork Report, identified credit as “the lifeblood of the modern industrialised economy.”¹⁴ Credit allows forward thinking enterprises to achieve optimal investment decisions and directs capital towards those who would seek to make productive use of it,¹⁵ and Goode observes a “world without credit would be impossible to imagine.”¹⁶ Insolvency law defines the terms of credit. Paulus describes insolvency law as the “*fluchtpunkt*”¹⁷ or ‘vanishing point’,

¹⁰ Jackson TH, *The Logic and Limits of Bankruptcy Law*, Beard Books (Washington: 1986), p7

¹¹ Goode R, *Principles of Corporate Insolvency Law*, 3rd ed, Sweet and Maxwell (London: 2007), p2

¹² Dennis V (2007), p1

¹³ Frisby S (2011), p358

¹⁴ Insolvency Law and Practice: Report of the Review Committee (Cmnd 8558, HMSO 1982), “The Cork Report”, ch 1 para 10

¹⁵ A detailed explanation of the borrowing and lending as investment decisions and the advantages of being able to acquire credit can be found in Gravelle H and Rees R, *Microeconomics*, 3rd ed, Pearson Education (Harlow: 2004), from p233, and in most undergraduate microeconomics textbooks.

¹⁶ Goode R (2007), p2

¹⁷ Paulus C, *Der Internationale Währungsfond und das international Insolvenzrecht*, I Prax (1999), p148

which in a one point perspective drawing is the position from which all depth lines are drawn. Falke translates this as “constitution”¹⁸, those fundamental principles around which all other laws are defined. Insolvency law is the constitution of credit because it defines the boundaries and fundamental principles within which one borrows or lends.

There are two principal fashions in which laws are typically considered to govern behaviour. The first is the cornerstone of economic analysis of a law, neatly summed up by the phrase “a fine is a price”¹⁹, which is to say the one will compare the cost of obeying the law against the cost of disobeying the law and choose the option that costs the least. The classic example, attributed to Gary Becker by Gneezy and Rustichini²⁰, is that if the cost of a parking fine multiplied by the probability of getting caught is less than the cost of the parking ticket, then you will not buy the parking ticket, i.e. where $\text{fine} * \text{probability of sanction} < \text{price}$, you will commit the sanctioned behaviour.

The second fashion in which laws drive behaviour is their normative value: “citizens sometimes do what legal rules stipulate simply because they are legal rules.”²¹ This provides an alternative explanation of citizens’ obedience of laws where the sanction costs less than compliance to simple mathematical incompetence, although Smith’s argument that economic analysis of law tends to focus exclusively on material incentives²² should not be taken to imply that there is no economic analysis of the behavioural impact of normative values. The application of insights from behavioural economics to the law will form a significant part of the second half of this thesis.

Cross pollination between disciplines is slow however, and mainstream recognition of

¹⁸ Falke M (2003), p23

¹⁹ Gneezy U and Rustichini A, “A Fine is A Price”, *The Journal of Legal Studies* 29 (2000) 1-18

²⁰ *Ibid*, 1

²¹ Smith SA, “The Normativity of Private Law”, *Oxford Journal of Legal Studies* 31(2) (2011) 215-242, p215

²² “Nearly all economic accounts assume that private law influences behaviour exclusively by attaching material consequences to specified actions”, Smith SA (2011), p218-219

behavioural economics is relatively new, thus Smith's suggestion that the vast majority of law and economics focuses on rational materialism as the determinant of behaviour is persuasive. Even so, the study of the role of normative behaviour in commerce is becoming increasingly important. In their description of the normative role of the 'London Approach' in English banking, which will be discussed in more detail in Chapter 5, Armour and Deakin state that "where once it was commonplace to assume that laws take on a directly price-like character in individual optimisation calculations, it is now understood that norms may bypass (or substitute for) law's impact altogether."²³ They continue:

If the function of norms is to save on the transaction costs of endlessly searching for the solution to commonly recurring co-ordination problems, it may be said that norms are a kind of information resource they embody information about the likely strategies of players.... In the context of the commercial transactions which we are considering here, in addition to numerous tacit and uncodified conventions, there are many institutionalised norms which derive from the legal system, as well as from the activities of trade associations and professional bodies.²⁴

So insolvency laws can be described as determining the conditions of credit and the conduct of business both through materialistic and normative factors. Whether the impact on behaviour is principally materialistic or normative, that insolvency laws do impact on investment and consumption is uncontroversial. The IMF, effectively expressing western insolvency orthodoxy, recognises insolvency law's constitutional role when describing its "major role in strengthening a country's economic and financial system."²⁵ In the context of American law it has been argued that insolvency law preserves the national economy by providing an important safety net that "prevents secured creditors from collectively starting a downward spiral of

²³ Armour J and Deakin S, "Norms in Private Insolvency: The London Approach to the resolution of financial distress", *Journal of Corporate Law Studies* 1 (2001) 21-51, p21

²⁴ *Ibid*, p30

²⁵ IMF (1999), Foreword

foreclosures and bank failures that could result in the failure of the entire economy, as it nearly did in 1933.”²⁶ Other qualities of insolvency regimes include the following.

- They define the conditions for investment, as banks adjust their lending and reorganisation practice in response to changes in insolvency law.²⁷
- They help remove poor performers from the market²⁸, making space and freeing up resources for more effective players.
- They limit the public cost of financial crisis by ensuring the participation of private creditors.²⁹
- They are the arbiters of the bottom line for social and political values, such as the relative importance placed on the protection of employees or the family home, amongst which “the key question will often be how to find the appropriate balance.”³⁰

The phrase “in the shadow of the law”³¹ is used by both the IMF and the World Bank and repeated in insolvency literature. The phrase originates in Mnookin and Kornhauser’s³² 1979 work on the impact of divorce law on marriage, which in turn has clear links with the concurrently developing notion of territoriality. Territoriality describes the way in which use of space communicates ownership, authority and

²⁶ Bufford SL, “What is right about Bankruptcy and Wrong About its Critics”, *Washington University Law Quarterly* 72 (1994) 829-848, p836

²⁷ Davydenko SA and Franks JR, “Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK”, *The Journal of Finance* 63(2) (2008) 565-608, p566

²⁸ Dahiya and Klapper provide evidence to support the common sense conclusion that “poor performance is the primary reason for firm disappearance.” Dahiya S and Klapper L, “Who survives? A cross-country comparison”, *Journal of Financial Stability* 3 (2007) 261-278, p270

²⁹ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p9, “4 - Rehabilitation Procedures”, p35

³⁰ *Ibid*, p13

³¹ For example the IMF describe that rules governing insolvency lead “out-of-court agreements being reached ‘in the shadow’ of the law” IMF (1999), Foreword, and the World Bank state that “Informal workouts are negotiated in the “shadow of the law” World Bank (2001), p5; an example in academia is Finch V, “Pre-packaged administrations: bargains in the shadow of insolvency or shadowy bargains?”, *Journal of business law* (2006) 568-588

³² Mnookin RH and Kornhauser L, “Bargaining in the shadow of the law: the Case of Divorce”, *The Yale Law Journal* 88(5) (1979) 950-997

power, most notably in Lefebvre's *La Production de l'espace*³³ and the work stemming from Foucault's *Space, Knowledge and Power*.³⁴ The word 'space' is used in its widest possible sense, including both space as a room or a gathering, and space as a distance between people or objects. It encourages us to consider the law as part of an interactive system where behaviour is influenced by people's understanding of the law (whether accurate or otherwise).

When Mnookin and Kornhauser state that "the preference of parties, the entitlements created by law, transaction costs, attitudes toward risk, and strategic outcome will substantially affect the negotiated outcomes,"³⁵ the application of the principle clearly extends beyond divorce and is echoed, for example, when Davydenko and Franks describe the situation where "banks significantly adjust their lending and reorganisation practices in response to the country's bankruptcy code."³⁶ The management of insolvency is seen to impact on issues including "property laws, contract and commercial law, the law dealing with mortgages and other types of security, as well as tax and inheritance laws, employment and social security regimes, and even family and matrimonial law questions."³⁷ In the English courts the management of insolvency can be observed repeatedly challenging our principles and our legal mechanisms, from pushing the boundaries of constructive trusts³⁸, via debating the rights of cohabitants³⁹, to operating as the "testing ground for novel types of intangible property."⁴⁰ Practical examples of the behavioural impact of changes in insolvency law include the emergence of the use of hire purchase in order

³³ Lefebvre H, *The Production of Space*, Blackwell (Oxford: 1991), tr. Donald Nicholson-Smith, first published as Lefebvre H, *La Production de l'espace* (Paris: 1974)

³⁴ Foucault M, "Space, Knowledge and Power" in *The Cultural Studies Reader*, 2nd Ed, Routledge (New York: 1984), Chapter 10, 134-141, article first published in 1982

³⁵ Mnookin RH and Kornhauser L (1979), p997

³⁶ Davydenko SA and Franks JR (2008), p566

³⁷ Falke M (2003), p113-114

³⁸ *AG for Hong Kong v Reid* [1994] 1 All ER 1

³⁹ *Lloyds Bank v Rosset* [1991] AC 107

⁴⁰ Bridge M, *Personal Property Law*, 3rd ed, OUP (Oxford: 2005), p7

to avoid buyer in possession terms⁴¹ and its subsequent role as a quasi-security transaction, or the shift to asset based lending that occurred after *Re Spectrum Plus*⁴² determined that security on book debts were a floating rather than a fixed charge. Frisby's work on insolvency outcomes found a link between lengths of proceedings and uncertainty surrounding the *Brumark*⁴³ decision regarding charges over book debts, as described by one practitioner interviewee: "We've got receiverships that have been open from 1999 which, had it not been for *Brumark*, would have been over, and now, after *Spectrum*, we've got a flurry of activity going on to close them'."⁴⁴ High end commercial behaviour is demonstrably responsive to changes in insolvency law.

Recognising insolvency laws do impact upon commercial practice, the theoretical divide between normative and material incentives is crucial when evaluating how insolvency laws impact upon behaviour. This is particularly the case if trying to write laws to achieve a particular outcome, such as viable rescue or increasing investment. By applying a materialist economic analysis to developing insolvency laws you will, to borrow the metaphor, simply seek make the parking fine cost more than the price of the ticket divided by the probability of getting caught. Failure to take into account both the normative and material incentives will lead to incorrect conclusions about the impact of the law. Some people will choose to pay for their parking ticket even if there is no chance that they will be caught. The difficult question is to what extent insolvency laws need to take these factors into account.

⁴¹ Tested in *Helby v Matthews* [1895] AC 471

⁴² *Re Spectrum+* [2005] UKHL 41

⁴³ *Agnew v Commissioners of Inland Revenue* [2001] 2 AC 710, declining to follow *Re New Bullas Trading Ltd* [1994] BCLC 485 and subsequently followed by the House of Lords in *Re Spectrum Plus Ltd* [2005] 2 AC 680

⁴⁴ Frisby S, *Report on Insolvency Outcomes* (2006),

<http://webarchive.nationalarchives.gov.uk/+http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/InsolvencyOutcomes.pdf> (accessed 30 November 2012), p28

1.2 ORDERLY AND EFFECTIVE INSOLVENCY AND THE ASIAN FINANCIAL CRISIS OF 1997

Recognising the economic importance of insolvency laws, the “Orderly and Effective” model of insolvency law reform was developed from a series of recommendations by the International Monetary Fund (IMF)⁴⁵ and the World Bank⁴⁶ to the transitional economies after the Asian financial crisis of 1997. The IMF report was drafted by Sean Hagan from the IMF legal department representing a team of IMF lawyers and consulting widely with academics and professionals. It was designed to build upon the “Key Principles and Features of Effective Insolvency Regimes”⁴⁷ report of the G-22 Working Group on International Financial Crisis, by identifying the key issues involved in the design and application of insolvency laws and the advantages and disadvantages of different approaches. Hagan described the work as “an important component of IMF-supported economic programs in many countries because of the impact such reform can have on a country’s economic and financial system,”⁴⁸ and sizable IMF loans were conditional upon pursuing economic reforms that included changes to insolvency law, intended both to help solve the problems that caused the crisis and also to safeguard IMF resources by increasing chances of repayment.⁴⁹ The fact the loan conditions were built upon IMF recommendations suggests that this was not a neutral document, but rather one proposing a positive policy “relevant to all countries.”⁵⁰

⁴⁵ International Monetary Fund Legal Department, *Orderly and Effective Insolvency Procedures Key Issues*, (IMF: 1999)

⁴⁶ World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, (World Bank: 2001)

⁴⁷ Annex A, G22 Report of the Working Group on International Financial Crisis, 2 Oct 1998, found at <http://www.imf.org/external/np/g22/ifcrep.pdf> (accessed 12 May 2013)

⁴⁸ Hagan S, “Promoting Orderly and Effective Insolvency Procedures”, *Finance & Development* (March 2000), 50-52, p50

⁴⁹ IMF, *IMF Conditionality*, International Monetary Fund Factsheet (IMF: March 2012), p1

⁵⁰ Hagan S (2000), p51

The Asian financial crisis was a sovereign debt crisis that started in Thailand and quickly spread throughout East Asia, collapsing currency values and sending interest rates soaring. It has been described as a crisis of success, “caused by a boom of international lending followed by a sudden withdrawal of funds. At the core of the Asian crisis were large-scale foreign capital inflows into financial systems that became vulnerable to panic.”⁵¹ Now that developed nations are suffering their own financial crisis, with European states seeking IMF bailouts amidst serious questions about levels of sovereign debt and panic in the markets, it is pertinent to ask whether they should be following similar advice.

Financial crises can usefully be described from a selection of five characteristics: macroeconomic policy induced, financial panic, bubble collapse, moral hazard and disorderly workout. Radalet and Sachs, whose work defines these characteristics, argue that the Asian Crisis was a panic followed by a disorderly workout⁵², on the grounds that it was largely unanticipated and followed by a large number of nominally good loans going bad. Others focus on moral hazard issues in the Asian financial systems which “magnified the financial vulnerability of the region during the process of financial markets liberalization in the 1990s, exposing its fragility vis-à-vis the macroeconomic and financial shocks that occurred in the period 1995-1997”⁵³, while Krugman argues that “the Asian story is really about a bubble in and subsequent collapse of asset values in general, with the currency crises more a symptom than a cause of this underlying real (in both senses of the word) malady.”⁵⁴

⁵¹ Radalet S and Sachs J, “The Onset of the East Asian Financial Crisis”, in Krugman (ed) *Currency Crisis*, University of Chicago Press, (Chicago: 2000), 105-162, p106

⁵² *Ibid*, p111

⁵³ Corsetti G, Pesenti P, Roubini N, “What caused the Asian Currency and Financial Crisis?”, *Japan and the World Economy* 11 (1999) 305-373, p306-307

⁵⁴ Krugman P, “What happened to Asia” (1998), <http://web.mit.edu/krugman/www/DISINTER.html> (accessed 30 Sep 2012), part 1: “Thinking about Asia”

The interdependency of finance is such that crises are likely to contain elements of all these characteristics, making it difficult to forensically diagnose particular flaws in any national economy or legal regime. The recent occidental crisis has included a housing bubble collapse (triggering the crisis through bundled securities), the exposure of vulnerable financial systems, market panics (the Northern Rock bank run⁵⁵ being the most obvious but certainly not the largest example), and moral hazard issues (bankers' pay, incentives and management structures being particularly topical at the moment).⁵⁶ There are notable differences between the credit crunch and the Asian financial crisis. For example, withdrawal of foreign credit during the Asian crisis caused soaring interest rates⁵⁷, whereas occidental nations are currently managing to maintain low interest rates (although these lower interest rates have not entirely mitigated tightening credit conditions which are a symptom of both crises). It is equally important to recognise that developed and developing nations have different requirements regarding credit governance, as the World Bank describes:

While much credit is unsecured and requires an effective enforcement system, an effective system for secured rights is especially important in developing countries. Secured credit plays an important role in industrial countries, notwithstanding the range of sources and types of financing available through both debt and equity markets. In some cases equity markets can provide cheaper and more attractive financing. But developing countries offer fewer options, and equity markets are typically less mature than debt markets. As a result most financing is in the form of debt. In markets with fewer options and higher risks, lenders routinely require security to reduce the risk of non-performance and insolvency.⁵⁸

⁵⁵ Crawford K, "Robert Peston Ate My Bank: How Perceptions of Risk, Failure and Insolvency Created the Northern Rock Crisis" (2008). Available at SSRN: <http://ssrn.com/abstract=1392686> (accessed 30 Nov 2012)

⁵⁶ For an overview of the current financial crisis a good place to start is Stiglitz JE, *The Stiglitz Report: Reforming the International Monetary and Financial Systems in the Wake of the Global Crisis*, The New Press (New York: 2010), from the United Nations report of the same name.

⁵⁷ Radalet S and Sachs J (2000), p115

⁵⁸ World Bank (2001), p4

The fifth, and final, characteristic of financial crisis is disorderly workout, which brings corporate insolvency law clearly into the equation. A disorderly workout is where an illiquid or insolvent borrower is driven into liquidation even though they are worth more as a going concern. Thus we might define orderly workouts as those that prevent firms that are worth more as a going concern from being driven into liquidation, providing a key definition within the Orderly and Effective model. Falke suggests that the Asian financial crisis exposed “the inadequacy of corporate insolvency law regimes or their application in many of those economies. In times of rapid growth the significance of functioning insolvency systems was largely ignored because banks and other creditors could extend credit without repayment risk and governments could afford to bail out failing debtors.”⁵⁹ The implication is that during economic downturns the likelihood of disorderly workouts increases, although it is an open question as to whether this is because workouts are more likely to be disorderly or because there are simply more failures (or, indeed, both). Radalet and Sachs explain that

disorderly workout occurs especially when markets operate without the benefit of creditor coordination via bankruptcy law. The problem is sometimes known as a “debt overhang.” In essence, coordination problems among creditors prevent the efficient provision of working capital to the financially distressed borrower and delay or prevent the eventual discharge of bad debts (e.g., via debt-equity conversions or debt reduction).⁶⁰

This may be interpreted in two ways. A first, strict, approach would be that in conditions of efficient provision borrowers will never choose to liquidate a firm that is worth more if it continues to trade. At one extreme this leads to the argument

⁵⁹ Falke M, “Insolvency Law Reform in Transition Economies”, Doctoral Thesis, Humboldt University Berlin, dissertation.de – Verlag im Internet GmbH, (Berlin: 2003), available at <http://www.dissertation.de/englisch/buch.php3?buch=2101> (Accessed 13 May 2010), p25

⁶⁰ Radalet S and Sachs J (2000), p109

that all government intervention is inefficient⁶¹, but as Cartwright observes “it is widely recognised that markets are frequently imperfect in practice”⁶². Even in an otherwise perfect market there will be occasions when users choose to liquidate even though they would make more money by supporting a rescue. Furthermore this decision is likely to have more to do with the peculiarities of how people make decisions and interpret data, than any calculated model of the utility of revenge or excluding rogue directors being greater than the monetary return of an effective rescue.

A second approach would be that if in a perfectly efficient system creditors still choose to make less money by liquidating a viable firm, an Orderly and Effective system will support that choice. It is submitted that in English law this is not the case. The extent to which English law pursues a business rather than a corporate rescue approach will be considered in Chapter 2 but it is quite clear that it will restrain creditor liberty of choice in favour of viable rescue: “the court has clearly reinforced the aim of the statute (to preserve value) and the rescue culture supported by government i.e. to save business as a going concern wherever possible and to maximise the return to all creditors, even in the face of opposition from a major creditor.”⁶³ Nor does it seem to fit the definition of orderly workout that requires orderly insolvency laws not to liquidate firms that are worth more if rescued.

⁶¹ Benson BL, “Enforcement of Private Property Rights in Primitive Societies: Law without government”, *The Journal of Libertarian Studies* 9(1) (1989) 1-26

⁶² Cartwright P, *Banks, Consumers and Regulation*, Hart Publishing (Oregon: 2004), p14

⁶³ Cohen M and Crooks S, “Re DKLL Solicitors: Obtaining an Administration Order to Facilitate a Pre-Packaged Sale of the Business and Assets, in the Face of Opposition from the Majority Creditor”, *International Corporate Rescue* (2007) 4(4) 218-221, p221, see also “The legislature clearly intended to prioritise the rescue of the company, or at least its business, over piecemeal realisation of the company’s assets for the benefit of secured creditors.” Mokal RJ and Armour J, “The New UK Corporate Rescue Procedure – The Administrator’s Duty to Act Rationally”, *International Corporate Rescue*, 1(3) (2004) 1, p2

Accepting it is policy that effective rescue should be prepared to override the will of creditors, the question becomes what conditions encourage creditors both to correctly identify whether a workout will provide better returns than liquidation and, if a perfect market is not enough, then what can be done to encourage creditors to choose viable rescue? Equally, does such a policy make initial investment more attractive?

1.3 EFFICIENT INSOLVENCY

Efficiency modelling has had a profound impact upon the analysis of insolvency law, both because of its important role in 20th century economic theory and because it provides a means to effectively circumvent the problem of identifying the value of a rescue outcome. It will be seen that these principles are clearly echoed in the Orderly and Effective insolvency model, but are not slavishly followed. This tension is rooted in a problem that both efficiency theorists and their critics are confronted by: how we determine and equally how we perceive the value of a distressed enterprise.



Woolworths was one of the high profile casualties of the financial crisis. The “£1 deal” headline is misleading. The Times⁶⁴ went on to describe that Hilco’s offer included assuming £35 million debt in return for ownership of the Woolworths retail branch. For a lawyer it is an echo of £1 per annum ground rent paid by the widow in *Thomas v*

*Thomas*⁶⁵, and the contract law principle that consideration must be sufficient but need not be adequate, which is encapsulated in the notion of “peppercorn rents.”⁶⁶ It would be hard to argue that the assumption debt was not adequate consideration in itself, leaving the extra £1 an anachronism of English contract law, but it is an anachronism that one frequently encounters in this type of transaction. Does this mean the “£1 deal” headline is simple journalistic mischief making, or is there

⁶⁴ Helen Power, The Times, 24 Nov, p37, "Woolworths' suitor set to sweeten £1 deal for shops."

⁶⁵ *Thomas v Thomas* (1842) 2 QB 851

⁶⁶ Poole J, *Textbook on Contract Law*, 11th Ed, OUP (Oxford: 2012), p121

something more to it? Is there something about selling a chain of Woolworths' shops for the price of a bag of their 'pick and mix' that makes it stick in the zeitgeist?

One of the primary objectives identified by the IMF in an Orderly and Effective insolvency regime is to "maximise the value of the assets of the estate."⁶⁷ The most obvious way to measure value is price, and it is an often cited principle of economics that value equates to price: "the economic value of something is how much someone is willing to pay for it or, if he has it already, how much money he demands for parting with it."⁶⁸ Yet part of what the Woolworths' story illustrates is an on-going concern with a perceived divergence between value and price. This has been a long standing conundrum for insolvency legislatures, for example "one of the main reasons for the reforms to the UK insolvency law as proposed in the Cork Report (1982) and as partly reflected in the 1986 Act was to prevent a receiver (receiver manager), representing the collection of debenture-holders, selling the business for too low a price."⁶⁹ This raises a significant sticking point: how do you know when the price is too low? As Lopucki observes, "Scholars in law, finance, and economics have long debated the best way to determine a distressed company's value... [accountants typical preferred method future cash flow valuation has been] famously referred to as a 'guess compounded by an estimate'."⁷⁰

It is widely accepted that the price of a firm and its assets drops when it becomes insolvent; "Bankruptcy scholars for years have viewed the choices facing a corporation as either to reorganise consensually in order to preserve going-concern value or have its assets sold piece by piece for a fraction of their value."⁷¹ Lopucki and Doherty have demonstrated the profound impact liquidation, as opposed to

⁶⁷ IMF (1999), 3 - Liquidation Proceedings, p16

⁶⁸ Posner RA (2007), p10

⁶⁹ Webb DC (1991), p151

⁷⁰ Lopucki LM and Doherty JW (2007), p8

⁷¹ Baird DG and Rasmussen RK, "Chapter 11 at Twilight", *Stanford Law Review* 56 (2003) 673-700, p691

reorganisation, has on the value of a firm: “companies sold for an average of 35% of book value but reorganised for an average fresh-start value of 80% of book value and an average market capitalization value—based on post-reorganisation stock trading—of 91% of book value.”⁷² Their work was controlled for differences in pre-filing earnings, limiting the impact of the argument that firms that were capable of being reorganised were simply less overvalued than those that were liquidated, and in a different context Espen Eckbo and Thorburn have shown that even in an auction environment (where one would expect a more effectively functioning market) piecemeal liquidation significantly reduces the achievable price of the assets of a firm.⁷³ This provides strong evidence that insolvency reduces price, but what does that tell us about value? Are these collapsing bubbles or distorted values? How are we to assess whether a rescue is worthwhile if prices are unstable?

For some the best tactic is to avoid the problem altogether. This can be achieved by applying theories of perfect competition, in which “a perfectly competitive economy is allocatively efficient: resources could not be reallocated to improve anyone’s welfare without reducing the welfare of another.”⁷⁴ This has encouraged an approach to markets where regulators try as much as possible not to interfere in the decisions of private parties. The principle appears imbedded in the English law principle of freedom of contract as described in *Printing and Numerical Registering Co. v Sampson*⁷⁵:

If there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their

⁷² Lopucki LM and Doherty JW (2007), p3-4

⁷³ Espen Eckbo B and Thorburn KS, “Automatic bankruptcy auctions and fire sales”, *Journal of Financial Economics* 89 (2008) 404-422, p421

⁷⁴ Anand P “Welfare: From Income to Wellbeing”, in Dawson G, Mackintosh M and Anand P (eds.), *Economics and Economic Change: Microeconomics*, Open University (Milton Keynes: 2006), 200-231, p222

⁷⁵ *Printing and Numerical Registering Co. v Sampson* (1875) LR 19 Eq 462

contracts entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice.⁷⁶

Yet what here can be read as a social point about individual liberty has grown into a philosophy about optimal choice. In insolvency law “the general policy of the law is to treat creditors themselves as being in the best position to decide what is in their interests”⁷⁷, reflected in principle 27 of the World Bank Principle that “the court/tribunal or regulatory authority should be obliged to accept the decision reached by the creditors that a plan be approved or that the debtor be liquidated.”⁷⁸ This is fully realised in the assertion that “the first function of bankruptcy is to allow unpaid creditors to seize the insolvent debtor’s assets, sell them and invest the proceeds in other venues.”⁷⁹ This philosophy of insolvency efficiency – that creditors are best placed to judge the best outcome and the law should operate to realise their intentions – is embodied in the creditors’ bargain theory which grew out of the 1970’s law and economics movement in the US and has dominated the field ever since.⁸⁰ The economic theory of law and the efficiency theory of the common law should not be confused. Economic theory of law tries to explain many legal phenomena through the use of economics. Efficiency theory of law hypothesizes a specific economic goal: economic efficiency in the Kaldor-Hicks⁸¹ sense.⁸² Thus the insolvency efficiency model applies the economic theory of perfect competition to

⁷⁶ *Printing and Numerical Registering Co. v Sampson* (1875) LR 19 Eq 462 at 465

⁷⁷ Keay AR and Walton P (2008), p263, citing *Re Crigglestone Coal Co Ltd* [1906] 2 Ch 327

⁷⁸ World Bank (2001), p11

⁷⁹ Brogi R and Santella P, “Two New Measures of Bankruptcy Efficiency”, The European Money and Finance Forum, Vienna: SUERF (*SEURF Studies: 2004/6*) (2004), found at <http://suerf.org/download/studies/study20046.pdf> (accessed 30 Nov 2012), p9

⁸⁰ Keay AR and Walton P (2008), p25

⁸¹ Kaldor-Hicks efficiency is a modification of Pareto-Optimality where a move is permitted that reduces utility for one party where the benefit to another party is sufficient that they could compensate the loser (whether they chose to or not). Kaldor-Hicks moves are allocatively efficient whilst allowing government to manage the “inherent trade-off between efficiency (the Pareto assumption) and freedom”, Anand P, “Welfare Economics and Social Choice”, in Simonetti et al (eds.), *Doing Economics: People, Markets and Policy Book 1*, Open University (Milton Keynes: 2010), 161-210, p176. Utility theory will be explored in greater detail in section 6-2.

⁸² Posner RA (2007), p26

argue that reducing intervention and enforcing creditor agreements is allocatively efficient and therefore provides the most welfare in society.

It seems that there is an intellectual leap between Schwartz's declaration that "the efficiency goal holds that the object of business law, broadly speaking, is to maximise social wealth"⁸³ and Finch's description that those applying the insolvency efficiency model conceive that "the proper function of insolvency law can be seen in terms of a single objective: to maximise the collective return to creditors."⁸⁴ Maximising returns to creditors is not self-evidently the same thing as maximising social welfare. The key to understanding the argument is that for the efficiency theorist maximising creditor returns is the best way to maximise social wealth.

Jackson, the "main champion"⁸⁵ of the creditors' bargain theory, argues that the reason why disorderly workouts override individual's ability to achieve the best outcome independently is because of a market failure. The IMF lays out the exact same contention here:

When an insolvency debtor's assets are insufficient to meet its liabilities, an individual creditor's best strategy is to rush to take the necessary legal measures to attach and seize assets before other creditors have a chance to take similar action. Applying the prisoner's dilemma paradigm, while such behaviour will appear rational from the perspective of individual creditors, such a 'grab race' will not, in fact, be in the collective self-interest of creditors; not only are the legal actions taken by creditors costly, but such a disorderly piecemeal dismantling the entity will lead to a loss in value for all creditors.⁸⁶

This leads Jackson to argue that the primary rationale of insolvency law is to force creditors to abide by collective procedures that will overcome the prisoner's

⁸³ Schwartz A (1998), p1813

⁸⁴ Finch V, "The Measures of Insolvency Law", *Oxford Journal of Legal Studies* 17 (1997) 227-251, p230

⁸⁵ Walton K and Keay A (2008), p25

⁸⁶ IMF (1999), 2 – General Objectives and Features of Insolvency Procedures, p12

dilemma.⁸⁷ This is the crucial first element in understanding Schwartz's insistence that the only mandatory rules in insolvency law should be structural.⁸⁸ This de-minimus approach is focused on mandatory stays and collective action sufficient to overcome the grab race. It is intended to achieve an outcome that mirrors what parties would achieve from behind a Rawlsian 'veil of ignorance'⁸⁹, where creditors can achieve the outcome they would seek if not driven by fear of being betrayed by the others, or as Jackson puts it himself:

Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together... as such, it reflects the kind of contract that creditors would agree to if they were able to negotiate with each other before extending credit.⁹⁰

This approach leads to a very particular way of evaluating insolvency laws:

When one is dealing with firms, the question is how to convert the ownership of the assets from the debtor to its creditors, not how to leave assets with the debtor. But the process is costly. Bankruptcy law, at its core, is concerned with reducing the costs of conversion.⁹¹

A bankruptcy law can help to achieve this goal [maximising social wealth] by reducing the costs of debt capital.... This instrumental goal, in turn, is facilitated by maximising the creditors' expected return when the firm is insolvent. Therefore, an efficient bankruptcy system maximises the value that firms have in, and as a consequence of, the system and minimizes the costs of realizing that value.⁹²

The efficiency model is deliberately focused on the conversion of assets to satisfy the creditor, and the minimisation of costs in the process of this conversion. It is a model of law that is heavily focused on the extremity of insolvency, on liquidation. This is in the belief that, given a clear vision of how things will be resolved in the event of

⁸⁷ Armour J and Deakin S (2001) p24

⁸⁸ Schwartz A (1998), p1809

⁸⁹ Finch V (1997), p231

⁹⁰ Jackson TH (1986), p17

⁹¹ *Ibid*, p5

⁹² Schwartz A (1998), p1813-1814

liquidation, parties will have a clear incentive to make rational choices regarding reorganisation. The focus on costs ties back into the creditor's bargain as part of being a means to ensure that parties either get what they bargained for or what they would have bargained for, thus Schwartz suggests that "parties should be free to choose preferred bankruptcy systems in their lending agreements"⁹³, and Rasmussen that "for too long bankruptcy scholars have failed to realize that bankruptcy law is really part of contract law."⁹⁴ By keeping insolvency laws as narrow as possible efficiency proponents hope to create the minimum possible distortion of individuals' incentives to privately order themselves to their own advantage.

The natural extension of this reasoning is that questions of public interest, no matter how important they are in law or to society, are not applicable in insolvency law.⁹⁵ This is not, according to the insolvency efficiency model, a question of distributive priority but rather one of efficiency; "It is inefficient to reorganise firms to save jobs, and society has better means than bankruptcy to solve transition problems... bankruptcy systems should function only to reduce the costs to firms of debt finance."⁹⁶ It is argued that as communities are better placed to judge if a business should be supported, and investors are better placed to negotiate their priority on default, emphasis on efficiency actually minimises the costs of business collapse.⁹⁷ Insolvency efficiency does not ignore social welfare, but rather considers that the benefits of redistribution within the insolvency framework are outweighed by the costs of inefficiency. This piece of reasoning is how insolvency efficiency theorists are able to equate maximising social welfare with maximising the collective return to creditors.

⁹³ *Ibid*, p1810

⁹⁴ Rasmussen RK (1992), p121

⁹⁵ Jackson TH (1986), p25

⁹⁶ Schwartz A (1998), p1819

⁹⁷ Rasmussen RK and Skeel DA (1995), p85

Taken together this leads directly to perhaps the most famous characteristic of insolvency efficiency: rigid adherence to the absolute priority rule.⁹⁸ The principles of allocative efficiency have been applied to insist that “insolvency state rights should be preserved in insolvency states”⁹⁹, effectively restated by Goode in the notion that the “secured creditor is accorded priority because he bargained for it.”¹⁰⁰ An efficient insolvency law ensures that secured creditors are paid first.

The pinnacle of the use of the free market rationale in policy making was achieved through the application of Efficient Market Hypothesis (EMH) to the operation of financial markets, which was in fact “just an application of rational expectations to the pricing of securities”¹⁰¹ and an extension of the first welfare theorem that “as long as producers and consumers act as price makers and there is a market for every commodity, the equilibrium allocation of resources is Pareto efficient.”¹⁰² EMH was introduced by Eugene Fama in his doctoral thesis in 1970¹⁰³. He identified three forms of informational efficiency in capital markets: the weak, where past prices cannot be used to predict future security prices; the semi-strong, where publically available information cannot predict future security prices; and the strong, where security prices cannot be predicted.¹⁰⁴ Although the strong version can be rejected due to the existence of things like insider trading¹⁰⁵, the semi-strong and weak models proved extremely durable.

This then popularised the notion that prices in capital markets reflect all available information, or as Ayer puts it “if there is a five dollar bill lying on the street in your

⁹⁸ Goode R (2011), p71

⁹⁹ Webb DC (1991), p139

¹⁰⁰ Goode R (2005), p59

¹⁰¹ Mishkin FS, *The Economics of Money, Banking and Financial Markets*, 6th ed, Pearson Education (2003), p697

¹⁰² Morgan W, Katz M, Rosen H (2009), p437

¹⁰³ Fama E, “Efficient Capital Markets: A review of theory and empirical work”, *The Journal of Finance* 25(2) (1970) 383-417)

¹⁰⁴ Milne A (2011), p31

¹⁰⁵ *Ibid*

neighbourhood, someone has already picked it up.”¹⁰⁶ This idea was hugely influential on financial practice and investment strategy.¹⁰⁷ The most obvious problem with it is that the tools that were its progeny failed to manage either the dot-com boom in the early nineties or the current credit crunch. EMH is the intellectual father of Northern Rock – because models derived from EMH gave the markets confidence in securitised bundles of sub-prime debts – and the financial crisis has encouraged growing support for the criticism of the theory.

Two of the strongest criticisms are behavioural bias and cultural bias. Behavioural Economists Kahneman and Tversky’s ‘Prospect Theory’¹⁰⁸ demonstrates behavioural bias by showing that standard utility theory behaves poorly under conditions of risk, and cultural bias. Meanwhile an important proponent of the role of cultural bias, Schiller¹⁰⁹, has shown the large impact on markets of social and cultural aspects, media coverage and “dominant ideas in the popular discourse.”¹¹⁰ Stemming from these two critiques the notion of rationality in particular has come under fire:

“Too often consumer policy has focused on the allegedly average consumer, who is in fact imbued with the above average qualities of being ‘reasonably well informed and reasonably observant and circumspect.’ The law uses this model and assumes consumers observe information, rationally process it and act in predictable ways. Vulnerable consumers are seen as atypical consumers, for whom special protection measures may be needed, but whose needs should not get in the way of deregulation and liberalization to benefit the ‘average’

¹⁰⁶ Ayer JA, “The Role of Finance Theory in Shaping Bankruptcy Policy”, 3 *American Bankruptcy Institute Law Review* (1995) 53-83, p55.

¹⁰⁷ Milne A, (2011), p30-31, see Malkiel BJ “The Efficient Market Hypothesis and its critics”, *Journal of Economic Perspectives* 17 (2003) 59-82, and Malkiel BJ, *A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing*, WW Norton (New York: 2007)

¹⁰⁸ Kahneman D and Tversky A, “Prospect Theory: An Analysis of Decision Under Risk”, *Econometrica* 47(2) (1979) 263-291

¹⁰⁹ Schiller RJ, *Irrational Exuberance*, Princeton (New Jersey: 2005))

¹¹⁰ Milne A (2011), p32

consumer. The truth is that we are all to some extent vulnerable, because of the limitations of the human mind.¹¹¹

It is probably fair comment that this work “hasn't shown in aggregate how [behavioural economics] effects prices.”¹¹² It is also fair to say that markets are not always clear and prices do not reflect all available information, especially under circumstances where players’ “rational” behaviour is being compromised by strong social factors or exposure to risk. Yet this critique of efficient markets profoundly impacts upon the Orderly and Effective insolvency model both because it questions the effectiveness of the market mechanism through which user objectives are realised. More fundamentally, this highlights the fact that users are not always the best placed to judge what is in their own best interests. This is in direct contrast to the principle in *Printing and Numerical Registering*.¹¹³

Even if the behavioural critiques are rejected, concentrating on attempting to achieve perfect markets may not create more effective insolvency laws because Pareto-optimal results in a free market may not meet policy objectives:

While private market choices may lead to a Pareto-efficient outcome, ethical principles are required if we are to choose between outcomes that distribute economic benefits differently between individuals. It is also difficult to see how you might indicate your preference for, say, an integrated and sustainable transport system by walking into a shop and buying some particular product.¹¹⁴

English law is prepared to override the wishes of major creditors in order to pursue the overriding rescue objective.¹¹⁵ This might be justified on the basis of Kaldor-Hicks Efficiency, an alternative model that allows moves that disadvantage one party

¹¹¹ Howells G, “The Potential and Limits of Consumer Empowerment by Information”, *Journal of Law and Society* 32(3) (2005) 349-370, p359

¹¹² Myron Scholes - quoted in the economist, 18 July 2009, p72

¹¹³ *Printing and Numerical Registering Co. v Sampson* (1875) LR 19 Eq 462

¹¹⁴ Anand P (2010), p166

¹¹⁵ Cohen M and Crooks S (2007), p221

provided “the winners could compensate the losers, whether or not they actually do”¹¹⁶ and also known as potential Pareto superiority. However, prioritising viable rescue above all other outcomes must inevitably lead to Pareto inefficient solutions because it overrides individual utility: the conclusion is that if Pareto optimality is at the root of Orderly and Effective insolvency (via Insolvency Efficiency) then English insolvency law is not ideally Orderly and Effective.

However, Pareto efficiency is based on a “set of value judgements that are far from innocuous.”¹¹⁷ Two that are of particular note concerning this analysis of insolvency law are the assumptions of non-paternalism and process independence. Non-paternalism is the assumption that individuals are the best judges of their own welfare, which translates as the ability to make the sorts of calculations that underpin EUT. Process independence suggests that the means by which allocations are achieved is unimportant, which has been strongly refuted by procedural justice theory where preferences for adversarial over inquisitorial justice, regardless of outcome, have been established because it gave a greater opportunity to put what they felt was important in front of a judge.¹¹⁸ This problem might be overcome by allowing that satisfaction with the procedure is part of the utility achieved in the outcome, but this is not strictly part of the Pareto model.

Of course the Orderly and Effective model of insolvency predates the financial crisis and the current explosion in the popularity of behavioural economics. It is not difficult to see echoes of both efficient market hypothesis and pertinently the contractualists insolvency efficiency approach in the IMF model: the centrality of enforcing priority, emphasis on efficiency, the importance of the prevention of the

¹¹⁶ Posner RA (2007), p13

¹¹⁷ Gravelle H and Rees R (2004), p280

¹¹⁸ Thibaut J, Walker L, Latour S, Houlden P, “Procedural Justice as Fairness”, *Stanford Law Review* 26 (1973) 1271-1290

grab race and the link being made between cost of debt capital and returns to creditors from insolvency proceedings. The following quote from the guidelines shows how directly the IMF has applied the theories of the contractualists:

As a general rule, if the assets of the estate are encumbered, the proceeds of their sale should first be distributed to secured creditors to the extent of the value of their secured claim, plus any compensation arising from the stay that has not already been paid during the proceedings ... The inclusion of other statutory privileges, while they may be considered necessary for social or political reasons, should be limited to the extent possible since they generally undermine the effectiveness and efficiency of insolvency proceedings.¹¹⁹

Insolvency efficiency is an elegant solution to the problem of determining and comparing value in business failure, but one does not have to be particularly cynical to identify another reason why the efficiency model has proved both popular and enduring. Its central conclusion is that the best means to promote global welfare is to focus on protecting secured creditors, which for the most part means protecting the interests of the rich and powerful. Warren articulates her frustrations with the efficiency approach in her eloquent critique of Baird's work on contractualism:

Baird sees collectivism as something of an intellectual yardstick, a tool that he can use to determine whether a particular bankruptcy proposal is good or bad-solely by measuring whether it promotes or impairs collectivism... Collectivism is nothing but a veil to conceal his relentless push for single-value economic rationality, an excuse to impose a distributional scheme without justifying it, and, incidentally, a way to work in a damn good deal for secured creditors. By focusing on an economic rationale-without defending this exclusive focus, Baird eliminates without discussion or proof any other values that may be served by bankruptcy.¹²⁰

Communitarian theorists, like Warren, challenge the basic premises of the efficiency economic model of insolvency: "namely that individuals should be seen as selfish,

¹¹⁹ IMF (1999), 3 – Liquidation Proceedings, p 34

¹²⁰ Warren E (1987), p800,p803

rational calculators”¹²¹ They argue that insolvency law must weigh the interests of a broad range of different constituents and the wider community – employees, suppliers, government, consumers and neighbours. By considering a wider range of constituent interests it takes on a more “public law focus”¹²², attempting to intervene to balance the tensions that arise rather than leaving them to the market.

The over-simplification of the single value economic-rationality approach does not hold together well under scrutiny. When Rasmussen argues that “bankruptcy law is really part of contract law”¹²³ and thus only the initial arrangements should count, Goode counters that this “overlooks the fact that certain problems confronting claimants outside the common pool creditors arise specifically due to the company’s insolvency and for no other reason.”¹²⁴ An example is that for claims of employees wrongfully or unfairly dismissed the general law cannot prescribe priority as it makes no sense outside of the context of insolvency. Warren expands:

Contract law need not take account of the values relevant to sanctioning debtor default, because these values are accounted for in the debtor-creditor collection scheme. Without the refined and balanced system of debtor-creditor law – which includes a well-developed concept of bankruptcy – contract law itself would look very different, and its enforcement would be considerably more constrained... The enforcement scheme in debtor-creditor law acknowledges values different from those central to contract law. Idiosyncratic factors involved in the changed circumstances of debtors in extreme financial distress become important.¹²⁵

The claim that insolvency law is properly a species of contract law seems indefensible. The insolvency efficiency approach appears to be beset by this sort of overwhelming desire for ideological purity. Its proponents are prepared to conduct

¹²¹ Finch V (1997), p236-237

¹²² Keay A and Walton P (2008), p27

¹²³ Rasmussen RK (1992), p121

¹²⁴ Goode R (2011), p73

¹²⁵ Warren E (1987), p779

all sorts of acrobatic acts of reasoning in order to justify placing all needs secondary to giving secured creditors what they contracted for. Perhaps this is betraying a deeper ideology. The principle of freedom to contract, described above as sacred public policy in *Printing and Numerical Registering*¹²⁶, could in itself be described as a communitarian interest: a policy choice that one could explicitly choose ahead of greater returns. But such a policy choice would by definition be disorderly, as on occasion it would result in firms that may have greater worth being liquidated in the name of preserving freedom of contract.

Another likely element is that ideological inclinations are being exacerbated by methodological limitations. Abstraction is an essential part of economic modelling. Economics is traditionally considered the study of the production, distribution and consumption of goods and services, but “economics theory requires only that scarce resources must be allocated among competing uses.”¹²⁷ The word comes from the Greek for ‘household management’ and was developed as a species of sophistry. The modern discipline aspires to a more scientific approach, but relies heavily on abstraction rather than empiricism. Posner defends this approach in his seminal work on law and economics:

Abstraction is the essence of scientific inquiry, and economics aspires with some success to be scientific... an economic theory of law will not capture the full complexity, richness, and confusion of the phenomena – criminal or judicial or marital or whatever that it seeks to illuminate. But its lack of realism in the sense of descriptive completeness, far from invalidating the theory, is a precondition of theory. A theory that sought faithfully to reproduce the complexity of the empirical world in its assumptions would not be a theory – an explanation – but a description.¹²⁸

¹²⁶ *Printing and Numerical Registering Co. v Sampson* (1875) LR 19 Eq 462 at 465

¹²⁷ Benson BL (1989), p2

¹²⁸ Posner RA (2007), p16

Yet the obvious danger of abstraction is that it can be used to simply avoid issues that challenge your thesis. There is a natural propensity to “interpret information to support one’s instinctive opinions... to believe information that supports [one’s] viewpoint and discredit information that does not.”¹²⁹ Contractualists have been frequently criticised for building theoretical constructs without taking the time to verify them by empirical evidence¹³⁰, with Keay and Walton going so far as to state that contractualists’ answers are “too clear-cut and glib.”¹³¹ Warren makes the point very clearly:

If the central policy justification is nothing more than a single economic construct, specific conclusions with system wide impact follow neatly from an abstract principle... the uncomfortable normative issues can be avoided by playing a narrow game of logic.¹³²

She continues to describe the approach as “utterly self-referential”¹³³, attractive principally because it “spares the proponent from nasty hours searching out empirical evidence or trying to learn about what happens in real borrowing and lending decisions.”¹³⁴ This is not even the bluntest critique of the school of thought. Samuel Bufford, who at the time of writing was a Californian Bankruptcy Judge with ten years’ experience at the bench, offered the following evaluation of a series of papers written by some of the most influential contractualists of the day:

The central points of these papers are gravely mistaken... they completely misunderstand the character of the bankruptcy caseload and procedures, they ignore some important purposes of bankruptcy reorganisation, and they misstate the success rate for reorganisations... they

¹²⁹ Howells G (2005), p360

¹³⁰ Goode R (2011), p72

¹³¹ Keay A and Walton P (2008), p27

¹³² Warren E (1987), p796-797

¹³³ *Ibid*, p812

¹³⁴ *Ibid*

recommend radical changes in bankruptcy law, and they are based on the thinnest knowledge of bankruptcy practice. Incidentally, they also all take an economics approach to law.¹³⁵

The problem is not that insolvency efficiency takes an economic approach to the law, but rather that it often uses economic abstraction's ability to simplify in order to push what is essentially an ideological point via "19th century notions of laissez-faire economics... that rest on inarticulate groping towards efficiency."¹³⁶ Although purporting to avoid distributive questions their "conclusions are nonetheless driven by normative values and empirical assumptions"¹³⁷: the insolvency law they propose is redistributive from the weak to the strong.

Bufford goes to some lengths to present actual data from the insolvency courts to rebut the panel's arguments. His chief objection, perhaps unsurprisingly from a judge, is that the insolvency efficiency proponents are presenting their theories without supporting evidence, or where evidence is used very limited examples are taken to extrapolate to the whole:

This statement [that markets seem to be the only available devices which really do solve the problems of financial distress because markets are efficient and bankruptcy procedures are not] is simply incorrect. The empirical evidence shows that most markets are far from efficient: we have bankruptcy law in large part because of this problem. Debtors need an opportunity to suspend the rights of creditors because markets are so inefficient. Similarly, markets do not solve the problems of financial distress.¹³⁸

Nobody knows whether, on balance, the economy is better off because bankruptcy permits debtors to try to wait out imperfect markets: the data has not been collected.¹³⁹

¹³⁵ Bufford SL (1994), p829

¹³⁶ Pettet B, "Limited Liability – A principle for the 21st century?" *Current Legal Problems* 48 (1995) 125-159, p143

¹³⁷ Warren E (1987), p812, in this case talking specifically about the work of Baird, although she makes it clear she considers his co-conspirators, such as Jackson, equally culpable.

¹³⁸ Bufford SL (1994), p846

¹³⁹ *Ibid*, p847

Warren argues for a multi-value approach, “a dirty, complex, elastic, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to the policy decision.”¹⁴⁰ While this sounds marvellously poetic it does not appear to be particularly practically applicable. It risks avoiding making decisions by leaving all options valid and nothing but confusion for those who must actually draft and apply insolvency laws.¹⁴¹ The insolvency efficiency theorists’ economic analysis of the law provides a clearer model upon which to base policy. Equally, communitarians are no more immune to the limitations and seductions of economic abstraction than efficiency theorists, nor are they I suspect any more or less lazy as a group when it comes to looking for data or considering context. It would be more reasonable to recognise that conducting law and economics research is replete with technical challenges that lawyers are not always best equip to manage: “the majority of its practitioners are based in law schools, and have not received any systemic training in either sociological theory or research methods.”¹⁴² This is not some inherent deficiency in lawyers: we have all encountered otherwise well-educated and informed non-lawyers who find law in practice utterly mysterious and proceed to find everything but the right end of the stick.

When it comes to insolvency law in practice, however, the progenitors of English insolvency law recognised that an element of communitarian policy should exist in English law. A good insolvency law is defined as being one that is able to “recognise that the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public

¹⁴⁰ Warren E (1987), p881

¹⁴¹ Finch V (1997), p242

¹⁴² Banakar R and Travers M, “Law, Sociology and Method”, in Banakar R and Travers M, Theory and Method in Sociol-Legal Research, Hart (Oxford: 2005), p1, p2

interests are recognised and safeguarded.”¹⁴³ If the contractualists are correct this would strongly imply that English law is less effective than it could be, because these efforts to safeguard public interests will be reflected in higher costs of debt capital and subsequently reduced investment and lower aggregate welfare. Is this perfidiousness on the part of English law, compromising the principles of efficiency and associated greater welfare in order to address immediate social concerns? Are both English law and the Orderly and Effective model sheep in wolves’ clothing?

¹⁴³ Goode R (2011), p74-75

1.4 THE ORDERLY AND EFFECTIVE REGIME: PREDICTABILITY AND PROTECTION OF VALUE

The IMF explains that regimes should be Orderly and Effective. As we saw above, orderly regimes prevent firms that are worth more as a going concern from being driven into liquidation, and effective regimes maximise the value realised through the insolvency process. Consistent application of such procedures “plays a critical role in fostering growth and competitiveness and may also assist in the prevention and resolution of financial crisis: such procedures induce greater caution in the incurrance of liabilities by debtors and greater confidence in creditors when extending credit or rescheduling their claims.”¹⁴⁴ Thus two key objectives are identified: predictability, and preservation of value.

1.4.1 Predictability

The IMF demands that an Orderly and Effective insolvency regime ensure the allocation of risk in a “predictable, equitable, and transparent manner”¹⁴⁵, echoed by the World Bank’s statement that “a modern credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims.”¹⁴⁶ Further analysis reveals that these three words -predictable, equitable and transparent - speak to the same underlying idea. Predictability is the salve to uncertainty, which “erodes the confidence of all participants and undermines their willingness to make credit and other investment decisions.”¹⁴⁷ Equitability does not refer to equality but is a species of predictability as it is particularly concerned with “the problem of fraud and favouritism that often arises in the context of

¹⁴⁴ IMF (1999), 1 - Introduction, p6

¹⁴⁵ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p8

¹⁴⁶ World Bank (2001), p13

¹⁴⁷ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p8

financial distress.”¹⁴⁸ Fraud and favouritism undermine predictability by defeating expectation, which in turn reduces confidence in investment. Transparency is “vital to establishing public trust in the insolvency system... [It] allows the public to form opinions on the insolvency system through the media and other outlets.”¹⁴⁹ It is about ensuring parties have enough information for them to exercise their rights, both in terms of adequate guidance and ensuring that courts give sufficient explanation of their decisions.

The World Bank asks the legal system to make a difficult judgement call:

Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation to maximise recoveries for the benefit of creditors... On the other hand, where an enterprise is viable, meaning it can be rehabilitated... [it] should be promoted through formal and informal procedures... Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Though such laws may not be susceptible to precise formulas, modern systems generally rely on design features to achieve the objectives outlined above.¹⁵⁰

Balancing the need for swift predictable judgement and evaluating this wide range of commercial expectations rests upon “the degree of discretion that the law gives to this infrastructure when it applies the law.”¹⁵¹ Too much discretion and the system becomes unpredictable; too little and it ceases to be commercially responsive.

In English law the question of how to manage judicial discretion has been part of a long standing debate about the importance of legal certainty. Whether in Dicey’s rule of law protecting individuals from an arbitrary state¹⁵², or as principle of inherent morality in Fuller’s moral law¹⁵³, the concept of legal certainty has always been a key

¹⁴⁸ *Ibid*

¹⁴⁹ World Bank (2001), p59

¹⁵⁰ *Ibid*, p5

¹⁵¹ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p10

¹⁵² Dicey AV, *Introduction to the Study of the Law of the Constitution*, 10th Ed, MacMillan (London: 1968), p187

¹⁵³ Fuller L, *The Morality of Law*, Yale University Press (New Haven: 1973), p262

component of any discussion of the principles of proper law making.¹⁵⁴ Douzinas and Nead argue that property laws “must be justified by strict necessity and must follow general rules and a clear logic... [and] cannot indulge fanciful subjective considerations”¹⁵⁵, while Slapper and Kelly describe the practical importance of legal certainty for promoting predictability as follows:

Lawyers and clients are able to predict what the outcome of a particular legal question is likely to be in the light of previous judicial decisions. Also, once the legal rule has been established in one case, individuals can orientate their behaviour with regard to that rule, relatively secure in the knowledge that it will not be changed by some later court.¹⁵⁶

Two convictions are central to this notion of certainty. First, that preserving the rule of law protects us from the whims of the judiciary. Second, that predictability allows us to safely order our actions according to the probable legal response, as famously described by Oliver Wendall Holmes:

A man may have as bad a heart as he chooses, if his conduct is within the rules. In other words, the standards of the law are external standards, and, however much it may take moral consideration into account, it does so only for the purpose of drawing a line between such bodily motions and rests as it permits, and such as it does not. What the law really forbids, and the only thing it forbids, is the act on the wrong side of the line, be that act blameworthy or otherwise.¹⁵⁷

Principles like clarity, calculability and reliability are encoded into European Law¹⁵⁸ and are all the progeny of the desire for legal certainty, as is the doctrine of *stare decisis* in the common law.¹⁵⁹ In contemporary insolvency law there is a repeated focus on the creation of a “clear, predictable and transparent insolvency process

¹⁵⁴ See Popelier P, “Legal Certainty and Proper Law Making”, *European Journal of Law Reform*, 2(3) (2000) 321-342) for discussion of the role of legal certainty in law making, linking both Fuller and Dicey to European Law approaches to certainty, contemporary problems and the notion of justified uncertainty.

¹⁵⁵ Douzinas C and Nead L, “Law and Aesthetics” in *Law and the Image: The Authority of Art and the Aesthetics of Law*, ed Douzinas and Nead, Chicago Press (London: 1999), p2

¹⁵⁶ Slapper G and Kelly D, *The English Legal System*, 7th Ed, Cavendish (London: 2004), p94-95

¹⁵⁷ Holmes OW, *The Common Law*, ABA Publishing (Chicago: 2009), first published by Little Brown and Co (1881), p74

¹⁵⁸ Popelier P (2000), 331-333

¹⁵⁹ Slapper G & Kelly D (2004), p75

which enables both debtor and creditor to calculate the consequences in the event insolvency actually occurs.”¹⁶⁰ Promoting legal certainty in this form has been a pillar of the advice given to developing nations by organisations like the IMF, the World Bank and the OECD.¹⁶¹ The reasoning behind this is that it is felt that, in a legally certain insolvency regime, potential creditors will be able to better evaluate the risks, encouraging economic investment and stable development: “Mandatory rules, when precisely formulated, give legal certainty to the parties and avoid litigation; they facilitate the proceedings and reduce their cost. Moreover, specific rules and criteria provide for the predictability that is one of the overall objectives of an insolvency law.”¹⁶² This reference to precisely formulated mandatory rules has strong echoes of the work of the contractualists, discussed in Chapter 1.3.

Does this mean that the call for legal certainty by the IMF implies they agree that only structural rules should be mandatory? There is a clear logic in operation, based upon our expectations of creditor behaviour. If creditors are given a predictable legal system then they will privately order in the most efficient fashion possible; thus, in English law, the “secured creditor is accorded priority because he bargained for it”¹⁶³, and his ability to enforce his claim as a creditor reduces the risk of giving credit and thereby “increases the availability of credit and the making of investment more generally.”¹⁶⁴ It is a virtuous circle founded on the rationality of the creditor. The primacy of predictability is therefore somewhat undermined if we discover that in reality creditors are often irrational. The World Bank’s references to the importance of public trust and public opinion¹⁶⁵ suggest that predictability means something

¹⁶⁰ Falke M (2003), p38

¹⁶¹ See, amongst others, UNCITRAL, *Legislative Guide to Insolvency Law*, United Nations (New York: 2005), 10 – ‘Provision of certainty in the market to promote economic stability and growth’, World Bank (2001) p8 ‘Predictability’, and IMF (1999), 2 - General Objectives and Features of Insolvency Procedures

¹⁶² IMF (1999), 2- General Objectives and Procedures, p11

¹⁶³ Goode R (2007), p59

¹⁶⁴ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p8

¹⁶⁵ World Bank (2001), p59

more than a list of de minimus structural rules, and the IMF and World Bank approach to Orderly and Effective insolvency goes beyond basic contractualism. Nonetheless, the influence of contractualism and efficiency modelling is clear in their discussion of predictability.

1.4.2 Protection of Value

The second objective of insolvency law identified by the IMF is “to protect and maximise value for the benefit of all interested parties and the economy in general”¹⁶⁶, an objective that is achieved not only through rescue of viable businesses but also by the fashion in which unviable firms are liquidated. There is an implicit recognition of the role of creative destruction in the economy here, a phrase popularised as a positive force by Schumpeter in the 1950’s.¹⁶⁷ As Dahiya and Klapper observe:

All economies are marked by some degree of ‘turnover’ in the population of its firms via entry of new firms and exit of existing firms. This constant churning of the private sector plays a key economic role by constantly reallocating resources from non-surviving firms to surviving firms... Since the survivors are likely to be the better performing firms, the creative destruction of poorly performing firms is central to innovation and growth in an economy.¹⁶⁸

The availability of failure is essential in a predictable system, because it is considered to weed out weak players, “the discipline it imposes on a debtor increases the competitiveness of the enterprise sector and facilitates the provision of credit.”¹⁶⁹

This is reflected in one of the most important facts of insolvency: “poor performance

¹⁶⁶ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p8

¹⁶⁷ Schumpeter J, *Capitalism, Socialism and Democracy* (New York: Harper, 1975) [orig. pub. 1942], p 82-85

¹⁶⁸ Dahiya S and Klapper L (2007) p262, p276

¹⁶⁹ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p9

is the primary reason for firm disappearance.”¹⁷⁰ This is to say the most common reason for a firm going bust is because it was not very good at what it did. Removing bad firms from the market makes space for better firms to prosper, a notion which is a cornerstone of capitalism as Hobsbawm explains in his description of the development of the land commodity:

Since the size of the earth was limited, and its various pieces differed in fertility and accessibility, those who owned its more fertile parts must inevitably enjoy a special advantage and levy a rent on the rest... [therefore] entails and other prohibitions of sale or dispersal which rested on noble estates had to be broken and the landowner therefore subjected to the salutary penalty of bankruptcy for economic incompetence, which would allow economically more competent purchasers to take over.¹⁷¹

This is achieved by ensuring that insolvency regimes “curtail the deterioration of the value of their assets by providing them with a means of enforcing their claims.”¹⁷²

Protection of first claim secured credit, that is to say paying secured creditors first, is then correlated to the cost of credit in the broader economy:

The introduction of any measures that erode the value of security interests requires careful consideration. Such an erosion will ultimately undermine the availability of affordable credit: as the protection provided by security interest declines, the price of credit will invariably need to increase to offset the greater risk.¹⁷³

A prosperous economy requires that poor businesses fail, and the Orderly and Effective model points to the primacy of secured credit as a means to maintain this. The empirical evidence for this will be discussed in much greater detail in Chapter 4. The principle itself quickly runs into both economic and political difficulties. A

¹⁷⁰ Dahiya S and Klapper L (2007), p270 – expanded upon further in the text as follows: “Failure to survive is frequently a manifestation of poor performance.... delistings are frequently concentrated in the poorly performing firms... Across all specifications, firms that delist have lower returns on assets and lower sales growth.”, p273

¹⁷¹ Hobsbawm E, *The Age of Revolution 1789-1848*, Abacus (London: 2008), p184 then p186

¹⁷² IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p9

¹⁷³ IMF (1999), 3 – Liquidation Procedures, p23

relevant concern is that, particularly during financial crisis, widespread insolvency can cause significant harm: “credit collapses such as those in Asia are not simply the end of socially destructive bubbles but also (or even mainly) result in the destruction of socially productive output.”¹⁷⁴ Changing credit requirements, or the failure of customers or suppliers, can render businesses temporarily insolvent. This may lead to their liquidation regardless of their long term viability. A liberal model assumes rational creditors simply will not do this, but contemporary regimes seem unwilling to give them the chance. This may be exacerbated by the difficulty in determining who is meant by secured creditors.

English law’s definition of a security interest is arguably artificial in that it excludes agreements such as hire purchase transactions, chattel leases, retention of title clauses and outright assignments of debts when these clearly function as security (and, indeed, are often referred to as ‘quasi-security interests’, particularly amongst legal academics) but do not confer upon the counterparty any property interest in *assets of the company*.¹⁷⁵

The definition of who is a secured creditor is not as transparent as might initially appear, as it excludes many types of people who are clearly holding some form of secured credit. This makes it dangerous to assume that secured creditor priority is simply about shoring up returns for banks at the expense of small businesses and employees. But even accepting that secured creditors include more than just the rich and powerful, the liberal economic model is a hard sell when people are losing their jobs. During the Asian financial crisis transitional economies’ governments were criticised for de-liberalising their systems to “utilize the insolvency system to correct overwhelming social needs of the society”¹⁷⁶, which may seem ironic now that European economies are engaged in bail-outs for failing banks and the automotive industries. Will the East now accuse the West of “vicarious measures that will

¹⁷⁴ Radalet S and Sachs J (2000), p150

¹⁷⁵ Frisby S (2006), p32

¹⁷⁶ Falke M (2003), p39

involve extensive use of public funds and give beneficiaries a substantial advantage over their less-favoured competitors”¹⁷⁷, following that well-established historical pattern that “in times of economic downturns insolvency policy concentrated on the promotion of enterprise reorganisation going along with the protection from mass-unemployment, whilst in times of boom liquidation-favoured policies prevailed”¹⁷⁸?

The narrow application of the insolvency efficiency model argued that it was in Asia’s best interests to strip social intervention from their insolvency systems and allow secured creditors the power to liquidate their interests as quickly as possible. By extension, compromises in English law regarding efficiency may be criticised as similarly crude political measures that reduce effectiveness and ultimately reduce social welfare. Such a critique would be misguided. An element of inclusivity and redistribution improves economics stability and the likelihood of effective rescue. English insolvency law is a living illustration of how pure efficiency is neither in secured creditors’ best interests nor is it actually what they seek from an insolvency regime, as shall subsequently be demonstrated.

¹⁷⁷ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p9

¹⁷⁸ Falke M (2003), p65

CHAPTER 2: ENGLISH INSOLVENCY LAW AND THE INTRODUCTION OF A RESCUE CULTURE

2.1 THE LAISSEZ FAIRE TRADITION OF ENGLISH LAW

If English insolvency law is Orderly and Effective, what is it intended to effect?

Effective law based on the recommendations of the OECD and the World Bank post the Asian financial crisis, as explored in Chapter 1, was geared towards improving foreign investment returns and consequently levels of foreign investment. English law was influential in the design of these recommendations. Are the objectives of English insolvency law therefore compatible with improving investment (whether foreign or otherwise)? Is it effectively optimised for preventing the liquidation of firms that would realise more as a going concern, and maximising the realisation for insolvency procedures?

A common characterisation of English law is that it is laissez-faire in that it “operates with a regard to those practices that develop within the commercial world”¹, a notion that may date back to its roots in the Law Merchant that “grew up and around the customs and practices adopted by traders across continental Europe” during the middle ages.² It is most iconically encapsulated in the principle of freedom of contract, which allows that “men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts entered into freely and

¹ “la traditionnelle attitude du législateur anglais de « laissez-faire » à l’égard des pratiques développées spontanément par le monde du commerce Santella P, “Le Droit des Faillites d’un Point de Vue Historique “(2002), Communication au colloque « Faillite et concordat judiciaire », Faculté de Droit de l’Université catholique de Louvain et Centre Jean Renault, Louvain-la-Neuve, 25 et 26 avril. found at <http://www.oecd.org/dataoecd/8/9/12771090.pdf> (accessed 2 March 2010), p9

² Dennis V (2007), p2

voluntarily shall be held sacred and shall be enforced by courts of justice.”³ Franks and Sussman argue English insolvency law’s approach makes it

little more than the strict enforcement of the default clauses in the debt contract, as negotiated ex ante by the lender and the borrower.... [parties] should expect the court to strictly enforce the existing contract rather than to try and “supervise” a solution to the company’s difficulties.⁴

If correct, this approach would find favour with American contractualist insolvency scholars like Schwartz, who argued that “parties should be free to choose preferred bankruptcy systems in their lending agreements”⁵, and Rasmussen who observed that “for too long bankruptcy scholars have failed to realize that bankruptcy law is really part of contract law.”⁶ The centrepiece of the contractualist theory, as introduced in Chapter 1, is that insolvency laws focus on enforcing the contractual arrangements of firms by ensuring that only structural rules are mandatory.⁷ Structural rules are those that “protect the integrity of a bankruptcy system [as opposed to those] whose goal is to augment the bankrupt estate”⁸, thus a mandatory stay is a structural rule and acceptable because it enhances parties ability to contract with certainty, whereas rules that require continued performance of a contract or impose prices are not because they are considered not to enhance ex-ante efficiency. For the contractualist the purpose of insolvency laws is to allow market mechanisms to ensure the most efficient allocation of resources and thereby maximise social utility, and the means of achieving this is to provide the minimum interference in privately ordered solutions.

³ *Printing and Numerical Registering Co. v Sampson* (1875) LR 19 Eq 462 at 465

⁴ Franks JR and Sussman O, “Financial Distress and Bank Restructuring of Small to Medium Size UK Companies”, *Review of Finance* 9(1) (2005) 65–96, p66

⁵ Schwartz A, “A Contract Theory Approach to Business Bankruptcy”, *The Yale Law Journal*, 107 (1998) 1807-1851, p1810

⁶ Rasmussen RK, “Debtor’s Choice: A Menu Approach to Corporate Bankruptcy” *Texas Law Review* 71 (1992) 51-121, p121

⁷ Schwartz A (1998), p1809

⁸ *Ibid*, p1839

Prior to the Enterprise Act 2002 the floating charge holder's freedom to contract for the right to appoint an administrative receiver, in order to take control of a distressed company's affairs, led to UK law being "regarded as a partial approximation to this "contract bankruptcy" model"⁹. The implicit suggestion is that modern English insolvency law, and in particular replacement of administrative receivership with a new streamlined administration system, represents a retreat from contractualism because it limits the freedom of secured creditors to contract for control of the distressed firm via a receiver. A retreat from contractualism would be in keeping with the changing academic mood. As seen in Chapter 1, the contract bankruptcy model has its critics. Lopucki states bluntly that Schwartz's model "employs materially inconsistent assumptions and the proof reaches its goal only through miscalculations from those assumptions"¹⁰, his critique focusing on problems of unequal access to information and conflicting incentives because of the simple fact that "creditors lend at different times or under different circumstances."¹¹ Westbrook argues that "[the] abolition of the British system in 2003 demonstrates empirically the serious weaknesses of secured contractualism"¹² because of the failure of the contract model to take into account the importance of control:

Control is the central concept in any persuasive model of the field. A lack of understanding of the role of control explains the failure to recognize and analyze the crucial distinction between an ordinary secured party and a dominant secured party and to see that the latter offers a possible alternative to the bankruptcy trustee.¹³

⁹ Armour J, Hsu A, Walters A, "Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002" 5 *European Company and Financial Law Review* (2008) 148-171, p153

¹⁰ Lopucki LM, "Contract Bankruptcy: A Reply to Alan Schwartz" *Yale Law Journal* 109 (1999) 317-342, p319

¹¹ *Ibid*, p340

¹² Westbrook J, "The Control of Wealth in Bankruptcy", *Texas Law Review*, 82 (2004) 795-862, p796

¹³ *Ibid*, p861

Contractualism gives concentrated lenders the scope to pursue their own interests ahead of those of other stakeholders. It thus does nothing to redress the power imbalance between groups such as, on the one hand, financial institutions, and on the other, unsecured involuntary creditors. Nor does it address the belief that “procedures controlled by secured creditors may tend to result in outcomes biased against the continuation of the insolvent company's business and towards piecemeal liquidation.”¹⁴ Armour, Hsu and Walters continue that:

The prevailing international trend appears to be on the side of the critics - that is, a strong preference for collective formal rescue proceedings in which control rights are vested (principally) in unsecured creditors. This is reflected in global and regional initiatives in the context of transnational insolvency such as the UNCITRAL Model Law on Cross-Border Insolvency and the EC Regulation on Insolvency Proceedings.¹⁵

This may seem incongruous given the results in the first chapter. The World Bank emphasised the important role of secured credit¹⁶ and the IMF stated that

the introduction of any measures that erode the value of security interests requires careful consideration. Such erosion will ultimately undermine the availability of affordable credit: as the protection provided by security interest declines, the price of credit will invariably need to increase to offset the greater risk.¹⁷

The primacy of contracted security is an important part of the contractualist model of efficiency and equally of the recommendations of the World Bank and the IMF. If the Enterprise Act represents such an erosion of the value of secured credit does this mean that the law is now less Orderly and Effective than when it was inspiring the models used by the World Bank and the IMF¹⁸?

¹⁴ Armour J, Hsu A, Walters A (2008), p154

¹⁵ *Ibid*

¹⁶ World Bank (2001), p4

¹⁷ IMF (1999), 3 – Liquidation Procedures, p23

¹⁸ Brierly P and Vlieghe G, “Corporate Workouts, the London Approach and financial stability”, *Financial Stability Review* (November 1999) 167-183, p170

This chapter, and the next, consider these questions by exploring the purpose of English insolvency law and whether this was changed by the Enterprise Act 2002. It looks at the objectives of English Law as described in the Cork Report¹⁹ and why these led to revisions to the 1986 law in 2002, the distinction between corporate and business rescue, and what difference the replacement of administrative receivership with administration has made. Chapter 3 will comprise of a closer examination of the hierarchy of objectives presented in paragraph 3 of Schedule B1 of the Insolvency Act 1986 and the nature of the administrator's discretion in the context of the "creditor friendliness" of the law, as well as a discussion of two important trends in modern English law: the Administration and CVA as rescue devices, and the Pre-Pack administration. It will be demonstrated across these two chapters that the increased inclusivity appears to have improved rather than eroded the position of secured creditors, and that this remains firmly in keeping with the traditional commercial sensitivity of English law.

¹⁹ Insolvency Law and Practice: Report of the Review Committee (Cmnd 8558, HMSO 1982), "The Cork Report"

2.2 FROM THE CORK REPORT TO THE ENTERPRISE ACT: THE INTRODUCTION OF A RESCUE CULTURE?

Insolvency Law in England is governed by the Insolvency Act 1986 and Insolvency Rules 1986. These have been amended several times since they were passed in to law, particular by the Enterprise Act 2002. One of the most important characteristics of the English regime is that the directors of an insolvent company have a duty to the creditors of that company.²⁰ Hopefully with this in mind, the directors of an insolvent firm have a range of options within this legal framework to deal with debts they cannot satisfy.

The first is to do nothing. This may seem trite but is actually rather important, not least because it is not an uncommon option for directors of insolvent companies to take. An insolvent company can continue as long as it wishes, provided none of its creditors seek to enforce their debt. The danger in doing nothing, of course, is exactly this. Creditors can petition the court to have the company wound up or to appoint an administrator, or a properly qualified floating charge holder can move to appoint a receiver. The holder of a floating charge will be properly qualified if they meet the requirement of the grandfathering provision²¹ that the security was taken before 15 September 2003, and the floating charge is over all or substantially all of the assets of the company.²² Administrative receivership was prospectively abolished by the Enterprise Act 2002 in favour of a new streamlined administration procedure, hence the requirement that floating charge holders meet the requirements of the grandfathering provision, but where still possible it represents one of the most dramatic examples of how under English insolvency law a debtor who chooses to delay dealing with their debts can quickly lose control of their own business. The

²⁰ *West Mercia Safetywear Ltd Liquidator of v Dodd* [1988] BCLC 250

²¹ s72A Insolvency Act 1986

²² s29(2) Insolvency Act 1986

express powers of a receiver will have been set out in the original debenture, alongside powers set out under s1 IA 1986 under which the management are replaced and the receiver can take possession and sell assets in order to satisfy the debt. Importantly, the receiver's duty is to the floating charge holder and not to the other creditors, and this duty is limited only by a requirement of reasonable conduct towards the company.

Alongside the danger that creditors will take matters into their own hands, another important risk to the passive debtor is the aforementioned shift, when the company becomes insolvent, from a primary duty to the company to a primary duty to the creditors. This opens them up to the possibility of action for wrongful trading²³, and a requirement to contribute personally to the assets of the company, or fraudulent trading²⁴, which imposes both criminal and civil liability on directors for acting against the interests of their creditors, not to mention the risk of disqualification under Company Directors Disqualification Act 1986. Thus while it is entirely possible for an insolvent company to continue trading without making use of formal or informal insolvency proceedings, there are significant risks both to the company and to the directors.

The second option, therefore, is to attempt to make some sort of deal with the creditors. At its most informal this can simply mean picking up the phone and arranging to make a payment a few days late, and informal re-negotiation of debt is an extremely common part of day to day business. In addition to this, English law offers two informal procedures for insolvent debtors to renegotiate their debts. The first is a Scheme of Arrangement under part 26 of the Companies act 2006. This effects a reorganisation of a company that, once it has the courts sanction, will bind

²³ s214 Insolvency Act 1986

²⁴ s213 Insolvency Act 1986

both dissenting and unknown creditors, but it is expensive and requires the involvement of the court.

The other informal procedure is a Company Voluntary Arrangement under ss1-7 Insolvency Act 1986, which is a written proposal by the directors in which they nominate an insolvency practitioner to supervise the plan, state how the business will be run during the CVA, give a summary of current financial information and the financial projections, and make a comparison with recoveries for creditors under other insolvency outcomes (in particular winding up). If the proposal is passed by vote then it binds all creditors who were given notice or who would have been entitled to vote, although secured and preferential creditors' rights to their priority cannot be affected without their consent. No further court involvement is required. Management remains in place, making reports to the supervisor nominated in the original plan. The Insolvency Act 2000 introduced a moratorium from companies in paragraph 2(1) of Schedule 1A, which includes small companies but excludes banking and insurance businesses, and this alongside lower costs has made the CVA a preferable option to the more expensive Scheme of Arrangement.

The third option for directors of an insolvent company is to put the firm into administration themselves. The directors may make an application to the court to appoint an administrator, which the court will do if they consider it reasonably likely that the administration will achieve its purpose. The Enterprise Act 2002 also introduced a new out-of-court procedure for appointing an administrator²⁵. Either way, the administrator takes over the management of the company and is appointed to fulfil the three stage tests under Schedule B 3(1). These stages are aimed at maximising returns to all creditors, and the first of them is to attempt to rescue the

²⁵ Schedule B1 paras 14-21 Insolvency Act 1986 allow a qualified floating charge holder to do so, paras 22-34 allow the company/directors to do so.

company as a going concern. He has wide ranging powers to carry on the business of the company, take possession and dispose of property of the company, raise money on security, and execute documents and deeds in the company's name. The appointment of administration creates an immediate moratorium on enforcement action, and within eight weeks of appointment the administrator circulates their proposals for achieving the purpose of the administration to Companies House, the creditors and the shareholders. A creditors' meeting is then usually held within ten weeks of appointment to consider the proposals and recommend changes, although the court may make interim orders where creditors do not agree, and the administrator may also make use of the CVA procedure if they consider it appropriate. Their appointment is automatically terminated after 12 months, although it can be extended once by 6 months with creditor agreement. The ultimate outcome for the company, and often more appropriately the underlying business, is a question for the good judgement of the administrator.

The fourth and final option for the directors of an insolvency company is a Creditors' Voluntary Liquidation (CVL). The company convenes an extraordinary general meeting at which it passes resolutions to approve the CVL (84(1)(c) and appoint a liquidator. This must be advertised in the Gazette within 14 days. A creditors meeting is then convened within 14 days of the advertisement, where the directors set out the companies affairs and the creditors can vote for the appointment of their own liquidator, or elect a committee from which the liquidator must seek approval when attempting to exercise certain of his powers. The liquidator is an agent of the company and must collect and realise the company's assets. He may seek to challenge voidable transactions or sue directors for wrongful or fraudulent trading, or disclaim onerous property, but needs permission of the committee (if there is one) or

the court if they wish to commence legal proceedings or carry on running the business. Assets are then distributed in the following order of priority:

- Liquidator's costs with relation to fixed charge assets;
- Fixed charge creditors;
- Liquidators costs with regards to floating charge assets;
- Preferential Debts, typically concerning employees or certain occupational pension funds;
- The prescribed part of the floating charge²⁶, which is 50% of first £10,000 then 20% thereafter up to a maximum fund of £600,000, to be distributed amongst unsecured creditors;
- Floating charge creditors;
- The liquidator's costs with regards to "free" assets and the general expenses of winding up;²⁷
- Unsecured creditors – ordinary trade creditors and crown debts;
- Interest on unsecured and preferential debts;
- Payments to shareholders according to their class of shares.

Thus English law might be characterised by the way in which it offers alternatives for the directors of an insolvency firm: doing nothing, doing a deal, informal procedures, administration, or voluntary liquidation. These options in turn are characterised by the way in which they change who controls and manages the firm, and the outcome being sought.

So how did the Enterprise Act operate to change this landscape? And where how comfortably does it sit with the Orderly and Effective model or as the paragon of

²⁶ s176A Insolvency Act 1986

²⁷ s115 and s156 Insolvency Act 1986

insolvency efficiency? The Enterprise Act did not introduce the notion of rescue to English law. The English 'rescue culture' was born twenty years before the Enterprise Act with the publication of "The Cork Report"²⁸, a government commissioned review into the reform of insolvency law that led to the introduction of the Insolvency Act 1986 and

... undoubtedly remains the most influential review of the principles and aims of UK insolvency law to ever be produced. Its clarity, completeness, and profundity is consistently remarkable and it therefore comes as no surprise that it continues to serve as a point of reference for insolvency scholars and insolvency professionals alike.²⁹

The Insolvency Act 1986 "can be seen as the first wave of rescue-oriented insolvency law reform in the United Kingdom."³⁰ As Lord Browne-Wilkinson observes in *Powdrill v Watson* "the rescue culture which seeks to preserve viable businesses was, and is, fundamental to much of the Act of 1986"³¹ It was also considered "a basic objective of the law to support the maintenance of commercial morality."³² This notion of commercial morality is an integral part of the assessment of commercial viability. An example of how English insolvency law attempts to achieve this is in the contemporaneous Company Directors Disqualification Act 1986. Section 6 demands that upon application the court will make a disqualification order or between 2-15 years where it finds that the conduct of the director of an insolvent firm "makes him unfit to be concerned in the management of a company."³³ The result is that there is "in every insolvency proceeding, an initial overview of the conduct of directors."³⁴

²⁸ Insolvency Law and Practice: Report of the Review Committee (Cmnd 8558, HMSO 1982), "The Cork Report"

²⁹ Frisby S (2011), p358

³⁰ Armour J, Hsu A, Walters A (2008), p150

³¹ *Powdrill v Watson* [1995] 2 AC 394, 442A-444A, cited by Armour J, Hsu A, Walters A (2008), p149

³² "The Cork Report", Para 191

³³ Company Directors Disqualification Act 1986, s6(1)(b) and s6(4)

³⁴ Frisby S (2011), p382

This is very different from simple strict contractualist enforcement of debtors' contracts.

The Enterprise Act was not, therefore, written to introduce a rescue culture into a contractualist English law but rather to improve the one that had already been introduced in 1986. As Frisby puts it "the Enterprise Act pioneers no new dogma, therefore, but rather seeks to apply an existing ideology more effectively."³⁵ It sought to address the concern that "rescue procedures introduced in the Insolvency Act 1986 were... underutilised and arguably failed to encourage a culture of corporate rescue."³⁶ The "foremost obstacle"³⁷ to achieving the rescue culture was considered to be the system of administrative receivership, which was "perceived to have been overused by lenders and to have created economic recessionary pressure."³⁸ This is reminiscent of Bufford's argument that insolvency laws exist as a safety net to prevent secured creditors from causing an economic downward spiral.³⁹

The Enterprise Act sought to redress an imbalance between the use of administration, CVAs (Company Voluntary Arrangements) and administrative receiverships. The key quality that distinguished administrative receivership from the other available remedies was that it is "by its nature a proprietary enforcement remedy, possessed by one creditor, as opposed to a collective remedy available to all creditors."⁴⁰ Its principle characteristic is the receiver's primary obligation and duty is to the appointer⁴¹: "limited obligations do not prevent a receiver ruthlessly promoting the interests of his appointer, and, in doing so, he owes no duty to

³⁵ Frisby S, "In Search of a Rescue Regime: The Enterprise Act 2002", *Modern Law Review* 67(2) (2004) 247-272, p247

³⁶ Dennis V (2007), p4

³⁷ Frisby S (2004), p251

³⁸ Dennis V (2007), p201

³⁹ "One of the unrecognized policies of bankruptcy law is to provide a safety net for the national economy. It prevents secured creditors from collectively starting a downward spiral of foreclosures and bank failures that could result in the failure of the entire economy, as it nearly did in 1933." Bufford SL (1994), p836

⁴⁰ Bufford SL (1994), p836

⁴¹ RE B Johnson & Co (Builders) [1953] Ch 634

consider the position of unsecured creditors of the company.”⁴² This conferred a great deal of power to the holder of a floating charge, which “underscored the common perception of the United Kingdom as a “bank friendly” jurisdiction.”⁴³ Not only could secured creditors appoint receivers to act on their behalf, but they also held a power of veto over the appointment of an administrator, which was “part of the explanation for relatively low usage [of administration and]... came under increasing scrutiny in policy circles.”⁴⁴ In essence the power of appointers was undermining the collectivity in insolvency proceedings.

Concerns about focused control allowing abuse of process by stronger parties are reminiscent of Westbrook’s critique of contractualism.⁴⁵ Mokal goes so far as to argue that the floating charge is a “residual management displacement device”⁴⁶ whose value is in that it allows the holder to “take control of the debtor by appointing a receiver”⁴⁷ in the event that they believe the business has become economically distressed.⁴⁸ This led to two key complaints that administrative receivership was contrary to the rescue objectives described in the Cork Report: first that it inhibited corporate rescue, and second that it disenfranchised unsecured creditors.⁴⁹

The first concern, that administrative receivership inhibited corporate rescue, was based upon the evaluation that the powers it granted to receivers “created incentives for opportunistic behaviour and the premature liquidation of insolvent

⁴² Frisby S (2004) p251, citing *Lathia v Dronsfield Bros.* [1987] BCLC 321.

⁴³ Armour J, Hsu A, Walters A (2008), p155

⁴⁴ *Ibid*, p158

⁴⁵ Westbrook J (2004)

⁴⁶ Mokal RJ, *Corporate Insolvency Law: Theory and Application*, OUP (Oxford: 2001a), p194

⁴⁷ Mokal RJ (2001a), p195

⁴⁸ Meaning that the business has become no longer viable, as compared to financially distressed due to difficult acquiring further credit (which may be independent of the underlying economic viability of the firm, for example when cash flow insolvent due to over-leverage).

⁴⁹ Frisby S (2006), p65

companies.”⁵⁰ The root of this argument rested on the notion that the appointers’ interests might not always be best served by the rescue of the firm:

If the interests of the appointer are best served by a ‘fire-sale’ of the insolvent estate then the receiver is duty-bound to pursue this strategy, notwithstanding that better realisations or a less terminal outcome for the company could be accomplished via a different approach.⁵¹

The existence of incentives not to rescue where rescue might be available leads to certain natural conclusions:

[the] receivership system had led to excessive liquidations and inflated bankruptcy costs: senior claimants lack incentives to maximise recoveries and minimise costs in cases where the firm’s assets are worth more than the face value of the senior debt. Secured creditor control, it was thought, therefore tended to reduce recoveries for junior claimants.⁵²

The receivership system was considered responsible for introducing perverse incentives that drove up costs and liquidated businesses that would have produced better returns if they had continued trading. These conclusions are not unproblematic. What are “excessive liquidations” and how can you tell whether the number is excessive? How do you determine if costs are inflated? These questions were approached through empirical work after the introduction of the Enterprise Act (which will be considered in the second half of this chapter), but at the time of the revisions such analysis was unavailable. Instead, the notion that perverse incentives were causing excessive liquidations (essentially that economically viable firms were being liquidated when a better option was available) gained strength during the 1991 recession⁵³ due to the impression that the availability of a quick exit route for

⁵⁰ Webb DC, “An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors’ Bargain?”, *Oxford Economic Papers* 43(1) (1991) 139-157, p152

⁵¹ Frisby S (2004), p252

⁵² Armour J, Hsu A, Walters A, “The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK”, Centre for Business Research, University of Cambridge Working Paper No 332 (September 2006), p1

⁵³ Frisby S (2011), p360

appointers was aggravating the poor economic climate.⁵⁴ The incentive was considered to be a particularly large problem where secured creditors were “over-secured”, such that the company’s assets in liquidation were worth as least as much as the secured creditors’ debt: “What incentive, the critics asked, did a receiver have to pursue a going concern strategy if the break-up value of the assets would be enough to repay the debt owing to the appointing creditor and cover the receiver's costs?”⁵⁵

The second concern, disenfranchisement of other creditors, is not just about unsecured creditors receiving lower returns. Collectivity and inclusion are seen as important parts of an improved insolvency regime:

The Government’s view is that, on the grounds of both equity and efficiency, the time has come to make changes which will tip the balance firmly in favour of collective insolvency proceedings - proceedings in which all creditors participate, under which a duty is owed to all creditors and in which all creditors may look to an office holder for an account of his dealings with the company’s assets.⁵⁶

This leads Frisby to suggest that even if administration were not any more likely to increase survival rates than administrative receivership then “abolition of receivership is nevertheless justified”⁵⁷ on the basis that receivership disenfranchised creditors. Collective responses are seen as a salve to the potential perverse consequences of handing control to one interested party, and more broadly to improve both fairness and efficiency. This is a bold claim. As shall be seen in section 2.3 of this chapter, receivership was both cheaper and faster than pre-Enterprise Act administration, and the efficiency argument is more typically the province of the contractualists.

⁵⁴ Dennis V (2007), p201

⁵⁵ Armour J, Hsu A, Walters A (2008), p159

⁵⁶ Productivity and Enterprise: Insolvency – A Second Chance (Cm 5234, Insolvency Service 2001), para 2.5

⁵⁷ Frisby S (2006), p65

Nonetheless, it was considered that the changes in the Enterprise Act 2002 “herald a new era of corporate insolvency law for the United Kingdom... intended to attain the goals of a superior corporate rescue environment, a better return for creditors and a generally fairer system of insolvency distribution.”⁵⁸ The re-emphasis on rescue should not be taken to imply that the Enterprise Act sought to introduce a ‘Chapter 11’ culture similar to the much discussed law of the United States. US law essentially offers two main routes for dealing with distressed firms, Chapter 7 with a focus on liquidation or Chapter 11 court supervised reorganisation.⁵⁹ Although American literature emphasises choice and market-led efficiency in insolvency as the route to redistributive justice⁶⁰, applying American commentary to English law is problematic because it is obsessed with Chapter 11 reform⁶¹, where, “as is well known, the debtor’s management usually remain in control of the firm during the proceedings.”⁶² With the possible exception of France, no other major western legal system does more than Chapter 11 to take choice out of the hands of the stakeholders and put it into the hands of the courts, in favour of the debtors.⁶³ Armour, Hsu and Walters’ implication that the a steady increase in “more stringent contracts regarding the provision of finance to firms in Chapter 11 proceedings”⁶⁴, combined with the weakening of control rights through the abolition of administrative receivership, is bringing the two jurisdictions closer together, should not cause the reader to forget just how far apart they began. Chapter 11 is focused on the debtor, whereas English law is and always has been focused on the creditor.

⁵⁸ Frisby S (2004), p247

⁵⁹ 11 U.S.C. Bankruptcy, Chapter 7 Liquidation ss 701-784, Chapter 11 Reorganisation ss 1101-1174

⁶⁰ "Emphasis on efficiency, far from ignoring the consequences of a business collapse, seeks to minimize the costs imposed by such events." Rasmussen RK and Skeel DA, "The Economic Analysis of Corporate Bankruptcy Law", *American Bankruptcy Institute Law Review* 3 (1995) 85-115, p85

⁶¹ "Virtually all the recent literature on (64) bankruptcy and finance seems to concern itself with Chapter 11", Ayer JD (1995), p63-64. Little has changed in American coverage since Ayer wrote this.

⁶² Armour J, Hsu A, Walters A (2006), p2

⁶³ See La Porta et als scale of creditor rights in insolvency, in La Porta R, Lopez-de-Silanes F, Shleifer A and Vishny RW (1998)

⁶⁴ Armour K, Hsu A, Walters A (2006), p2

The four “main planks”⁶⁵ of the Enterprise Act were:

- Abolition of administrative receivership;
- Reformation of Administration, towards “streamlined”⁶⁶ approach granting greater powers to the administrator;
- Abolition of Crown’s Preferential Status (s251);
- Creation of a ring fenced fund from proceedings of assets of a floating charge to be distributed amongst unsecured creditors (s252).

The cumulative intention behind the Enterprise Act reforms was therefore clear. The imposition of wider accountability on the insolvency practitioner was designed to increase the realizable value of the company's assets by addressing the problem of perverse incentives; the streamlining of administration was designed to make the procedure more flexible and easily accessible, and to reduce costs. The expectation of policymakers was that this twin approach would promote corporate rescue and, by increasing *gross realizations* and reducing the *costs* of formal rescue, produce better *net outcomes* for creditors across the board.⁶⁷

The focus is on getting the creditors as a whole better incentivised to pursue viable rescue, a tweak towards collectivity and the elimination of perceived perverse incentives. The pressing question is, did it work?

⁶⁵ Frisby S (2004), p247

⁶⁶ Frisby S (2006), p74

⁶⁷ Armour J, Hsu A, Walters A (2008), p161

2.3 IS ADMINISTRATION BETTER THAN RECEIVERSHIP FOR IMPROVING RESCUE?

There have been significant recent efforts to quantify and empirically explore the impact of the change in the English regime and the introduction on insolvency outcomes. Frisby's 2006 "Report on Insolvency Outcomes"⁶⁸ uses a combination of a database on administration outcomes and interviews with practitioners to show how practice has changed in response to the law. Armour, Hsu and Walters 2008 paper⁶⁹ uses a similar data set to explore the theoretical question of the virtue of secured creditor control in the context of shifting behaviour in the shadow of the Enterprise Act. In both of these papers statistics are used primarily descriptively but in combination with the qualitative evidence to provide a convincing picture of the changing approaches in insolvency practice. More sophisticated statistical analysis of the same data was performed in 2006 by Armour, Hsu and Walters to consider the costs and benefits of secured creditor control, and Katz and Mumford⁷⁰ used record of appointments from London and Edinburgh Gazettes in autumn 2004 in order to explore changes in the use of administration and look for evidence of abusive behaviour. As these papers look at data from the same period they can be usefully triangulated. One of the central contributions of this thesis is to attempt to combine the results from these papers to explore the effectiveness of English insolvency law at achieving returns for creditors.

The two immediately evident trends following the introduction of the Act were a small move in choice of procedure from liquidation to administration and a large

⁶⁸ Frisby S (2006)

⁶⁹ Armour J, Hsu A, Walters A (2008)

⁷⁰ Katz A and Mumford M, "Study of Administration Cases – report to the Insolvency Service" (Oct 2006), found at <http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/studyofadmindcases.pdf> (accessed 17 Nov 2012)

move from receivership to administration.⁷¹ Perhaps counter-intuitively the decrease in the use of liquidation is not held to imply an improvement in rescue rates; “administrations do not result in any significantly greater incidence of continued trading or going-concern sales than did receiverships, indicating that the new procedure is not preserving any more employment.”⁷² Frisby pragmatically observes that this should not be much of a surprise, as “the obvious explanation for this is that the same practitioners act as both receivers and administrators, and will tend to employ the same strategies.”⁷³

The second trend is equally unsurprising given that the Act sought to abolish receivership in favour of administration, but within this data is the interesting discovery that “lenders with grandfathered security, who are still entitled to appoint receivers, are, more often than not, choosing to appoint administrators instead.”⁷⁴ As Keay and Walton observe, “somewhat ironically, following the changes made by the Enterprise Act 2002, administration is quickly taking over from administrative receivership as the preferred insolvency procedure for debenture holders.”⁷⁵ Even where secured creditors have the power to instigate administrative receivership and claim the perceived advantage there seems to be a preference for the ostensibly weaker position in administration.

Why would those with the possibility of having more control through receivership choose administration instead? Administration has proved to be significantly faster than administrative receivership, taking “on average a little over half the time.”⁷⁶

They are also more expensive, having been found to be associated “with higher

⁷¹ Katz A and Mumford M (2006), p4

⁷² Armour J, Hsu A, Walters A (2006), p30

⁷³ Frisby S (2006), p65

⁷⁴ Armour J, Hsu A, Walters A (2008), p164

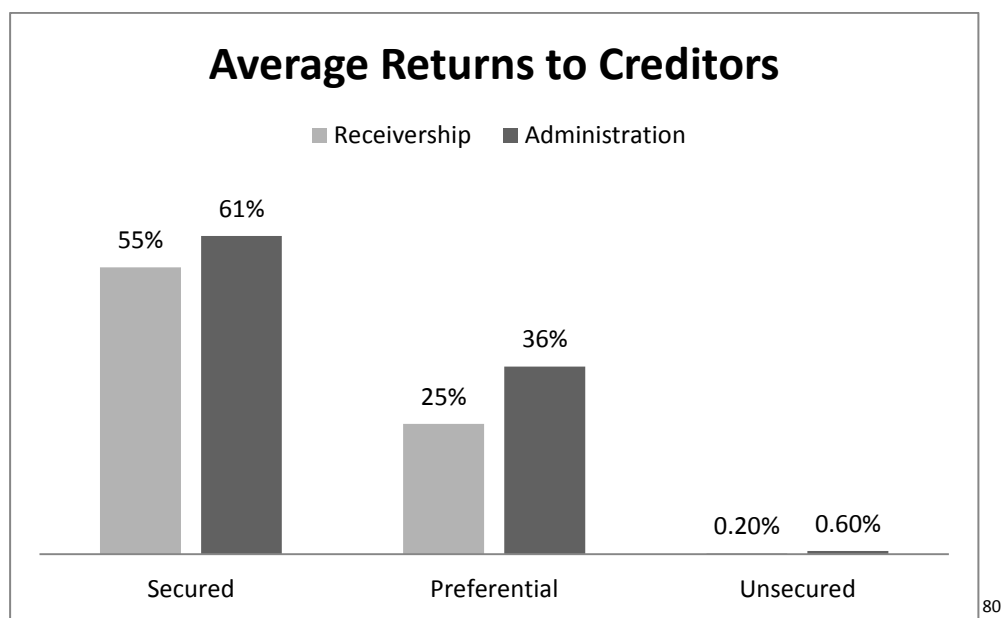
⁷⁵ Keay AR and Walton P (2008), p90

⁷⁶ Armour J, Hsu A, Walters A (2006), p29

direct costs than receiverships”⁷⁷ in spite of the efforts to streamline access. Frisby predicted that this would be the case in 2004:

The procedure remains very much either court- or creditor-driven, and in this regard will almost certainly generate more expense and delay than administrative receivership. The fact that the path into administration has been smoothed will not, it is submitted, drastically reduce either. Proposals to creditors will still have to be formulated, meetings still called, information still provided, voting still completed and notices filed with the court. Inclusivity, whilst an arguably laudable aim, is a double-edged sword and one that may, on balance, strike at those it was intended to guard. This is not to mention the increased burden on the court system.⁷⁸

The increase in costs lead Armour, Hsu and Walters to conclude that “there is no compelling statistical evidence that creditors as a whole do better out of administration than they did out of receivership.”⁷⁹ The bar chart below compares their findings on net payments/face value of the claim in administrative receivership and administration during the sample period:



⁷⁷ Armour J, Hsu A, Walters A (2006), p30

⁷⁸ Frisby S (2004), p267

⁷⁹ Armour J, Hsu A, Walters A (2008), p169

⁸⁰ Graph drawn from table 4, Armour J, Hsu A, Walters A (2008) 148, P169

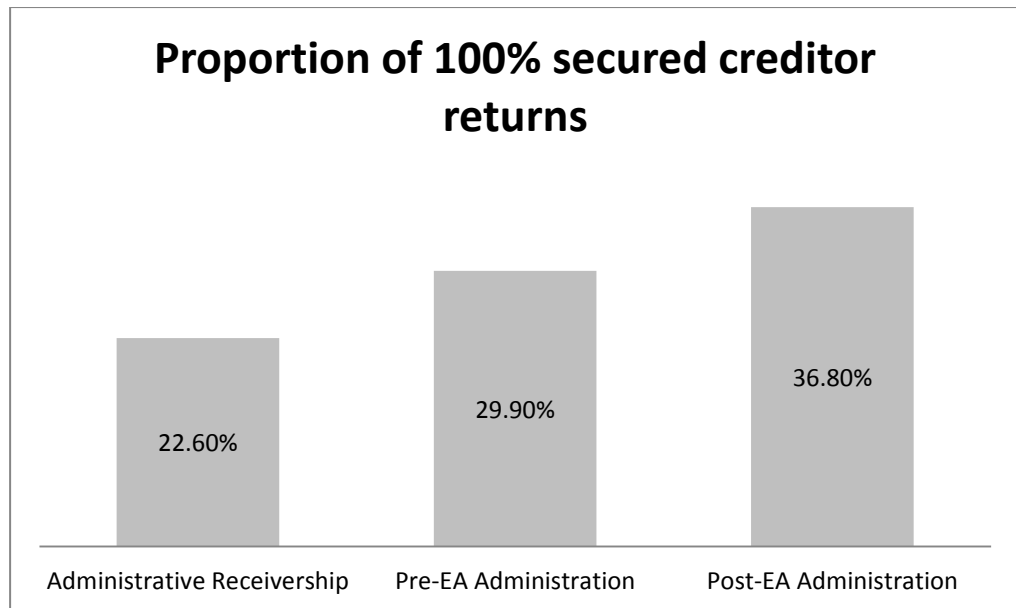
These results do appear to show an improvement in returns for all classes of creditors. The shifts in returns to preferential and unsecured creditors may, however, be better explained by the reprioritisation of HMRC⁸¹ than the streamlining of administration. Because the changes are expressed as percentages it is difficult to tell how the 11% increase in returns to preferential creditors compares to the 0.4% increase to unsecured creditors. It is suggested that “the increased recoveries in administration cases may have been eaten up by increased costs, which inference is supported by the general lack of any statistically significant increase in net recoveries to creditors under the new administration procedure.”⁸²

Vanishingly small increases in net returns may not seem much of a victory, as the increase in gross returns is cancelled out by the predicted increase in direct costs. Costs are, however, likely to be higher during a transitional period and it is reasonable to predict that costs will decrease as changes bed in. Even if the increases in returns are excluded as statistically insignificant achieving the same returns in a significantly shorter time period represents an improvement in the procedure, an assertion supported the fact that those security holders who have the choice post Enterprise Act often appear to be choosing administration ahead of receivership.

Frisby considers another way of measuring the improvement of returns that might help explain a preference for administration:

⁸¹ Enterprise Act 2002 s251

⁸² Armour J, Hsu A, Walters A (2008), p170



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This bar chart shows the proportion of procedures within the Frisby database where the secured creditors achieved 100% returns. It will be recalled that all three datasets were from the same time period as those measured by Armour, Hsu and Walters, and Mumford and Katz. Administration appears to have always provided a greater level of 100% returns and this improved substantially after the Enterprise Act. The difference pre-Enterprise Act may be due to a preference for administration in cases where higher returns were expected, but this does not tally with the expectation that receivership was attractive to the over-secured. Perhaps the decision by some secured creditors to push for asset sales through receivership was based upon an erroneous perception of the typical returns received (bearing in mind that empirical analysis of returns data was either limited or non-existent), and that one impact of the Enterprise Act is that it has led to more enlightened self-interest amongst secured creditors?

The increase in post-Enterprise Act 100% returns might more simply be ascribed to over-secured creditors that would have realised their assets through receivership

⁸³ From data presented at Frisby S (2006), p44, where the proportions of secured creditors paid in full are from the 718 out of 950 cases that recorded both debts owed and payments made.

moving to administration, and thus inevitably increasing the average. This does not fit the picture described by the means averages for secured creditor returns described above, given that pre-Enterprise Act administration was more effective than receivership, but merits further scrutiny as preventing perverse incentives for the over-secured was a key objective of the change in the law (and means can often be misleading). It is difficult to draw firm conclusions about the operation of the procedures from recoveries to secured creditors during this sample period, where the majority of floating charge holders are likely to have taken the security prior to 15 September 2003 and therefore had a choice as to whether or not to block the appointment of an administrator. Whilst the criticism that receivers working for over-secured clients may not take sufficient care to maximise realisation of the assets stands, it does not follow that given the choice over-secured floating charge holders will have a greater preference than other floating charge holders for receivership over administration. Being over-secured perhaps results in less desire for control, which would make the greater speed of administration attractive given they can be confident of recovering the debt. It will be necessary to keep track of changes in the data as grandfathered security slowly phases out.

A cynic may not be surprised to observe that banks were not universally thrilled to see the abolition of administrative receivership, as Frisby discovered during her empirical work on insolvency outcomes; “interviewees were generally adamant that the perception of receivership as a biased and destructive procedure were misconceived.”⁸⁴ However,

an intuitive response to the legal framework of receivership may be unreliable and may overlook some of the institution’s benefits. Granted, a receiver must prioritise his appointers’ interests, but this of itself does not inevitably prejudice all other stakeholders, nor is it

⁸⁴ Frisby S (2006), p68

necessarily inhibitive of corporate rescue. It is only when the appointer is over-secured that a receiver could properly pursue a break-up sale strategy. Where the appointer is under-secured, in order to maximise value and so comply with his duty to that appointer the receiver must look to other means of realising the security, and, as noted above, one method is to attempt to sell the business as a going concern.⁸⁵

Amour, Hsu and Walters find that the chief explanatory factor for the increase in returns in administration is the behaviour of the over-secured:

Realizations in administration in the over-secured sub-sample were on average around 60 % higher than in receivership. Conversely, using the same specification in the under-secured sub-sample, we did not find any statistically significant difference in levels of asset realization achieved in the two procedures. The implication is that the observed increase in realizations is largely confined to cases in which the secured creditor was over-secured: in other words, in precisely those cases where the impact of wider legal accountability might be expected to be at its most pronounced.⁸⁶

This seems to support the idea of the increase in returns overall and the increase in post-Enterprise Act administrations. However, Frisby's analysis also shows that only around 1 in 5 receiverships resulted in full repayment. This is supported by previous data that indicates that "appointments by under-secured chargees are the norm... and that one of the White Paper's main justifications for abolition is therefore fallacious."⁸⁷ Seen from the other side of the Enterprise Act the argument that administrative receivership was driving a recessionary spiral due to needless liquidations seems to be incorrect. Equally important, now that a proportion of any floating charge is diverted to the unsecured creditors⁸⁸ the conditions under which one can achieve 100% returns have changed. In effect it is now practically impossible

⁸⁵ Frisby S (2004), p253

⁸⁶ Armour J, Hsu A, Walters A (2008), p170

⁸⁷ Frisby S (2004), p253

⁸⁸ Enterprise Act 2002 s252, Insolvency Act 1986 s176A

to be over-secured via a floating charge;⁸⁹ it would require a situation where the floating charge holder is so over-secured as to have a cushion of £600,000 and there to be no better alternative than formal insolvency proceedings. Yet this shift, which nominally reduced the power of secured creditors and certainly forced them to share some part of the pot when 'fully' secured, appears to have also improved their returns.

⁸⁹ The derogations under 176A would not apply to situations of over-security. Where over-secured, the company's net property will not be less than the prescribed minimum, nor would the distribution be disproportionate to the benefits, as in both cases over-security implies that there are assets to satisfy outstanding debts. The ability to disapply the prescribed part under s174A(4) equally avoids concerns about over-security as the required arrangements require majority consent.

2.4 CORPORATE RESCUE OR BUSINESS RESCUE?

It has been shown that the Insolvency Act 1986 sought to introduce a rescue culture, which the Enterprise Act was designed to improve, but that although returns to creditors have arguably improved there is little evidence of increased corporate survival. It is submitted that in spite of this the Enterprise Act did improve the Orderly and Effective quality of English law. This was in part due to a development in the nature of the rescue culture: an appreciation of the importance of the distinction between corporate and business rescue and an increased willingness to sacrifice the former in favour of the latter.

The White Paper that preceded the Enterprise Act defined corporate rescue as meaning “that companies in financial difficulty should not go to the wall unnecessarily”⁹⁰, which is a direct echo of the description of orderly insolvency law introduced in Chapter 1. A narrow interpretation of corporate rescue would suggest that this means saving the corporate entity itself, but successful rescue encompasses a wider range of outcomes:

A distinction exists between rescuing the company and rescuing the business of the company. The former, which might be described as ‘pure rescue’, would involve the corporate entity emerging from the rehabilitation endeavour intact, so as to continue substantially the same operations, with the same workforce and in the ownership of the same people. The latter is perhaps most accurately expressed as a form of corporate recycling. The company’s business, or a viable part of that business, is sold as a going concern to a third party. This means that the productive part of the enterprise is removed from its original owners. There may be associated job losses, which will almost certainly include directorships. The business itself, however, can be said to survive, albeit under new ownership.⁹¹

⁹⁰ Productivity and Enterprise: Insolvency - A Second Chance Cm 5234 (London: HMSO, 2001), paragraph 2.6

⁹¹ Frisby S (2004), p248-249

Thus Armour, Hsu and Walters expand the meaning of corporate rescue to include all circumstances by which the business of an insolvent company avoids closure and is able to continue trading as a going concern⁹², whether through formal or informal procedures, as a continuation of the company as an entity or the survival of the undertaking under new ownership or management. Business rescue is considered to have many advantages; “it will almost always maximise value, in the sense that a premium is usually available on selling a collection of assets housed in a business over that that can be realised from a sale of the same assets on a break-up basis”⁹³, and is more in keeping with the laissez-faire ideal described by Santella, where English law “recognises the need to preserve the viable economic activities of a company in difficulty but not the company itself.”⁹⁴ This sort of pragmatism reflects the principle that unnecessary failure should be avoided, but equally that “corporate rescue mechanisms are not intended to maintain inefficient firms that are not economically viable.”⁹⁵ The effectiveness of a rescue culture thus depends on its ability to identify and support viability.

[Company’s may become distressed] simply because they creep under the secured lender’s radar, or because they seek advice too late in the cycle of decline, or seek it reasonably early but then ignore it. Finally, of course, some companies will inevitably become economically distressed as markets change and their products or services become obsolete. Attempting rescue of these enterprises would be futile, but where the company in question still houses a business that may be viable the current enquiry is as to whether an insolvency procedure in general, and administration in particular, is an appropriate vehicle through which to effect a

⁹² Armour J, Hsu A, Walters A (2008), p155

⁹³ Frisby S (2006), p65

⁹⁴ “la traditionnelle attitude du législateur anglais de « laissez-faire » à l’égard des pratiques développées spontanément par le monde du commerce, reconnaît la nécessité de sauvegarder les activités économiques encore viables des entreprises en difficultés mais pas nécessairement l’entreprise elle-même.” Santella P (2002), p9

⁹⁵ The Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group*, HMSO (London: 2000), para. 24.

rehabilitation. In other words, if informal rescue mechanisms have either failed or never been attempted, for whatever reason, can an insolvency procedure serve as a stop gap?⁹⁶

If a corporation is economically distressed but contains a potentially viable and more valuable business, then attempting to rescue the company would be contrary to the philosophy of the Act. This is just as much the case as for the pursuit of a hopeless rescue that merely increases costs and reduces the sum ultimately realised through liquidation. Frisby observes from her interviews with bankers and practitioners a feeling that the Enterprise Act “was misconceived in that it focused on a primary duty to rescue the company instead of the business. Further, there was a general view that legislation itself will not of itself lead to higher levels of rehabilitation, and that that can only be achieved through a modification of creditor culture.”⁹⁷ In practice this cultural shift seems to be both occurring and effective. Chapter 1 cited Cohen and Crooks’ observation that in *RE DKLL* “the court has clearly reinforced the aim of the statute (to preserve value) and the rescue culture supported by government i.e. to save business as a going concern wherever possible and to maximise the return to all creditors.”⁹⁸ They prefer saving business over saving the company.

A need for a cultural shift was identified and such a shift has been achieved. If it is accepted that rescuing ultimately unviable business is counterproductive, and in the absence of an objective measure of the proportion of business that is viable at any one time, determining that levels of business rescue have ‘increased’ or ‘decreased’ is meaningless. An increase in rescue could easily under such circumstances mean an increase in maintenance of unviable business. Instead the Enterprise Act has made changes that removed the bathwater without jettisoning the baby; the over-security issue appears to have been resolved without being over-egged, returns have

⁹⁶ Frisby S (2006), p62

⁹⁷ *Ibid*, p64

⁹⁸ Cohen M and Crooks S (2007), p221

marginally improved and are realised faster, and the judgement regarding viability is remaining in the hands of the creditors. By the reasoning of the Orderly and Effective insolvency law model this improvement in returns should lead to improved investment, in spite of the movement away from the efficiency underpinnings of the theory. The next chapter considers in greater detail how this judgement is operating in the new regime.

CHAPTER 3: CREDITOR FRIENDLINESS AND CHOICE OF PROCEDURE

3.1 CREDITOR FRIENDLINESS

Insolvency regimes are sometimes described on a scale between creditor and debtor friendliness. Creditor friendly regimes employ measures such as requiring creditor consent, replacement of management through the appointment of an administrator/liquidator, absence of automatic stays or asset freezes, and paying secured creditors first.¹ The importance of secured creditor priority links creditor friendliness with contractualism, and the view that distributive efficiency comes from enforcing market solutions by honouring contracted-for security. Debtor friendly regimes, meanwhile, may seek to keep management in place, and offer stays or moratoria to promote recovery. Davydenko and Franks compare two notional extremes of this scale, France and England:

In the creditor-unfriendly code of France, the state imposes court-administered procedures in bankruptcy with the explicit objective of preserving the firm as a going concern and maintaining employment. To achieve these goals, French bankruptcy courts are given control of the bankruptcy process and are not mandated to sell firm assets to the highest bidder. The role of creditors is reduced to an advisory function, and their approval is not required by the court in determining a reorganisation plan. By contrast, in the United Kingdom, although the state provides court-administered bankruptcy procedures, secured creditors can veto them and enforce the default provisions as specified in the debt contract.²

¹ Houston JF, Lin C, Lin P and Ma Y "Creditor rights, information sharing, and bank risk taking", *Journal of Financial Economics* 96 (3) (2010) 485-512, p487

² Davydenko SA and Franks JR (2008), p566

One of the most important efforts to determine the impact of insolvency laws on finance was La Porta et al's "pioneering and highly influential"³ paper "Law and Finance."⁴ This ambitious effort to provide a complete objective model of the qualities of individual insolvency laws was based on two key theses, as described here by Armour et al:

- "the greater the protection afforded to minority shareholders and creditors by a country's legal system, the more external financing firms in that jurisdiction will be able to obtain (the "quality of law" claim). If good legal institutions can reduce the risk of investor expropriation *ex post*, then investors will be more willing to advance funds *ex ante*."⁵
- "The quality of legal institutions varies systematically with the "origin" of a country's legal system... [it determines] the financing of corporate growth, and through that and other channels, the nature of the financial system and ultimately, perhaps, overall economic growth."⁶

One of the key results of the legal origins approach was to provide support from the notion that common law was "better able to respond to the changing needs of a market economy than are civilian systems."⁷ The validity of the legal origins model has been strongly questioned by Armour et al, whose time series analysis suggests that "any negative economic effects of civil law origin would seem to be confined to developing systems, and even then the evidence is not very clear."⁸ Of equal interest within the context of this thesis is their accusation that the legal origins theory is an

³ Armour J, Deakin S, Priya L and Siems M, "How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection" *American Journal of Comparative Law* 57 (2009) 579-629, p582

⁴ La Porta R, Lopez-de-Silanes F, Shleifer A and Vishny RW, "Law and Finance", *Journal of Political Economy* 106(6) (1998) 1113-1155

⁵ Armour J, Deakin S, Priya L and Siems M (2009), p583

⁶ *Ibid*

⁷ *Ibid*, p579

⁸ *Ibid*, p594

ideological construct of Hayekian origins with little supporting evidence.⁹ As seen in Chapter 1, this is not the first time that insolvency theory has been accused of applying an excessively broad brush.¹⁰ Finally, the time series analysis approach is particularly valuable as it demonstrates areas of convergence in legal practice.¹¹

La Porta et al's work is enormously important for an understanding of the "Orderly and Effective" model, both because of the clear similarities between the quality of law/legal origins thesis and the principles of Orderly and Effective insolvency outlined in Chapter 1, and because "the World Bank uses it in order to assess and promote a particular type of legal development."¹² The very notion of creditor friendliness can be derived from La Porta et al's construction of a ratings system of creditor rights which scored France at the lowest end of the spectrum, with a score of 0, and the United Kingdom as the highest at 4.¹³ The four marks are awarded, one a piece, for the following creditor friendly qualities: no automatic stay on enforcement rights, secured creditors paid first, restrictions on going into reorganisation, and management does not stay in reorganisation. This makes the analysis read a little like a scale of 'how close do the foreigners manage to get to being English law.' Indeed, there is a close resemblance between the recommendations of the IMF and World Bank, and what English law has been doing for years:

Many of the IMF's recommendations have long been part of the UK's insolvency regime, such as adherence to the ranking of claims, the treatment of director fraud, and co-operation with foreign insolvency proceedings. Although the government review predates the IMF's report,

⁹ *Ibid*, p593

¹⁰ See the critiques of Insolvency Efficiency in Chapter 1.3

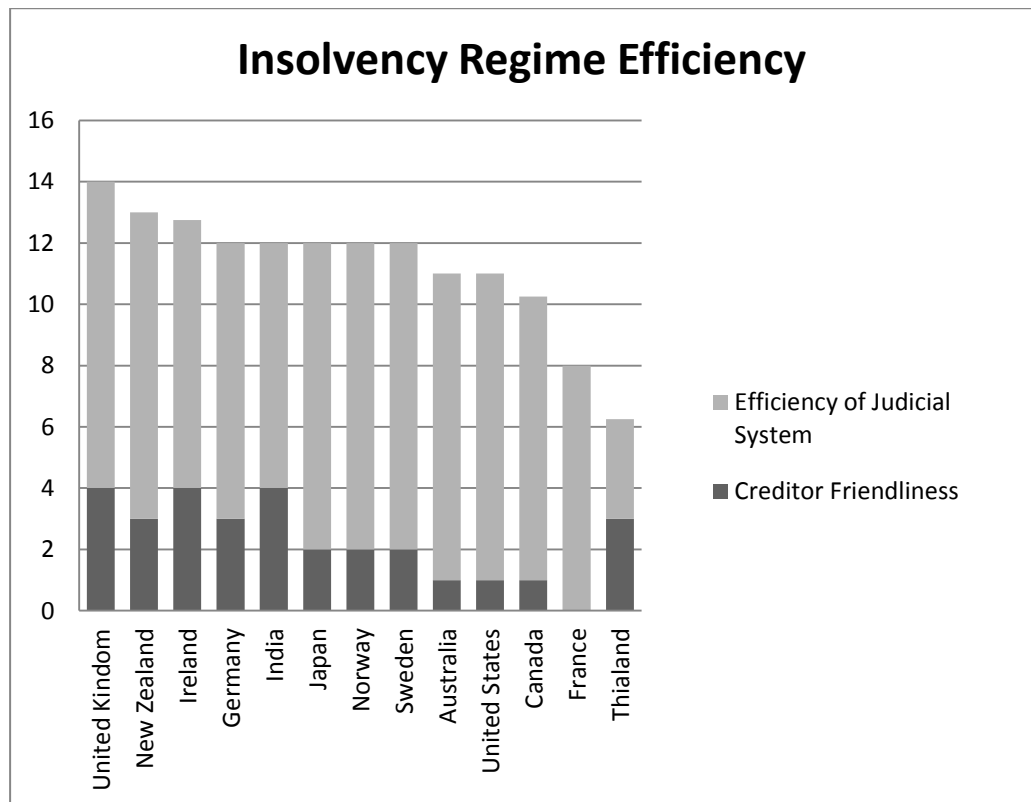
¹¹ Armour J, Deakin S, Priya L and Siems M (2009), p579

¹² *Ibid*, p583

¹³ La Porta R, Lopez-de-Silanes F, Shleifer A and Vishny RW (1998) table of creditor rights scaling p1136-1137, table of rule of law scaling p1142-1143

the fact that some of the proposals are in line with IMF recommendations reflects current thinking on insolvency regimes.¹⁴

This suggests that, at least prior to the Enterprise Act 2002, the Orderly and Effective model was strongly influenced by the English model of creditor friendliness. The relative creditor friendliness of English law in 1998 compared to other regimes can be illustrated below:



The chart above shows a selection of countries from La Porta et al's scaling system, combining the score for creditor friendliness with a mark for efficiency of judicial system¹⁵. The IMF argue that:

The degree to which an insolvency law is perceived as pro-creditor or pro-debtor is, in the final analysis, less important than the extent to which these rules are effectively implemented by a strong institutional infrastructure... effective implementation requires judges and

¹⁴ Brierly P and Vlieghe G, "Corporate Workouts, the London Approach and financial stability", *Financial Stability Review* (1999) 167-183, p170

¹⁵ Efficiency of judicial system evaluated by La Porta et al under their rule of law scalings, La Porta R, Lopez-de-Silanes F, Shleifer A and Vishny RW (1998), p1142-1143

administrators that are efficient, ethical, and adequately trained in commercial and financial matters and in the specific legal issues raised by insolvency proceedings. A pro-debtor law that is applied effectively and consistently will engender greater confidence in financial markets than an unpredictable pro-creditor law.¹⁶

Davydenko and Franks have found there to be a correlation between creditor friendliness and median recovery rates, based upon the bank's total final loss to total debt exposure at default, using a database of information from participating institutions. The highest score is achieved by the UK at 92% and the lowest by the perennial bogeyman of insolvency efficiency, France, at 52%¹⁷ The US remains, defiantly, statistically contrary. It scores a "1" as a debtor friendly regime but with substantially more de-listings and fewer acquisitions than its debtor friendly label suggests¹⁸, and an unexpectedly high recovery rate of 70%.¹⁹ It is important to note that the creditor ratings are from 1998 and the Davydenko and Franks return scorings from 2008, although it is not unreasonable to suggest that developments in the laws of the respective countries have not been so radical in the interim that significant changes have occurred. Sporadic data collection is a debilitating issue in the analysis of insolvency law. As Armour et al observe: "little has been done to investigate the *dynamic effects* of particular legal systems in relation to the production of substantive legal rules: that is, how particular attributes of legal origins or systems shape and influence the evolution of the law, and in turn, the real economy"²⁰, although clearly a great deal of speculation has taken place in the absence of clear evidence. Armour et al observe that the creditor rights index is weakened by the way in which "different constituent elements may cut in different directions.... some parts of the index may 'cancel out' others, thereby undermining

¹⁶ IMF (1999), 1 - Introduction, p6

¹⁷ Davydenko SA and Franks JR (2008), p581

¹⁸ Dahiya S and Klapper L (2007), p276-277

¹⁹ Davydenko SA and Franks JR (2008), p581

²⁰ Armour J, Deakin S, Priya L and Siems M (2009), p592

the meaningfulness of the overall score.”²¹ Yet the rather forced approach of grouping together these different characteristics and labelling them ‘creditor friendly’ helps build the ideological narrative based upon an idealised notion of the common law: promoting absolute priority leads to higher recovery rates for secured creditors, which if correct would fit the overarching objective of Orderly and Effective insolvency laws to improve investment returns.

If this creditor friendliness model were correct then the Enterprise Act must have been something of a disappointment. Part of the problem is the way the model is framed. Insolvency laws are described as a dichotomy between creditor and debtor friendliness, but this seems rather clumsy where a law is shifting priority between creditors. It does not seem immediately reasonable to describe the Enterprise Act, whose principal function is to shift some control from secured to unsecured creditors, as having become less creditor friendly. Directors are still removed under the streamlined administration system. Yet the shift in control represents a threat to one of the fundamental pillars of insolvency efficiency: that secured creditors get the security they contracted for. It represents a “shift away from a ‘concentrated creditor’ model of governance towards a ‘dispersed creditor’ model of governance which vests greater control rights in unsecured creditors collectively.”²² The law becomes more creditor unfriendly without become more debtor friendly – in essence, according to the efficiency model, the law simply becomes less effective.

It would be reasonable to hypothesise on this basis that the changes made in act would have reduced secured creditor returns. Instead the analysis in Chapter 2.3 suggests that the change either made a small positive difference or no significant difference to net secured creditor returns. Based upon analysis of CVA outcomes in

²¹ *Ibid*, p605

²² Armour J, Hsu A, Walters A (2008), p148

Chapter 3.4 this writer suspects that administration returns will ultimately prove to be a net improvement over receivership, and it would be interesting to repeat the costs research in a few years. Whether secured creditor returns increased or not, it is clear that they did not decrease. The reason for focusing on the impact of returns to secured creditors is because they are central to the insolvency efficiency analysis of insolvency laws. The justification for efficiency, in the sense that only structural rules are mandatory, is that improving secured creditor returns improves general welfare. If efficiency is not the optimal means to achieve maximum secured creditor returns, then the whole theory is called into question.

Applying the model of the impact of creditor friendliness applied above, three logical non-exclusive hypotheses can be derived for why it may be the case that changes in the Enterprise Act that actively sought to reduce secured creditor control did not result in reduced secured creditor returns:

1. The reduction in secured creditor control was offset by infrastructural improvements to the efficiency of the judicial system, which it has been suggested is of greater importance than the relative creditor/debtor friendliness of the system in the first place.
2. Secured creditor control does not improve secured creditor returns in a linearly positive fashion, perhaps suggesting that there is an optimal level after which increases in secured creditor control reduce secured creditor control returns.
3. The Enterprise Act made no significant practical difference to secured creditor control.

These hypotheses will be explored in further detail throughout the rest of this thesis, starting with a consideration of the operation of creditor control prior to the

commencement of formal insolvency proceedings and how this intersects with the purpose of administration. A fourth factor is important to note. The abolition of Crown preference had an instant effect but the prescribed part was prospective only.²³ Secured creditors holding floating charges that predated the act will have benefitted from the Crown's part being returned to the general pot. This will not be explored further as the only way to be sure would be to repeat the insolvency outcomes investigations, which is beyond the resources of this writer. The focus instead is on how the new law has changed the environment within which insolvency is negotiated.

²³ Insolvency Act 1986 s176A(9)

3.2 CHOICE OF PROCEDURE – WHO DECIDES?

Insolvency is the technical state of being unable to pay debts,²⁴ but this has no practical consequence until someone attempts to enforce the debt. As described in the opening of Chapter 2.2, directors of insolvent firms have a range of options for how to deal with an unpayable debt, up to and including do nothing at all. There are a number of reasons why a firm may avoid paying a debt, for example simple human error, genuine disputes, or points of principle:

Debtors may not be able to meet their obligations for a host of different reasons. Their stupidity, greed, misfortune, bad judgment, or inadequate foresight may leave them unable to pay. They may not be able to pay over the short term or the long term. They may be victims of their own mistakes or of unforeseeable circumstances.²⁵

Very often those facing financial difficulty are not best placed to assess their own situation. The stresses and strains that inevitably accompany financial problems may cause undue panic, or alternatively a ‘head in the sand’ mentality... Surprisingly, when a debtor faces a financial crisis, the position the creditors may take is often overlooked... It is remarkable how accommodating a fully informed creditor can turn out to be. Unfortunately, what is more common is that the debtor has avoiding tackling its creditors, keeping them in the dark and providing increasingly unlikely excuses.²⁶

Informal negotiation regarding outstanding debt is a normal part of everyday business; “much will depend upon the response to this factual situation of its various stakeholders, and, in general, some form of intervention is more likely where default has become routine or acute”²⁷ Thus some event or factor beyond simple technical insolvency is typically required, and being technically insolvent need not lead to formal insolvency proceedings. For formal insolvency proceedings to commence

²⁴ Insolvency Act 1986, s123.

²⁵ Warren E, “Bankruptcy Policy”, *University of Chicago Law Review* 54 (1987) 755-814, p779

²⁶ Dennis V (2007), p12, p15

²⁷ Frisby S (2011), p351

somebody, whether creditor, debtor or state, must take steps to commence them.

An insolvent firm can continue as long as creditors do not seek to enforce their claims. Any liquidation or formal rescue has passed through phases of negotiation, possibly iteratively, with differing levels of formality and court intervention, each terminated when at some point one of the parties decides that the current level of negotiation has failed.

The amended Insolvency Act 1986 offers five different formal insolvency procedures:

- Compulsory liquidation, by court order at the petition of a creditor where the company is unable to pay its debts (s122(1)) or where it is just and equitable that company should be wound up (s122(1)(g));
- Creditors' Voluntary Liquidation led by company directors;
- Administration. Schedule B offers three means to appoint an administrator:
 - Para 12 - administrative application to the court by one or more creditors of the company;
 - Para 14 - out of court appointment by floating charge holders;
 - Para 22 – appointment by the company or its directors;
- Administrative receivership, where the receiver is appointed by a floating charge holder with grandfathered security that predates 2003;
- Company Voluntary Arrangement , initiated by the company under s1-7b where “very basically, a proposal is formulated by the company’s directors and put to the company’s unsecured creditors, who may vote to approve it, amend it, or reject it outright.”²⁸

The range of options presented is in keeping with what Armour, Hsu and Walters describe as a tendency in developed insolvency systems to “provide a menu of

²⁸ Frisby S (2011), p352-353

collective procedures offering (at minimum) a choice between a terminal liquidation procedure for the orderly winding up of the insolvent company's affairs and a rescue or reorganisation procedure."²⁹ This can be distinguished from Rasmussen's proposed menu-approach to insolvency in that it limits ex-ante control in favour of ex-parte intervention. There is clearly still scope for parties to order themselves favourably prior to formal proceedings, not least because of this period of negotiation that exists between technical insolvency and formal insolvency proceedings. Armour, Hsu and Walters state that "once companies are financially distressed, insolvency law casts its shadow."³⁰ This perhaps underestimates the extent of the shadow, as the workings of insolvency law can be seen in the very earliest negotiations between creditor and debtor. Adler, discussing corporate insolvency theory in the context of debtor friendly US law but in this case clearly applicable in our own jurisdiction, argues that this process goes all the way back to the initial negotiations for credit where "because investors *choose* an initial capital structure, they may adopt a debt component that renders unlikely the simultaneous occurrence of insolvency and viability."³¹ The suggestion is that investors should be able to plan such that the only circumstances in which technical insolvency occurs are the economic unviability of the business. Although this rather exaggerates the prescience or indeed the powers of investors, banks in particular are in the position to extend or withdraw credit, and negotiate to attach security, as suits their assessment of a business's viability and their own bargaining power. This allows for a distinction between formal and informal rescue

[formal rescue procedures] refer to insolvency procedures, enshrined in or recognized by statute, that facilitate rescue outcomes.... By way of contrast, a financially distressed company

²⁹ Armour J, Hsu A, Walters A (2008), p153

³⁰ *Ibid*

³¹ Adler BE, "A Theory of Corporate Insolvency", *New York University Law Review* 72 (1997) 343-382, p344

is rescued *informally* where, following a restructuring occurring without invoking a formal rescue procedure, it is able to continue its business. Typically this will involve "turning around" the company's business to restore it to profitable trading, and/or a consensual "workout" involving a restructuring of the company's capital structure with the agreement of its creditors.³²

Consideration of informal proceedings naturally takes place prior to formal proceedings. Parties to informal negotiation retain a first mover advantage as they are not subject to the collectivism of formal insolvency arrangements, and options available during informal negotiation are virtually limitless to the extent that they are defined by the needs and desires of the parties.³³

Unsecured creditors may prefer to maintain informal negotiations because an important consideration regarding formal workouts is the need to involve secured creditors. Secured creditors are typically essential to any reorganisation³⁴ because of the effective powers of veto they hold over formal arrangements due to their continuing powers of action. There are, however, significant advantages to the involvement of insolvency professionals or the clearing banks (who are often secured creditors) as it opens up a wide variety of what could be called semi-formal workout options. These options are not formal procedures identified in the Insolvency Act but involve professionals and procedures specifically related to the management of insolvency. Major clearing banks have developed "sophisticated support systems for their customers"³⁵, and firms can access so called "company doctors" who look into the operation of the firm to provide advice on strategy, management and funding, and turnaround professionals who conduct "intensive care"³⁶ while principal creditors informally agree to withhold enforcement action. This may be particularly

³² Armour J, Hsu A, Walters A (2008), p156-157

³³ Dennis V (2007), p89

³⁴ *Ibid*, p88

³⁵ Frisby S (2006), p22

³⁶ Dennis V (2007), p90

useful where there are a number of secured creditors because of the costs and complexity of collective solutions. Unsecured creditors who can achieve no traction with the debtor may benefit from the greater powers of their secured brethren. It has been argued that the modern banking industry is much keener on these semi-formal approaches to resolving insolvency:

[banks] activities in providing advice and guidance *outside* insolvency demonstrate their commitment to the rescue ideology in general. It is the notion that the rescue ideal should become the primary driver *inside* insolvency that was generally contested, on the grounds that the very onset of an insolvency procedure makes efforts in that regard sterile.³⁷

The bank's role in informal negotiation and the so called 'London Approach' will be explored in more detail in Chapter 5.

Only where informal negotiation is exhausted, unavailable or undesirable will formal insolvency proceedings be commenced. Entering into formal insolvency proceedings dramatically changes the nature of negotiations because "the collective rights of creditors come to the fore."³⁸ The informal negotiation period gives players an opportunity to strategically position themselves, but once formal proceedings begin statutory priority takes effect and freedom to negotiate becomes more limited. This can lead to the impression that entering into administration or other formal insolvency proceedings becomes almost self-fulfilling, causing the loss of the confidence of customers, employees and suppliers:

There is almost, therefore, a point of no return which, once passed, signals that the best outcome that can realistically be achieved is a maximisation of value through a sale of the company's business. There is arguably no harm caused in requiring practitioners to consider the possibility of pursuing the survival of the company in administration, but it is suggested that at the same time it is perfectly acceptable to acknowledge that this will be a realistic

³⁷ Frisby S (2006), p64

³⁸ Dennis V (2007), p23

proposition in only the most exceptional cases... One interviewee remarked that even today directors (of small, owner/managed companies in particular) take the view that the involvement of an insolvency practitioner, even in an advisory capacity, will inevitably lead to the demise of the enterprise.³⁹

Secured creditors may seek to recover their debt by appropriating the collateral, but “this will very often be effected through the instigation of a formal insolvency procedure”⁴⁰, while unsecured creditors “may seek to execute against unencumbered assets of the company or, alternatively, to initiate a formal insolvency procedure.”⁴¹ Frisby, however, argues that “it is only the compulsory liquidation procedure that can sensibly be described as primarily initiated by unsecured creditors”⁴², as unsecured creditor-led appointments are hindered by degree of investigation and investment typically required. The administrator has a duty to present a plan for the administration in order to justify the purpose of the administration, which means that “in the vast majority of cases a strategy will have been decided upon before the administrator is appointed and the particular objective in paragraph 3 to be pursued will be equally pre-determined.”⁴³ Whoever is driving a strategy leading into administration it is not unsecured creditors.

³⁹ Frisby S (2006) p65, p11

⁴⁰ Frisby S (2011), p352

⁴¹ *Ibid*

⁴² *Ibid*

⁴³ *Ibid*, p363

3.3 ADMINISTRATION AND BUSINESS RESCUE

Business rescue (45%) is chosen massively ahead of corporate rescue (1%).⁴⁴ This does not appear to represent a radical change in insolvency practice. Prior to the Enterprise Act the dominant insolvency procedure for viable returns was receivership, which could not result in corporate rescue. Does this mean that by continuing to adopt a business rescue approach post Enterprise Act administrators are undermining the over-arching purpose of administration? The objectives of administration were defined in the Insolvency Act 1986 Schedule B para 3(1), introduced in part 10 of the Enterprise Act and representing an apparent “seismic shift in emphasis.”⁴⁵ It lists the purposes of administration as:

- (a) Rescuing the company as a going concern; or
- (b) Achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in administration);
- (c) Realising property in order to make a distribution to one or more secured or preferential creditors.

Dennis argues that paragraph 3 is “one purpose with a hierarchy of objectives”⁴⁶, the purpose being to rescue the company. Similarly Phillips and Goldring state “this provision makes it expressly clear that administration is first and foremost about rescuing the corporate entity.”⁴⁷ If this were correct then administrators would clearly be failing in their duty, but the statutory duty is rather more subtly drafted than that and the overarching purpose is not corporate rescue. Mokal and Armour

⁴⁴ Frisby S (2011), p365

⁴⁵ Frisby S (2004), p260

⁴⁶ Dennis V (2007), p122

⁴⁷ Phillips M and Goldring J, “Rescue and Reconstruction”, *Insolvency Intelligence* 15 (2002) 75, p76, cited by Frisby S (2004), p261

argue that administrator must work through this list sequentially, eliminating each option in turn if he considers that it is not reasonably practicable to achieve it, or that the pursuit of the objective next in the list would bring better returns to creditors as a whole.”⁴⁸ The final purpose, realising property to satisfy secured or preferential creditors, is thus only being targeted where the first two are not reasonably practicable and this strategy would not unnecessarily harm the interests of the company’s creditors as a whole. This is accurate, but may still leave the inaccurate impression that corporate rescue sits at the top of the hierarchy.

The reason why this is not the case becomes a great deal clearer once the benefits of viable rescue to all parties are understood. If a business rescue would achieve better returns than a corporate rescue then the administrator has a clear duty to pursue this course of action, and a liquidation will only achieve better returns for creditors as a whole where a rescue option is unavailable:⁴⁹ “The ostensible top-table place of corporate rescue in the statutory scheme is, therefore, arguably illusory... paragraph 3 does not advocate a ‘rescue as of right’ philosophy but rather retains a wholly justifiable flexibility, to be exercised on the basis of commercial considerations.”⁵⁰ In their interviews Armour, Hsu and Walters found mixed opinions regarding the impact of these changes amongst insolvency professionals, some feeling that their role had always been to maximise realizations, and that regardless they felt “constrained by professional regulation and reputational concerns to ‘do the job properly.’”⁵¹ Whether acting as receivers or administrators, insolvency professionals were principally concerned with “commercial, rather than legal considerations”⁵², ranging from the viability of the company’s business to the extent of expected support from

⁴⁸ Mokal RJ and Armour J (2004), p1

⁴⁹ The clear advantages of maintaining active trading, typically through a CVA, will be illustrated in section 4 of this chapter.

⁵⁰ Frisby S (2011), p362, p368

⁵¹ Armour J, Hsu A, Walters A (2008), p164

⁵² Frisby S (2011), p363

lenders, suppliers and customers. The appointment of a professional, one with experience, discretion, and flexibility, may increase the confidence of parties:

The power to appoint an insolvency practitioner as administrator of the company can be seen as a move to reassure management that the procedure itself is not necessarily ‘the beginning of the end’... it may encourage management to seek assistance at a point nearer the beginning of the cycle of decline rather than towards the very end. The restoration of a degree of autonomy that the appointment power may be seen to offer, and the fact that directors may be able to appoint a practitioner who has advised them, and so has a degree of knowledge about the company and the options open to it, is clearly intended to provoke a ‘virtuous circle’ of early consultation leading to more recuperative outcomes.⁵³

This being the case the abolition of receivership may have been as much about restoring confidence in insolvency professionals as it was about improving the legal mechanism, notwithstanding the importance of correcting the perverse incentive for the relatively small number of over-secured claimants.

The Enterprise Act⁵⁴ sought to “put company rescue at the heart of insolvency procedures because we want to save companies which have a decent chance of survival so that they are not driven to the wall unnecessarily.”⁵⁵ The nominated administrator is responsible for making an evaluation of the commercial factors and pursuing a rescue outcome where “reasonably practicable.”⁵⁶ They must apply their discretion to determine if the firm has a decent chance of survival: “the point with out of court administrations is that they do rely on your judgment call.”⁵⁷ How does the exercise of this judgement call fit within criteria for Orderly and Effective insolvency?

⁵³ Frisby S (2006), p11

⁵⁴ See Chapter 2 for more on the Enterprise Act and the distinction between corporate and business rescue.

⁵⁵ Mokal RJ and Armour J (2004) p2, citing *Hansard*, 2 July 2002: Column 188 (Lord MacIntosh of Haringey).

⁵⁶ IA 1986 Schedule B para 3(1)(a)

⁵⁷ Frisby S (2006), p16, from an interview with an Insolvency Practitioner on the proper uses of the administration procedure.

There are a number of ways in which the administrator's exercise of his discretion might come before a court. Two important fashions are paragraph 74 and paragraph 75 applications under schedule B of the Insolvency Act 1986: "Paragraph 74 seems to target an administrator who is either careless or who deliberately and unnecessarily sacrifices the welfare of one 'interest group', whereas paragraph 75 seems more directed at the 'dishonest' administrator."⁵⁸ Exercise of the administrator's discretion regarding the best commercial outcome leaves plenty of opportunity for controversy, be it the accusation that "administration is being used as a quasi-liquidation with no attempt to save the company or its business or trade the business"⁵⁹, or unsecured creditors finding the phoenix pre-pack "probably the most infuriating outcome in any insolvency proceeding."⁶⁰ More broadly there is the common anxiety that viable firms are being allowed to fail, such as Keay and Walton's concern that rescues attempts were occurring "in less than 10% of administrations."⁶¹ As Katz and Mumford astutely observe "there is an urgent need to clarify... the definition and measurement of "better result" in circumstances where this may be marginal or inconsequential."⁶² Lacking any way to know for certain how many firms in administration would survive if rescue were pursued, it is difficult to know whether 10% is a good or a bad return. Faced with say an application that an administrator has sacrificed the welfare of a floating charge holder by attempting an ultimately failed rescue, or sacrificed the welfare of employees by liquidating a viable firm, how is the judge to determine if the administrator's discretion has been properly applied?

⁵⁸ Frisby S (2004), p264

⁵⁹ Keay AR and Walton P (2008), p95, and see Chapter 3.3 for further discussion of quasi-liquidation.

⁶⁰ Frisby S (2011), p387, and see Chapter 3.4 for further discussion of pre-packaged sales.

⁶¹ Keay AR and Walton P (2008), p143

⁶² Katz A and Mumford M (2006), p47

A baseline approach would be simply to look for dishonesty. The judge would only rule discretion had been incorrectly applied upon discovering evidence of malfeasance. s75 is clearly aimed at this sort of behaviour. Frisby identifies the administrator as having a duty to act honourably as they are an officer of the court under Schedule B paragraph 5, suggesting that unlike a receiver they cannot partake in certain value maximising activities such as actively repudiating some unprofitable contracts entered into before their appointment.⁶³ Yet the administrator's duties regarding the application of his discretion clearly go beyond simply behaving honourably, otherwise there would be no need for s74.

Mokal and Armour argued in a 2004 paper that in the exercises of his discretion the administrator was subject to a fiduciary duty to the creditors, applying the rule in *Hastings Bass*⁶⁴ to the administrator as a fiduciary:

- (i) Did the fiduciary take into account an irrelevant consideration or did not take into account one that was relevant? And if so,
- (ii) would his decision have been different had all the relevant considerations been taken into account, and the irrelevant ones ignored?⁶⁵

This seems to bring us closer to an econometric approach to the law, where the judge might consider the same sorts of factors as described above (past earnings, stock and bond prices, etc.) and then make a comparison where

not to take into account reasonably discoverable factors relevant to determining whether the continuation of the company as a going concern (by preserving for its benefit the specific skills and knowledge of the local market of its pre-distress shareholder-managers, say) would result in better expected returns for its creditors than if the company's business were to be sold off to another company (with little knowledge of and enjoying no goodwill in the market), would

⁶³ Frisby S (2004), p268

⁶⁴ *Hastings Bass* [1975] Ch 25, 41 (Buckley LJ)

⁶⁵ Mokal RJ and Armour J (2004), p5

be to ignore considerations relevant to serving the creditors' interests, and would thus constitute a breach of duty.⁶⁶

This is a really interesting way of thinking about the courts discretion. Perhaps regrettably, Mokal and Armour's thesis does not survive more recent application of insolvency law, for example the ruling in *Unidare PLC*⁶⁷ that the administrator "retains a wide discretion based on his subjective opinion which will only be capable of challenge in instances of bad faith or irrationality."⁶⁸ It is also difficult to conceive of how the administrator could have a fiduciary duty to all creditors when inter-creditor conflict is a common part of the insolvency process. Rather, it seems that a s74 intervention is extremely unlikely to occur on the grounds that the court consider the administrator to have incorrectly assessed the viability of a firm "unless the courts can see their way clear to adopting some form of 'irrationality' test in this regard it is at least arguable that an administrator, having once formed the view that a particular objective should be pursued, cannot be called to account under paragraph 74."⁶⁹

The question being approached in this chapter, however, is not whether Mokal and Armours interpretation of the administrator's duties is still applicable but whether such an approach to his duty would promote Orderly and Effective insolvency. The IMF have declared that "mandatory rules, when precisely formulated, give legal certainty"⁷⁰ but the World Bank warn that modern rescue procedures responding to the commercial expectations of dynamic markets "may not be susceptible to precise formulas [but] generally rely on design features to achieve the objectives."⁷¹

⁶⁶ Mokal RJ and Armour J (2004), p6-7

⁶⁷ *Unidare Pld v Cohen and Power* [2005] BPIR 1472

⁶⁸ Dennis V (2007), p122, citing *Unidare Pld v Cohen and Power* [2005] BPIR 1472

⁶⁹ Frisby S (2004), p265

⁷⁰ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p11

⁷¹ World Bank (2001), p5

This is a different type of certainty, recognised as counterbalance to discretion:

The greater the discretion that the law confers upon the court and the designated officials, the greater need there is for an adequate institutional infrastructure. Countries that give their judges such a key role in the decision-making process often find it necessary to establish a specialized court system, such as a commercial court or a bankruptcy court. The members of the court may be professional judges, preferably with special training and experience, or may be elected by the business community.⁷²

The uncertainty created by effective commercial engagement in the negotiation phases, and the power of the judge to recognise the expertise of the insolvency specialist, is offset by increasing institutional certainty. Specialist courts, specialist judges and highly trained insolvency professionals with a duty to act as officers of the court allow players to know that although they cannot be sure of the outcome they can be sure that it will be decided by an institution with a good understanding of the situation. Court oversight to limit bad faith and irrationality improves confidence in the commercial system.

There are good reasons to be concerned that judges avoid dabbling in the uncertainty of diagnosing the reasons for commercial failure, as demonstrated in the shocking recent decision at the High Court by Smith J to order that HBOS pay out to creditors of Farepak as its refusal to extend the failing firm's overdraft "might have kept Farepak going... [and] what happened there, whilst apparently legally acceptable, might not be regarded in the public's eyes as being acceptable."⁷³ The Farepak case is discussed in more detail in Chapter 7, but fear of judicial overreach and inability to make good commercial decisions has been a frequent concern of theorists and particularly insolvency efficiency theorists. Jackson complained that

⁷² IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p12

⁷³ "Farepak collapse: Judge partly blames HBOS bank", 21 June 2012, <http://www.bbc.co.uk/news/business-18540914> (accessed 17 August 2012)

judges lacked business training and were overly optimistic about firm's chances of success, the result being that "bankruptcy valuations by judges are systematically too high."⁷⁴ The common theoretical belief that judges did not make good commercial decisions has, however, been subject to strong challenge. In 2007 Morrison, who had himself previously been a critic of the judiciary's faculty for commercial decision making, performed an empirical study of the docket of a US bankruptcy court over the course of a calendar year comparing the continuation decisions made by judges against the optimal decision making model.⁷⁵ He discovered that judges actually made very good decisions about whether cases should be continued or not, that their behaviour was very close to the optimal decision-making model, and they played a major role in filtering failing firms from viable ones with no systemic bias in favour of saving non-viable firms.⁷⁶ In 2008 Djankov et al considered the role of judicial control and its relation to creditor returns in a cross country study of debt enforcement in 88 countries, using survey responses from insolvency professionals regarding a model medium sized firm.⁷⁷ They found that richer countries were considerably more effective than poorer countries. The difference was linked to the use of specialist courts that were able to deal with cases faster but crucially also increase the likelihood that the firm continued as a going concern.⁷⁸ When developing countries attempted to mimic the use of specialist courts differences in administrative and judicial competence were found to result in more expensive procedures without the associated increased returns:

In the rich countries, although these procedures are timeconsuming and expensive, they typically succeed in preserving the firm as a going concern. In the developing countries, in

⁷⁴ Jackson TH (1986), p220

⁷⁵ Morrison ER, "Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies", *Journal of Law and Economics* 50(2) (2007) 381-419

⁷⁶ *Ibid*, p385

⁷⁷ Djankov S, Hart O, McLiesh C and Shliefer A, "Debt Enforcement around the World", *Journal of Political Economy* 116 (6) (2008) 1105-1149

⁷⁸ Djankov et al (2008), p1135

contrast, these procedures nearly always fail in their basic economic goal of saving the firm; in fact, 80 percent of insolvent businesses end up being sold piecemeal.⁷⁹

What this demonstrates is that the one size fits all approach of insolvency efficiency is not an appropriate way of viewing creditor returns. If a country's legal system is underdeveloped, undersupported, or perhaps vulnerable to corruption then absolute priority may be the way to go. However, if your system can properly support specialist courts then better returns can be achieved by allowing the application of judicial discretion and incorporating a rescue component.

⁷⁹ *Ibid*, p1146

3.4 CVA VERSUS PRE-PACK: IS THERE ONLY ONE GENUINE RESCUE PROCEDURE?

This chapter opened with a consideration of the notion of creditor friendliness, and explored the idea of English law being based around a range of choices and alternative procedures. Who makes these choices, and how, has a significant impact upon outcome. The discretion of both insolvency professionals and the judiciary therefore play an important role in the process. I now turn to two examples of modern, business-rescue orientated practice in English commercial law (and how they can create problems of confidence in the system): the housing of CVAs within administration, and the pre-packaged business sale. The purpose is to highlight the way in which outcomes can be influenced by how choices are made during the process.

These represent very different types of rescue solution. Both are effective in their own way, just as both have individual shortcomings. It will be shown that the Administration + CVA, and particularly the trading CVA, can produce excellent returns for creditors, but requires significant complicity from all parties with the result that it is underused relative to other insolvency procedures. The Pre-Pack, meanwhile, provides what may be surprisingly positive returns given the extent of the negative coverage it receives, but that negativity undermines public confidence in the insolvency process and possibly the survivability of pre-packaged rescues.

The purpose of exploring the virtues of the administration housed CVA is not to argue that pre-packs should be removed or limited. One of the strengths of the more English law is that both options are available, and it is clear that there are circumstances in which one is preferable to the other. Rather, the aim is to highlight that the inclusivity of the administration + CVA procedure, from the input of

specialist's discretion to the role of creditor votes, has a positive impact on returns. There are lessons to be learned here that might further improve the pre-pack procedure and insolvency practice generally.

3.4.1 Is the Administration+CVA the only genuine rescue procedure?

Administration is not in itself considered to be a particularly effective rescue mechanism, but there is greater enthusiasm for its use to house a Company Voluntary Arrangement (CVA) "which might just lead to a full blown rescue."⁸⁰ Some practitioners consider this "the only genuine *insolvency* rescue mechanism"⁸¹ in the post Enterprise Act regime. In the Administration + CVA combination the administrator proposes the CVA to the creditors once he has control of the assets. This may be principally because it allows them to avoid the Schedule B1 paragraph 65 Insolvency Act requirement to make an application to the court in order to distribute to secured or preferential creditors. The combination has, however, the additional benefit of giving the administrator access to the unique flexibility and elements of creditor collaboration inherent in the CVA.

Governed by s1-s7b of the Insolvency Act 1986 a Company Voluntary Arrangement is "a statutory form of binding agreement between a company and its creditors."⁸² It is designed to facilitate swift and straightforward arrangements between the company and its creditors. When used independently of administration it is most likely entered into with a view to the continued survival and operation of the company⁸³,

⁸⁰ Frisby S (2011) p366

⁸¹ Frisby S (2006), p63

⁸² s1(1) Insolvency Act 1986

⁸³ Frisby S (2011), p370

and possibly maintaining customer relationships.⁸⁴ Being largely contractual in nature⁸⁵ its main advantage is flexibility⁸⁶, or as Keay and Walton put it, “one is immediately struck with how little detailed guidance is given as to what a CVA should look like or do.”⁸⁷ It is therefore most useful where

the company’s underlying business may be sound, but it cannot afford to pay all its creditors all that it owes them... It may prove to be more beneficial to the company’s creditors to come to some arrangement whereby the creditors are paid less than they are owed, but the amount paid is more than the creditors could expect on winding up.⁸⁸

Directors who wish to set up a CVA must appoint an insolvency practitioner as nominee who is asked to endorse their proposal, whereas a CVA housed within an administration already has an insolvency practitioner in place (the administrator) who is familiar with the case. The nominee reports to the court if a creditors’ meeting vote on the proposal passes the threshold of 75% value and 50% of members. This process is highly technical, meaning that the Administration/CVA has an inbuilt advantage when it comes to effectively achieving a CVA as in practice it is “virtually impossible for the directors of the company to prepare a [CVA] proposal without assistance.”⁸⁹ They typically come in two types: trading CVAs, which involve an arrangement to pay a certain amount each month, and asset CVAs, where assets are sold and used to pay off creditors. Like schemes of arrangement they are attractive because they are binding over all creditors whether they accept or not, and creditors may even be bound if they did not receive notice.⁹⁰

⁸⁴ Walters A and Frisby S, *Preliminary Report to the Insolvency Service into Outcomes in Company Voluntary Arrangements* (2011), <<http://webarchive.nationalarchives.gov.uk/20110525173706/http://www.insolvency.gov.uk/insolvencyprofessiona/ndlegislation/research/corpdocs/CVA-Report.pdf>>, (accessed 12 September 2011), p19

⁸⁵ *Re Kudos Glass Ltd (in liquidation)* [2001] 1 BCLC

⁸⁶ Dennis V (2007), p96

⁸⁷ Keay AR and Walton P (2008), p142

⁸⁸ *Ibid*, p141

⁸⁹ Dennis V (2007), p98

⁹⁰ s5(2)(b)ii IA 1986

The CVA had been described as the bridesmaid of rescue techniques because of “the perceived cost, the lack of speed in implementation, the attitude of creditors and the need to obtain the consent of such a high proportion of creditors to the arrangement... [and] a common concern of creditors that the proposed nominee [in a CVA] acts as a ‘mouthpiece’ of the directors.”⁹¹ The rights of the secured creditors hang like a “Sword of Damocles”⁹² over the negotiation as they cannot be altered by a CVA without their consent.⁹³ It can also be difficult to get holders of floating charges on board because if “the CVA fails prematurely, the debenture holder may find that most, if not all, of the floating charge assets have been swallowed up under the CVA in favour of the unsecured creditors. This potentially disastrous result needs to be considered before a debenture holder gives its consent to a CVA.”⁹⁴ A combination of administration and CVA mediates all of these problems: the administrator has the skill and expertise to efficiently implement the CVA, secured creditors and floating charge holders are already party to the administration and so are easier to bring on board with the CVA, and the administrator’s duty to achieve the best possible return for all creditors ameliorates the impression that they are the directors’ mouthpiece.

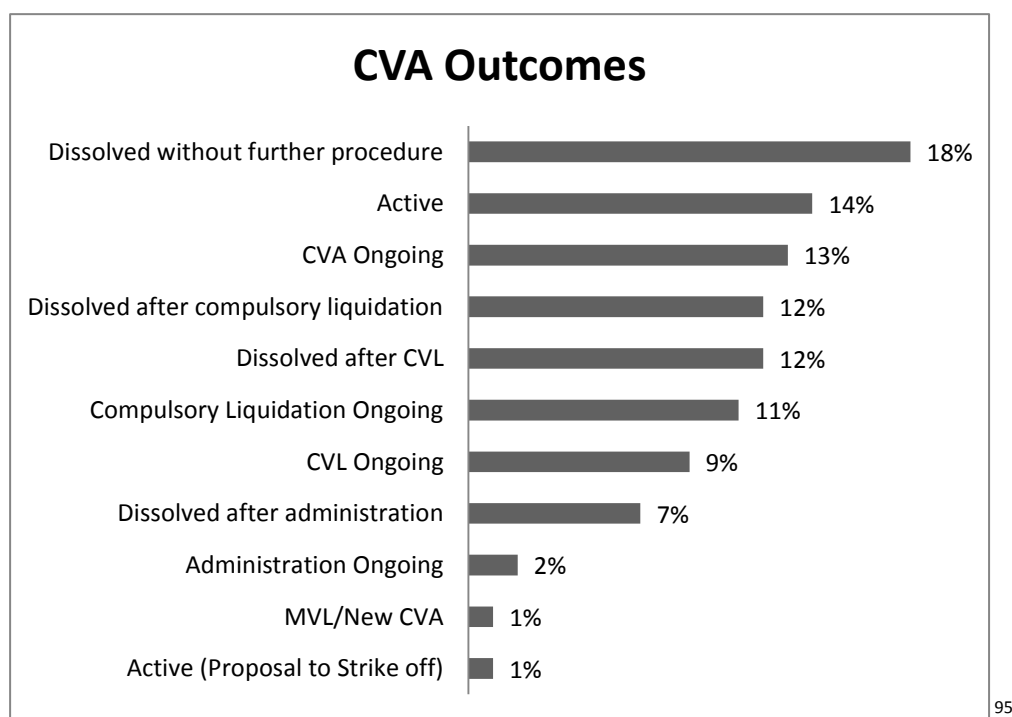
⁹¹ Dennis V (2007), p94, p102

⁹² *Ibid*, p106

⁹³ Insolvency Act 1986 s4(4)

⁹⁴ Keay AR and Walton P (2008), p164

3.4.2 CVAs are Liquidation in Disguise?



52% of CVAs commenced in 2006 ended with some form of insolvent outcome, “in the sense that the CVA was terminated prematurely by the supervisor, almost invariably on the ground that the company had failed to make the agreed contributions.”⁹⁶ At the other end of the scale, 14% emerge as active firms and the further 13% of on-going CVAs are likely to lead to a rescue outcome as by this point they have been trading profitably for 5 years.⁹⁷ The obvious difficulty is determining whether 27% rescue is a good return compared to the 52% dissolution.

Lacking a frame of reference may lead to the seductively easy conclusion that because there is more dissolution than rescue the procedure is ineffective as a rescue technique. The ostensibly high level of failure has led the accusation that via the CVA “administration is being used as a quasi-liquidation with no attempt to save the

⁹⁵ From pie chart found at Frisby S (2011), p372

⁹⁶ Frisby S (2011), p373

⁹⁷ *Ibid*

company or its business or trade the business”⁹⁸, or more moderately, “there is some evidence that the administration procedure is being used where a company voluntary liquidation might, ostensibly at least, be equally appropriate.”⁹⁹ Certainly there is strong evidence of a proportionate switch from the use of CVLs to administration.¹⁰⁰

Frisby suggests four reasons why administration might be being used as a substitute for a CVL:

1. As a response to the ruling in *Re Leyland DAF*¹⁰¹ that made costs and expenses of liquidation no longer payable in priority to claims of the floating charge holder, by contrast these expenses are protected by statute in administration.¹⁰² If this is the principal reason then she observes that we should expect liquidation in disguise to disappear after the statutory reversal of *Re Leyland DAF*.¹⁰³
2. If the insolvency professional recommends administration they secure their own appointment, whereas recommending liquidation may result in the appointment of another practitioner.¹⁰⁴
3. The ‘new entrant phenomenon.’ This is connected to the second reason in that smaller newer firms dealing with liquidations do not believe they will get appointed as liquidators but want the business as an administrator, complemented by “tentative evidence from the data to support the

⁹⁸ Keay AR and Walton P (2008), p95

⁹⁹ Frisby S (2006), p16

¹⁰⁰ Katz A and Mumford M (2006), p13

¹⁰¹ *Buchler v Talbot* [2004] UKHL 9

¹⁰² Frisby S (2006), p74

¹⁰³ Insolvency Act 1986 s176ZA, which restored priority of expenses in winding up.

¹⁰⁴ Frisby S (2006), p77

interviewees' assertions that the 'disguised liquidation' is carried out more often by smaller firms."¹⁰⁵

Frisby's new entrant theory may be supported indirectly by Katz and Mumford's findings regarding 'abuse' of administration procedure. They found that from their sample of administrations 29% by number but 3% by value were either unjustified or only justified by the existence of secured and preferential creditors (and therefore arguably not within the meanings of the objectives).¹⁰⁶ Procedural justification need not correlate cleanly with abuse,¹⁰⁷ although equally it is not *de facto* the case that the increase in asset sales within administration means there were an increasing number of "disguised liquidations".¹⁰⁸ However, what evidence there is of the existence liquidation-in-disguise is associated with an area of the market made up of large numbers of small-value administrations (hence 29% by number and 3% by value),¹⁰⁹ exactly the type you would expect to be handled by smaller firms. This is also evidence of an important fact about the insolvency market: there is diverse behaviour between different groups, for example between large scale accountancy firms and small IP practices, and this should encourage caution when considering aggregate statistics.

3.4.2 Administration Housed CVAs are Orderly and Effective.

The fourth reason presented by Frisby for the shift from CVLs to asset based sales within administration is, if cynicism can momentarily be suspended, convincing in its simplicity. Insolvency practitioners may be choosing administration over liquidation

¹⁰⁵ *Ibid*, p79

¹⁰⁶ Katz A and Mumford M (2006),p5

¹⁰⁷ *Ibid*,p46-47

¹⁰⁸ Frisby S (2006), p79

¹⁰⁹ Katz A and Mumford M (2006),p5

not for selfish ends or as a back door to quick liquidations, but because it achieves better all round results:

Administration has considerable advantages over liquidation in terms of the speed at which it can be entered, and the enhanced powers of an administrator in dealing with assets and managing the business of the company. Liquidation has some deleterious effects in terms of terminating contracts of employment and, in some cases, other contracts subject to *ipso facto* clauses which may not arise in an administration.¹¹⁰

Frisby expands upon this theme in a later paper:

The most probable explanation for this is that the company finds itself in a position where it cannot be the subject of a solvent winding up, its debts exceeding its assets, but that a relatively short period of continued trading would result in the completion of executory contracts which in turn would swell the assets of the company, thus allowing for an enhanced insolvency dividend for its creditors. In other words, the eventual dissolution of the company is contemplated from the outset, but the use of a CVA is designed to facilitate an orderly and more productive wind down of its operations without the risk of creditor pressure or non-co-operation threatening the maximisation of value a trading strategy is calculated to enhance.¹¹¹

Reworking of the presentation of the data in the recent *Preliminary Report to the Insolvency Service into Outcomes in Company Voluntary Arrangements* by Frisby and Walters demonstrates the dramatic advantages to unsecured creditors of CVAs over liquidation.¹¹² This paper considers a sample of 177 CVAs, out of which the average return to unsecured creditors was 16%. They observe that “perhaps disappointingly”¹¹³ 52% of creditors receive a return of 0%, but find it “to some extent heartening to note that dividends of over 30% were returned in 14% of the

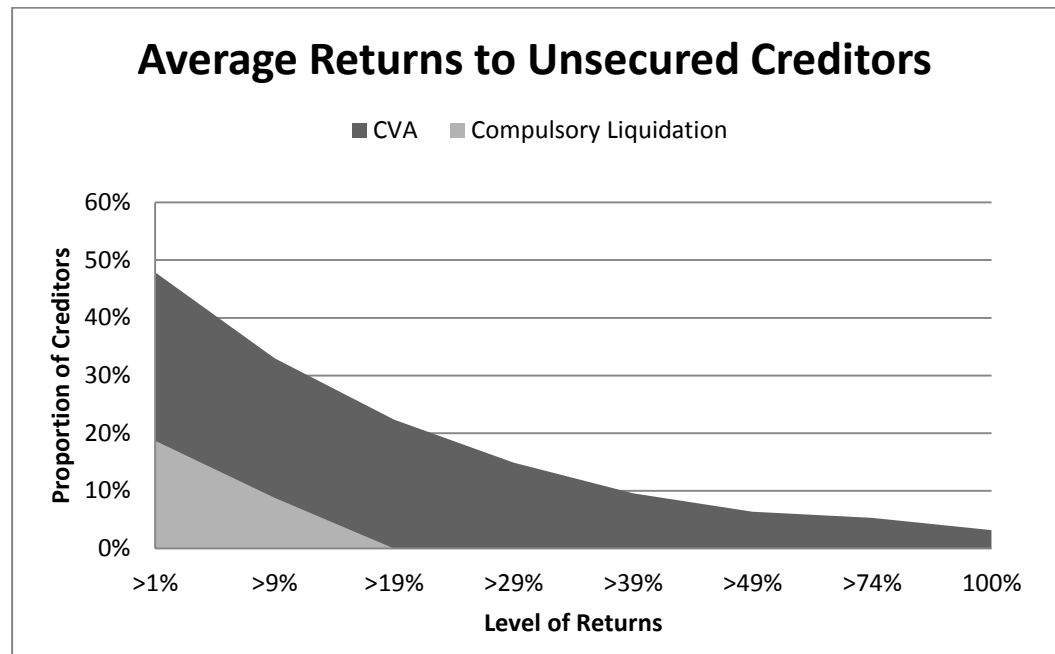
¹¹⁰ Frisby S (2006), p80

¹¹¹ Frisby S (2011), p374

¹¹² Walters A and Frisby S (2011)

¹¹³ *Ibid*, p24

cases in the sample.”¹¹⁴ By drawing on different pieces of evidence in their paper it is possible to avoid the problem of judging CVAs in a vacuum and make some clear observations about the relative efficacy of CVAs compared to liquidations:

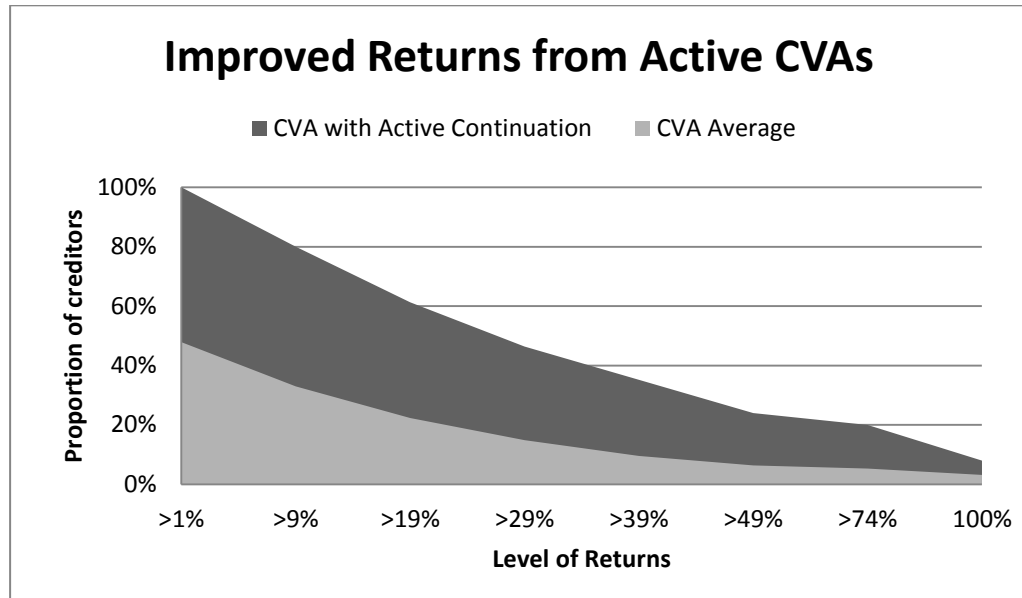


This chart is devised from two tables presented in the CVA outcomes report¹¹⁵, and makes the advantages of CVA returns over CVL returns abundantly clear. Participants in a CVA are on average far more likely to get far greater returns. This in itself is not particularly surprising, as it is well known that returns to creditors in liquidations are lower than in other procedures. It would be illuminating to be able to properly compare returns from differing insolvency procedures in the same way, although there are difficulties in comparing like-with-like and it will require more time and data than currently available to produce the sorts of studies required. What this data does show us is that when a director or administrator meets the requirement of

¹¹⁴ Walters A and Frisby S (2011), p24

¹¹⁵ *Ibid* - Figures on returns to unsecured creditors after compulsory liquidation p38, Figures for returns to unsecured creditors after CVA's from table 15 p24. Percentages were recalculated to exclude unknowns (6% unknown in CVA and 9% unknown in compulsory liquidation). Even if the 6% CVA's were 0% returns and the 9% Liquidations 100% returns, which would be startling to say the least, it would do almost nothing to change the overall picture of strongly better returns through CVAs. The data is from a sample of 177 companies out of the 547 CVAs recorded as commence in 2006 by Companies House, and is therefore 32.4% of the entire population of 2006 CVAs.

including in their CVA proposal a financial assessment including comparison of the likely CVA outcome compared to a liquidation outcome, the CVA is likely to be a much more attractive alternative. If an active, trading CVA can be achieved the results are even better:



	CVA	Compulsory Liquidation
>1%	47.87%	19%
>9%	32.98%	9%
>19%	22.34%	0%
>29%	14.89%	0
>39%	9.57%	0
>49%	6.38%	0
>74%	5.32%	0
100%	3.19%	0

	CVA Average	CVA with Active Continuation
>1%	47.87%	100%
>9%	32.98%	80%
>19%	22.34%	61.3%
>29%	14.89%	46.4%
>39%	9.57%	35.2%
>49%	6.38%	24%
>74%	5.32%	20%
100%	3.19%	8%

CVAs are significantly better for unsecured creditors than compulsory liquidation.

The most dramatic result, if one is concerned for the fate of unsecured creditors, is that 100% of creditors achieve some degree of return from an active CVA, as opposed to 48% from CVAs overall and only 18% in compulsory liquidation. CVAs are so much better than liquidation, even including the fact that half of CVAs end in

insolvent outcomes, that even the most risk-averse creditor should usually be voting in favour of the CVA and trying to keep the firm trading through its difficulties even if this will almost inevitably end in liquidation.

The data for returns to unsecured creditors from an active CVA are from chart 25 in the Walters and Frisby report¹¹⁶, although the data has had to be manipulated to make it comparable. First, the returns between categories are smoothed as Walters and Frisby did not categorise the returns from active CVAs in the same fashion as the returns from CVAs overall or liquidations. Second, their categories are not spaced evenly. The strongest impact this has on the presentation of the data is diminishing the tail towards the right of the curve. Redistributing the subsets is avoided in order to keep at least one set of data the same as reported in the original work, but as compulsory liquidations do not achieve returns beyond 20% this makes little difference to the comparison. Third, the average CVA returns includes within it the data on returns from active CVAs. This means that returns from CVAs as a whole are lifted by the performance of active CVAs. The returns from active CVAs as compared to non-active CVAs is actually relatively better than appears in the second diagram.

This leads to the most important problem with the comparison regarding choice between entering administration with a view to achieving a trading CVA and the possibility of an asset sale, or straight liquidation. A proportion of CVA outcomes presented will be for cases where liquidation was never appropriate as the underlying business was sound. If in the future CVLs are abolished and current liquidations are treated as administrations this would have a downward pressure on average results from CVAs. Although the results strongly suggest that it is better to

¹¹⁶ Walters A and Frisby S (2011), p37

go for an Administration + CVA even where it is likely to result in dissolution, this is not a direct comparison of liquidation against quasi-liquidation.

Further research and/or access to the original data set could correct many of these issues, for example performing a comparison between average returns from potential quasi-liquidations identified as having inadequately defined purposes in Katz and Mumford's research with contemporaneous returns through CVL.¹¹⁷ Even working with the data as presented in the report allows us to see very clearly the advantage to unsecured creditors of running a CVA, as Walters and Frisby plainly state: "The average return from active CVAs is 37%, as compared to 13% from the entire sample and it is submitted that this would far outstrip average returns from other insolvency procedures."¹¹⁸ Averages are not the best way to evaluate performance in subsets, but it would be a fairly dramatic (although feasible) turnaround to discover CVAs were not better for all classes of creditors, even creditors of quasi-liquidations. Nonetheless, further research to provide verification is required. These results make it even harder to argue with Frisby's conclusion, stemming from the original insolvency outcomes report, that quasi-liquidation through administration is still justifiable under paragraph 3b of the objectives where it gets better returns for creditors.¹¹⁹ Katz and Mumford suggest:

Some of the difficulties with the criteria for administration could be resolved by making administration more widely available... even in marginal cases, administration is likely to produce a result at least equal to that achievable in a CVL. Such a change could bring about a substantial further increase in the proportion of administration to liquidation cases but we do not see that as a problem. It could in practice bring about (or extend) a two tier market: on the one hand for the typically larger cases where there is a prospect of saving the company or

¹¹⁷ Katz A and Mumford M (2006), p5

¹¹⁸ Walters A and Frisby S (2011), p37

¹¹⁹ Frisby S (2006), p80

some of its business or otherwise managing a more complex realisation strategy; and on the other hand for the typically smaller cases of a liquidation nature.¹²⁰

Returns from liquidation are so poor that for any objective risk neutral unsecured creditor the gamble on achieving an active CVA through administration is most likely the best choice, even if the odds of success are long. Indeed, it has been argued that CVLs are becoming redundant¹²¹ and removing the procedure altogether in favour of a “single gateway”¹²² approach to management of insolvency through administration makes a great deal of sense, given the better returns involved and the reduced costs. This would seem a sensible direction for English law to take.

Naturally, creditors are human and therefore unlikely to be either objective or risk neutral. An interesting additional quality of the Administration + CVA combination is that, as well as improving returns, CVAs also enhance inclusivity because they require a realistic proposal that achieves creditor support.¹²³ A CVA is legitimised by because the “company’s creditors will have actively approved the proposal put to them by the company.”¹²⁴ More importantly an active CVA depends on maintaining relationships with creditors, whether they are the bank or the taxman, suppliers or customers. Getting the cooperation of the unsecured creditors increases the chances of the rescue. It is not outlandish to suggest that most rescues depend on the goodwill of stakeholders. Rather than being a side effect, the inclusive element of the CVA may be an essential part of its success. This makes it crucial that creditors are persuaded of the benefits of CVAs:

To the extent that CVAs regularly fail then creditors, particularly repeat players such as secured creditors and the Crown, begin to doubt the procedure’s integrity and prospects for

¹²⁰ Katz A and Mumford M (2006), p48

¹²¹ *Ibid*

¹²² Frisby S (2006), p81

¹²³ *Ibid*, p63

¹²⁴ Frisby S (2011), p377

success as a whole. Following on from this, it may be that even realistic proposals will not clear the hurdle of acquiring creditor support.¹²⁵

Frisby continues to observe a “certain mistrust of the procedure in general... [such] that the most fruitful route to rescue inside insolvency may be subject to an obstacle that thwarts even realistic proposals.”¹²⁶ This is an interesting dichotomy. What evidence exists strongly suggests the using CVAs within administration is a highly effective means of maximising creditor returns, and it is submitted that the element of inclusivity and creditor co-operation is part of this because of the prominent advantages of active and trading CVAs. However, if participant confidence in the procedure is undermined this can kill it off before it even begins. This chapter will now turn to a much clearer example of a divide within insolvency law between the quality of a strategy’s results and public confidence in that strategy: pre-packs.

3.3.5 Prepacks

An example of English flexibility that most certainly and by design does not enhance unsecured creditor involvement is the pre-pack:

Pre-packing basically involves a period of pre-insolvency negotiation with a prospective purchaser of the business of an insolvent company. The assets required by that purchaser will be agreed and a price for the business settled, invariably by reference to an independent valuation. Administration is then entered into and the business, comprising the agreed assets and goodwill, contracts and the like, and employees are transferred to the purchaser.¹²⁷

Pre-packs are negotiated and agreed prior to formal insolvency, enabling them to be executed very quickly in the event of insolvency. Pre-packs may involve a business sale to a third party or a ‘phoenix’ sale where the previous directors take over the

¹²⁵ Frisby S (2006), p63

¹²⁶ *Ibid*

¹²⁷ *Ibid*, p69

new firm. They have several advantages, usefully outlined by Katz and Mumford¹²⁸ and Frisby¹²⁹ as including increased realisation from sale of assets, high speed of transaction, reduction of uncertainty, preservation of employment, and maintenance of existing contracts and of the 'goodwill' asset should it exist. It is a "quasi-corporate rescue device"¹³⁰, a "peculiarly matter-of-fact solution... one that has become especially useful as contemporary commercial conditions [and that] solves the very common problem of a lack of funds to support a period of trading while the business is marketed and sold during the course of the procedure."¹³¹ An important disadvantage is that, while preventing exposure to the market may improve confidence and increase sale speed, it also undermines accurate pricing and excludes potentially superior outcomes.¹³² This is not, however, the reason why doubts about pre-packaging have become "the one most substantial threat to the perception of the integrity of insolvency practice".¹³³

it may be used perfectly honourably and in the best interests of all concerned, or it may be exploited by the unscrupulous in what has been described as a 'debt-dumping' style... in its most egregious form it clearly has the potential to raise serious doubts as to the integrity of insolvency practitioners and, indeed, the effectiveness of UK insolvency law in terms of its ability to deal with what would be widely recognized as 'malpractice'.¹³⁴

When a pre-pack deal is agreed "there is never any intention of putting a proposal to the creditors' meeting or of even considering a possible rescue through a trading administration."¹³⁵ Some commentators argue that pre-packs were "clearly not envisaged by parliament when the Enterprise Act was being passed"¹³⁶ and that "if an

¹²⁸ Katz A and Mumford M (2006), p50

¹²⁹ Frisby S (2011), p389

¹³⁰ Frisby S (2006), p72

¹³¹ Frisby S (2011), p378

¹³² Katz A and Mumford M (2006), p50

¹³³ Frisby S (2011), p396

¹³⁴ *Ibid*, p385, p380

¹³⁵ Keay AR and Walton P (2008), p125

¹³⁶ *Ibid*, p92

administrator has a duty to consider rescuing the company and prior to becoming an administrator is bound to a pre-pack agreement to sell the business to the company's management team, it is arguable that the administrator has fettered his or her discretion"¹³⁷ contrary to the rule in *Re Scotch Granite Co*¹³⁸. Yet pre-packs have been recognised for some time as part of normal insolvency practice. "Phoenixing" via pre-packs, where the sale is affected to previous owners or directors, is often seen as particularly egregious. Although concern about phoenixing was a significant driver behind the movement to create a unified bankruptcy code "the Cork Committee itself noted that it was important to distinguish between 'innocent' and 'objectionable' phoenixes"¹³⁹ Provisions have been introduced into the law to attempt to do this, such as s216 IA1986 which prevents the use of the name of a previously liquidated company, and mechanisms in the Company Directors Disqualification Act 1986 intended to "'police' serial failures."¹⁴⁰ These measures do not appear to have corrected long standing concerns about pre-packs, but they were never likely to. This is because the problem is less the potential for abuse (which as we have seen exists in administration as well) than the fact that the other creditors have little to no power to exercise choice. Unsecured creditors ability to intervene in a pre-pack appears largely toothless. Paragraph 74 or 75 applications from Schedule B1 of the Insolvency Act 1986 that the administrator either is or has acted so unfairly as to harm the interests of the applicant, or has misplaced or restrained money, are likely to founder on practical difficulties: "the likelihood of a creditor being able to produce persuasive evidence that some other strategy would have realized significantly more in terms of value is remote in the extreme."¹⁴¹ Paragraph 88

¹³⁷ *Ibid*, p130

¹³⁸ *Re Scotch Granite Co* (1868) 17 LT 538

¹³⁹ Frisby S (2011), p384

¹⁴⁰ Dennis V (2007), p149

¹⁴¹ Frisby S (2011), p391

applications on the grounds of inadequate account of decision making will in turn be avoided by compliance with SIP 16 provisions¹⁴². The result is that

for unsecured creditors at least, the phoenix pre-pack is probably the most infuriating outcome in any insolvency proceeding. Interestingly, interview evidence from the author's most recent roll-out of the research into pre-packs tends to suggest that unsecured creditor objections tend to be based more on principle than on financial considerations: in essence, such creditors intrinsically object to connected parties regaining control of a business after its corporate 'owner' enters insolvency and the level or lack of dividend is barely relevant to this objection, which is based more on ideology.¹⁴³

This powerful testimony comes from one of Frisby's interviews:

It's nothing short of scandalous. The guy ran up nearly £7,000 of debt with us, we let it go at first and then we started ringing up, sending e-mails, trying to get some money out of him but nothing happened, and then the next thing we know there's a letter from the administrator saying that the company's bust but that the same guy has bought the business. We were told we could go to a meeting, but to be honest I simply didn't see the point, everything seemed to be done and dusted by that time. I read through what the administrator said, that there was no-one else who wanted to buy the business so he decided to sell it to this guy, but I just don't agree with that, the fact is that he's dropped a lot of debt and he's managed to keep his company because he's dropped all that debt. I know some of the other creditors around here, and we all take the same view, there's something wrong with a system that allows that to happen, or there's something wrong with the administrator who thinks that it's okay to do it... Interestingly, this interviewee went on to acknowledge that a dividend of in the region of 7% was expected to be paid later in the year. This, he stated, made no difference to his view of the impropriety of the transaction: 'If you asked me whether I'd rather see him out of business or get £500 I wouldn't hesitate, he shouldn't be allowed to carry on in business.'¹⁴⁴

Naturally the response of this one creditor may not be representative of the whole, but combined with the other evidence provided above there is clearly a problem with

¹⁴² *Ibid*, p392

¹⁴³ *Ibid*, p387

¹⁴⁴ *Ibid*, p387

pre-packs. The creditor is infuriated with an effective and commercial beneficial solution that is in keeping with the principle objectives of the law, because the feeling that it is unfair or immoral leads them to prefer to receive no money and see the business fail. Further empirical work by Polo has supported Frisby's findings regarding the financial benefits of the pre-pack, that they are an effective procedure that appears to preserve businesses that would otherwise be liquidated piecemeal and equally that there is "no evidence of exploitation of conflict of interests."¹⁴⁵ Concerns about pre-packs seem to be ill founded.

As such, that some creditors would prefer to reject an option that would most likely be more commercially beneficial for all parties does not seem problematic, especially given that there is very little chance of them being able to prevent the pre-packaged sale and English law has already been demonstrated to be prepared to seek best returns ahead of satisfying the wishes of the creditors.¹⁴⁶ But there are two reasons to care about steamrolling creditor disquiet. The first is the damage it does to public confidence in the system. The second specific point with pre-packs is that while Phoenix pre-packs are more likely to succeed in the long term they are more likely to fail than other going-concern sales in the short to medium term.¹⁴⁷ If stakeholders feel that the sale is illegitimate they are less likely to co-operate with the new entity, damaging its chance of continued survival. Simply pointing out the probable improved returns are insufficient where the creditors have no say in the outcome: "For the most part, it would appear that no amount of explanation of the commercial justifications of pre-pack phoenixing will convince those disenfranchised from the process ... [the argument that] something should be done to address this

¹⁴⁵ Polo A, "Secured Creditor Control in Bankruptcy: Costs and Conflict", *Available at SSRN 2084881* (September 2012), p28

¹⁴⁶ Cohen M and Crooks S (2007)

¹⁴⁷ Frisby S (2011), p386

air of mistrust becomes quite compelling.”¹⁴⁸ The trick will be to find a way to mediate creditor unhappiness without losing the efficiency benefits of pre-packing, which I will return to in the final chapter of this thesis.

The contention that the administration housed CVA is the only genuine rescue procedure is clearly false. Pre-packs can be highly effective. They could be more effective, given some tweaks to improve unsecured creditor inclusivity and thus improve the survivability of companies post pre-packaged sale. It is essential to emphasise that when I say tweak I mean exactly that: the strength of the pre-pack is in many ways that it rides rough-shod over the unsecured creditors, but the anger that is generated by this approach and the potential subsequent withdrawal of support might be mediated by small measures to improve communication and interaction. I will return to this question in later chapters with an exploration of creditor decision making. For the time being the comparison between these two extremes of English rescue, the Administration housed CVA and the Pre-pack, is intended to emphasise that the strength of English effectiveness formed by a menu approach driven by informed discretion, and that where available and practicable the best procedures are inclusive procedures.

¹⁴⁸ Frisby S (2011), p390; Ministerial Statement referenced: Davey, Minister for Employment Relation, Consumers and Postal Affairs, Written Ministerial Statement: Improving Transparency and Confidence in Pre-Packaged Administrations (31 March 2011) <<http://www.bis.gov.uk/assets/bispartners/insolvency/docs/insolvency%20profession/consultations/prepack/responses/sales%20of%20administrations%20pre%20packs%20hoc%20300311.pdf>> accessed 12 September 2011.

CHAPTER 4: INSOLVENCY REGIMES, INVESTMENT AND THE COST OF CREDIT

4.1 THE COMMON SENSE LINK BETWEEN BUSINESS FAILURE AND THE COST OF CREDIT.

In 2008 then Confederation of British Industry (CBI) Director General, Richard Lambert, observed that as a result of the financial crisis “the biggest threat hanging over businesses is cash-flow. If they cannot get their hands on the cash and credit they need to go about their day-to-day business, there is a real risk that we could see healthy firms go under.”¹ This notion of healthy firms going under is interesting: why is “going under” not enough in itself to demonstrate that the firm was unhealthy? It suggests that there are circumstances where the health of a firm can be distinct from its ability to get credit or indeed that healthy firms can become insolvent and fail.

Bankruptcies and corporate liquidations are falling

<http://www.bbc.co.uk/news/business-11701334>

However, with bank credit remaining tight and the government's austerity measures yet to begin in earnest, analysts warned difficult conditions would persist, particularly for smaller companies.

They said banks and other creditors - including HM Revenue and Customs - had been reluctant to force companies into formal insolvency. But as government cutbacks feed into the economy, or if interest rates were to rise, the trend could worsen again in future.

Personal insolvencies stabilising, official figures say

<http://www.bbc.co.uk/news/business-14416410>

Meanwhile, the number of businesses going bust fell by 5% to 1,232 in the second quarter, though they were still up 22% on a year ago.

Louise Brittain, insolvency partner at accountancy firm Deloitte's, said: "Whilst insolvencies are still commonplace, we are not seeing the severity that we have seen in recent years.

"Low interest rates have gone a long way in helping individuals to keep their finances at a manageable level," she added.

Accessed 12 Sep 2011

¹ The Times, "Banks need extra £110bn of public money to start lending again", 24 Nov 2008, p15

Insolvency lawyers often explore a similar distinction by distinguishing between economically and financially distressed firms.² Economically distressed firms are inviable due to intrinsic difficulties, such as producing a product for which there is no longer a demand. Financially distressed firms may be intrinsically viable but have difficulty acquiring credit, for example becoming cash-flow insolvent because they are over leveraged. In an efficient market all economically viable firms would be able to find finance. The implication in the notion of “healthy firms going under” is that there is some sort of market failure occurring such that the ordinary pricing mechanisms of credit are not correctly distinguishing between these ‘healthy’ and ‘unhealthy’ businesses, and thus that intervention is required to protect economically viable businesses by maintaining cheap credit.

As a result ensuring the availability of cheap credit has remained a significant objective in monetary policy. The MPC (Monetary Policy Committee) has kept base rates low in spite of inflation above the Bank of England target³ as a response at least in part to the on-going call for cheaper credit to meet the financial crisis. It is credible that inflation would remain above target even with interest rate increases, due to cost push caused by higher energy and commodity prices, the increase in VAT and the depreciation of sterling⁴, and the MPC might legitimately maintain low interest rates for the benefits to struggling households or to maintain inter-bank liquidity during the financial crisis, but the idea that improving the flow of credit reduces business failure is clearly an influential consideration.

² See Mokal R (2001a), p195

³ At the time of writing, their most recent minutes observed that “cost of bank credit to smaller businesses remained elevated and the supply of credit to them was still restricted” Minutes of the Monetary Policy Committee meeting held on 3 and 4 August 2011, found at <http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1108.pdf> (accessed 7 September 2011), p4-5 para 16, thus supporting the argument for maintaining record low interest rates.

⁴ Minutes of the Monetary Policy Committee meeting held on 3 and 4 August 2011, found at <http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1108.pdf> (accessed 7 September 2011), p8 para 31

A company can survive as long as it can acquire credit, which can mean anything from bank loans to an informal arrangement with a supplier. The starting point to understanding this relationship seems to be to treat credit as performing according to a simple cost function.⁵ Cheaper credit is therefore held to correspond with a greater supply of credit. Interest rates are the price a borrower pays for the use of another party's money. The base interest rate typically refers to the overnight deposit rate from the central bank. The rate includes inflationary expectation, in order to compensate the owner for the expected devaluation of his property over time, and a risk premium, which accounts for the assessed danger that the loan will not be repaid.

Increased risk premiums due to uncertainty were an important factor in the Asian financial crisis; "domestic bank lending stopped abruptly in the three countries with IMF programs (Indonesia, Korea, and Thailand). There were widespread anecdotes about firms unable to obtain working capital, even in support of confirmed export orders from abroad."⁶ This is reflected in the approach taken in the development of the Orderly and Effective insolvency model, clearly applying the cost function approach:

The Principles and Guidelines highlight the relationship between the cost and flow of credit (including secured credit) and the laws and institutions that recognize and enforce credit agreements (sections 1 and 2)... The ability of financial institutions to adopt effective credit practices to resolve or liquidate non-performing loans depends on having reliable and predictable legal mechanisms that provide a means for more accurately pricing recovery and enforcement costs... uncertainty about the enforceability of contractual rights increases the

⁵ See Malinvaud E, *Lectures on Microeconomic Theory*, tr. Silvey A, North-Holland Publishing (London: 1972), p64-68, for a description of the cost-function.

⁶ Radalet S and Sachs J (2000), p116

cost of credit to compensate for the increased risk of non-performance or, in severe cases, leads to credit tightening.⁷

So the Orderly and Effective model reflects this common theory of insolvency that higher cost of credit = lower availability of credit = higher levels of business failure. The direction of causality is not one-way. These factors are interrelated as increased business failure can in turn increase the risk of lending and put pressure on credit availability and cost. This leads to a focus on reducing the cost of credit (either through, for example, base interest rate cuts or seeking to remove market failures to increase Pareto optimality), although it must leave the Bank of England feeling like it is trying to steer a speedboat with an oar.

The purpose of this chapter is to illustrate that there is no straightforward relationship between cost of credit and business failure. This does not mean that the MPC is wrong to lower interest rates, or that lowering interest rates cannot sometimes improve business survival. Nor does it mean that there is no relationship, or that there are not times when reducing the cost of credit will reduce business failure. Rather, the point is that applying a simple cost model to credit in order to justify greater marketization of insolvency law is dangerously unempirical. There are clear occasions where enforcing absolute priority and encouraging pure insolvency efficiency will reduce creditor returns.

⁷ World Bank (2001), p3-4

4.2 AN EXAMPLE OF APPLIED INSOLVENCY EFFICIENCY: THE BROGI/SANTELLA MODEL

In 2003 Riccardo Brogi of the Italian Bankers' Association, and Paulo Santella of Banca d'Italia and the OECD, presented a study to the annual conference of the European Association of Law and Economics that proposed two empirical models for evaluating the efficiency of bankruptcy and creditor protection legislation.⁸ These two models, intended to be complementary, focused on length of insolvency procedures, the recovery rate of banks in the event of insolvency, and how this impacted on the differential cost of credit. The work represented an ambitious effort to demonstrate how the relationship between insolvency workouts and cost of credit could be measured, but makes the fatal mistake of confusing a logically consistent model with a proof.

They begin by suggesting that costs in insolvency can be divided into direct costs, the measurable expenses associated with the bankruptcy procedure, such as legal and administrative costs, and indirect costs, which are considered unmeasurable and include lost sales, decline in value of inventory, or poorer business performance due to insolvency procedures.⁹ Other work has been done to explore the impact of direct costs of insolvency, for example adjusting net returns from proceedings by reducing realised asset value by a combination of practitioner remuneration and costs and fees of realisation¹⁰, but direct and indirect costs are inevitably interrelated. An example is that paying for a more experienced administrator may result in higher returns from asset sales. There is also an element of the straw man in the notion that there is a hard line between measurable and unmeasurable costs. Maintaining

⁸ Brogi R and Santella P, "Two New Measures of Bankruptcy Efficiency", The European Money and Finance Forum, Vienna: SUERF (*SEURF Studies: 2004/6*) (2004), found at <http://suerf.org/download/studies/study20046.pdf> (accessed 30 Nov 2012)

⁹ *Ibid*, p29

¹⁰ Armour J, Hsu A, Walters A (2008), p167

the measurability of legal costs was part of the argument for restricting COMI (Centre of Main Interest) migration in *Re Daisytek*¹¹, and insolvency professionals are regularly involved in measuring these un-measurable indirect costs. Lopucki and Doherty provide an excellent summary of how this is done, even though they observe that this sort of valuation is occasionally referred to as “guess compounded by an estimate.”¹² Yet the distinction made by Brogi and Santella is important because it allows them to highlight that measuring the costs of insolvency is exceptionally problematic, which is used to justify why their models are intended to circumvent this issue.

In the first of their models Brogi and Santella broadly categorise national regimes according to degree of creditor’s protection and length of proceedings. The UK, as governed by the Insolvency Act 1986, is described as “low cost”, and France, governed by the *loi* 1985 is considered “average-high” cost, down from “high” prior to the modifications to the process made in 1994.

	Brogi and Santella ¹³			La Porta et al ¹⁴
Country	Bankruptcy Procedure Length (months)	Average Length of Civil Procedures (months)	Legal Costs for Creditors	Creditor Rights Ratings (0 low 4 high)
Sweden	12	48	Low	2
UK	<1 year	52	Low	4

¹¹ Re Daisytek-ISA Ltd & Ors [2003] BCC 562,p567, citing Virgos-Schmidt report on the Convention on Insolvency Proceedings.

¹² Lopucki LM and Doherty JW (2007), p8, preceded by a useful summary of methods used to evaluate the value of a failing business.

¹³ Brogi R and Santella P (2004), p28

¹⁴ La Porta R, Lopez-de Silanes F, Shleifer A, Vishny RW (1998), p1136-1137

Germany	12/27	50	Low (Average-Low)	3
France	24-36	89	High (Average-High)	0
Italy	72	116	High	2

Essentially they have made a list of five countries according to average length of insolvency proceedings, alongside their assessment of the legal cost to creditors (which appears to correlate positively with the length of proceedings). This is used as the basis of the argument that longer proceedings weaken creditors and returns to creditors, and thus “every legislator should give directive powers to creditors in bankruptcy”¹⁵ in order to improve insolvency efficiency. It should be noted that when we compare Brogi and Santella’s hierarchy with La Porta et al’s (1998) system of creditor rights rating, as in the above table, there does not appear to be much correlation (although it is hard to say with only five countries). Their categorisation is principally a precursor to their second model, where they justify why focusing on length of procedure and banking returns enables to most effectively evaluate the impact of insolvency regulation.

As businesses fund their operations through a combination of equity and credit, then the efficiency of a regulatory framework will be reflected in the cost of credit:

Any insolvency system brings about losses to all creditors involved in a bankruptcy event. If attention is paid to banks – as main financial creditors – [it] can be maintained that granting loans to firms which probably will default results in higher cost due to the bank’s [increased] capital position. In other words, within this scenario any banking industry meet[s] an ‘insolvency-law cost’ in order to comply with safety and soundness in the financial system.

¹⁵ Brogi R and Santella P (2004), p11

The same cost, to the same extent, passes on to the borrower in terms of a greater interest rate.¹⁶

This complements the World Bank principles and guidelines, for example the previously cited observation that “uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of non-performance.”¹⁷ Brogi and Santella suggest that longer insolvency proceedings will result on costs being passed on to consumers. Focusing on the cost of credit as a measure of the efficiency of insolvency regulation allows the analyst to sidestep the problem of measurability of direct and indirect costs.

Brogi and Santella begin by looking at how cumulative recovery changes if they decrease the length of the procedure. Taking their estimate of the average Italian recovery rate of 38 Euro per 100, they apply a zero coupon yield curve to plot how the cumulative recovery rate changes by decreasing the length of the procedure from the Italian average of seven years to six and a half, and three and a half years (the average length of proceedings in other EU countries). A yield curve maps the relationship between the cost of borrowing and the time to maturity of a loan for a given borrower in a given currency (in this case Euros), and is a fairly typical statistical device. From this they determine that the yearly operational costs of banking and the length of the procedure are eroding Italian recoveries by almost 35% to 24.58 Euros, and that successfully reducing the average length of the procedure would increase this recovery to 30.77 Euros.

This is followed by a second sensitivity analysis, this time changing the recovery rate but maintaining a static recovery time of seven years. Sensitivity analysis is the process of determining how the output of a model can be apportioned to different

¹⁶ *Ibid*, p33

¹⁷ World Bank (2001), p4

sources of change in the model: in this case, how much of the variable cost of credit can be assigned to the two factors in our model, the length of the recovery process and the rate of recovery in case of default. Increasing the recovery rate results in an increased Net Present Value of the credit in the event of insolvency. A comparison of these two analyses reveals that recovery rate is a more important factor than length of procedure; “the recovery effect accounts for 71 per cent, while the length effect the remaining 29 per cent.”¹⁸

From these two analyses Brogi and Santella present three models of Italian insolvency: the regime as it was, and two more “virtuous”¹⁹ models. From the Net Present Values of each model we can then determine the respective Loss Given Default.²⁰ Their results are thus clear:

It can be observed that an insolvency law is far from affecting only corporations that have gone bankrupt. This is the proof that the whole Italian economic system suffers from such a regulatory competitive disadvantage. As a result, not only is any virtuous process impeded, but also a vicious circle can be bred by a cumbersome insolvency regulation and by the same token the economic growth of a country can be dwarfed.²¹

... except that their model could only ever produce this result because the reasoning is circular. Brogi and Santella describe this model as a proof but it is derived from only two significant data points: the recovery rate (which itself is an estimate) and the length of procedure in Italy. Although the zero-coupon yield curve is applied through historical data, the use of a record of changes in economic cost implies into the model a relationship between our principle variables and cost of credit. The rest of the data is similarly extrapolated from a statistical model.

¹⁸ Brogi R and Santella P (2004), p41

¹⁹ *Ibid*, p39

²⁰ Loss Given Default = 1 – Net Present Value

²¹ Brogi R and Santella P (2004), p42

Their models are an excellent exposition of an ideological position, but they do not solve the problem of how to measure insolvency costs because it is only a model and not a proof. They may be right. The median length of proceedings in the UK is 1.45 years, compared to 2.15 years in the US, 3.05 years in France, which appears to correlate inversely with La Porta et al's (1998) creditor rights scores²² until you notice that the average in Germany (creditor rights score of 3) is 3.82 years.²³ The IMF observes that:

Delays in court's adjudication can have an adverse effect on the value of the assets or the viability of the enterprise. It is therefore critical that procedures be put in place that ensures that hearings can be held quickly and that decisions are rendered soon thereafter. Similarly, it is critical that an accelerated appeal process be available.²⁴

The important distinction is between delay and duration. Not all activity that takes time is a waste of time. Specialist courts are more cumbersome than kangaroo courts. It is reasonable to suspect that long duration is likely to correlate with long delay, but more evidence would be required to prove that. One of the most significant changes that appears to have occurred with the introduction of the Enterprise Act is a reduction of the duration of insolvency proceedings. In Frisby's outcomes investigation of 2004 while most receiverships lasted between 323-793 days (558 on average), most administrations took between 206-548 (an average of 377 days compared to 558 for receivership).²⁵ Furthermore, pre-Enterprise Act administrations lasted an average of 438 days whilst post the act the average was 348.²⁶ This leads Frisby to the following observation about the impact on costs:

It is worth noting that expedition is not an end in itself, and one would hope to find that the shorter average time spent in administration will bring with it a commensurate reduction in

²² La Porta R, Lopez-de Silanes F, Shleifer A, Vishny RW (1998), p1136-1137

²³ Davydenko SA and Franks JR (2008) , p581

²⁴ IMF (1999), 5 – Institutions and Participants, p50-51

²⁵ Frisby S (2006), p25

²⁶ *Ibid*

the level of costs incurred and payable in priority to both unsecured, preferential and floating charge creditors. This outcome is not, of course, a foregone conclusion, as there will inevitably be cases where the automatic end date will simply mean that the company moves from administration into CVL, and a new generation of costs will be incurred from that time. There should perhaps, therefore, be research into the overall length of the two procedures before any concrete conclusions as to reductions in costs are proffered.²⁷

All other things being equal, a shorter procedure means lower costs but all things are rarely equal. A shorter duration is not going to improve returns if it means administrations being prematurely terminated. The reduction in the length of administrations may also be due to a change of culture in the banking sector with a view to earlier intervention and business 'intensive care.' Research explored in Chapter 2 found that the new administration costs incurred higher direct costs than receivership.²⁸ Could the increased complexity and cost be placing an upward pressure on the length of proceedings that is being disguised by changes in culture and the introduction of a default time limit? A significant expansion of the outcomes research, particularly one that allowed time series analysis over an extended period, would help answer these questions. For the time being it is essential to appreciate that a reduced length of procedure cannot reliably be taken to indicate a more virtuous insolvency system.

²⁷ *Ibid*, p31

²⁸ Armour J, Hsu A, Walters A (2006), p30

4.3 CAN THE ASSUMPTION THAT CHEAP CREDIT SAVES BUSINESSES BE RELIED UPON?

Insolvency costs were to be reduced in order to lower the cost of credit, which in turn would reduce the rate of business failure. The Brogi and Santella model illustrates some of the difficulties of confusing an ideological model with an empirical proof. This raises the question: how certain is it that lower interest rates reduce business failure?

Let us take figures for total number of liquidations by quarter²⁹ and base Bank of England interest rates by quarter³⁰, and perform a regression analysis: in this form, this is a simple descriptive technique to see whether there is any obvious correlation between the two.

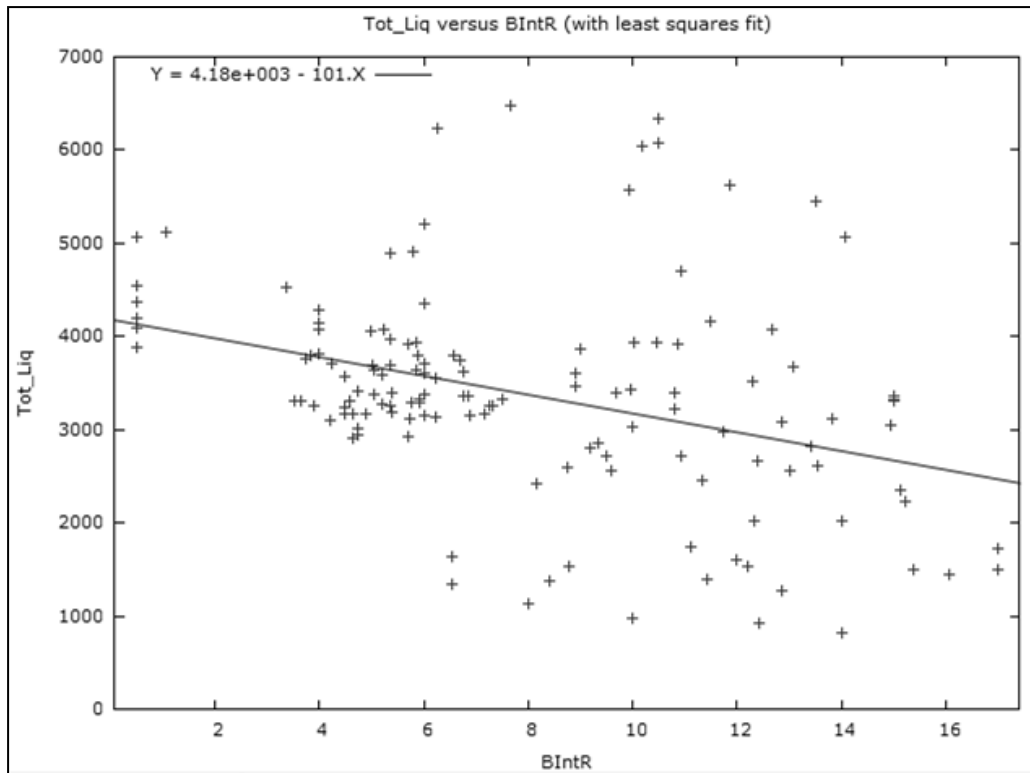
```
Model 4: OLS estimates using the 136 observations 1977:1-2010:4
Dependent variable: Tot_Liq
```

VARIABLE	COEFFICIENT	STDERROR	T STAT	P-VALUE
const	4181.34	202.799	20.618	<0.00001 ***
BIntR	-100.812	22.6419	-4.452	0.00002 ***

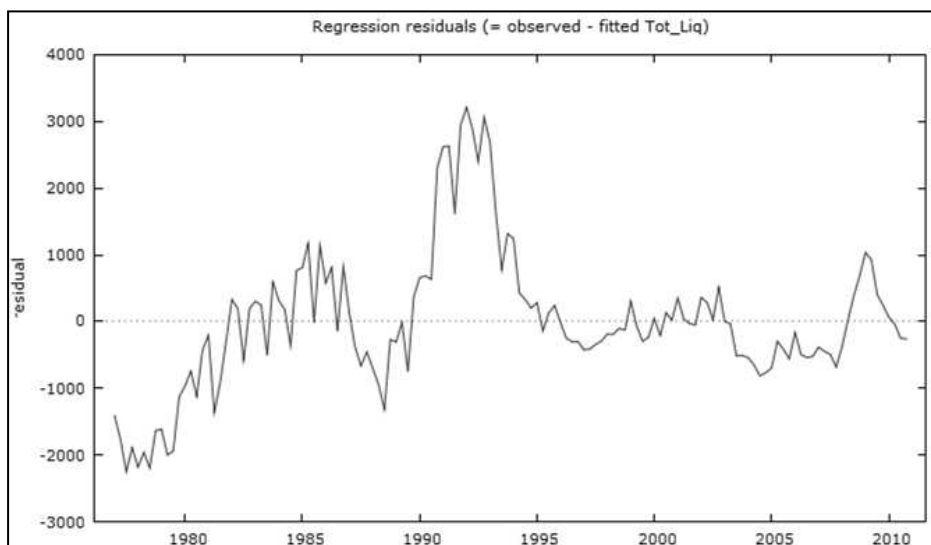
Mean of dependent variable = 3373.18
Standard deviation of dep. var. = 1125.98
Sum of squared residuals = 1.491e+008
Standard error of residuals = 1054.84
Unadjusted R-squared = 0.12888
Adjusted R-squared = 0.12237

²⁹ Insolvency Service, <http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201108/index.htm#tables> (accessed 6 Oct 2011)

³⁰ Bank of England, <http://www.bankofengland.co.uk/statistics/index.htm>, (Accessed 28 July 2011)

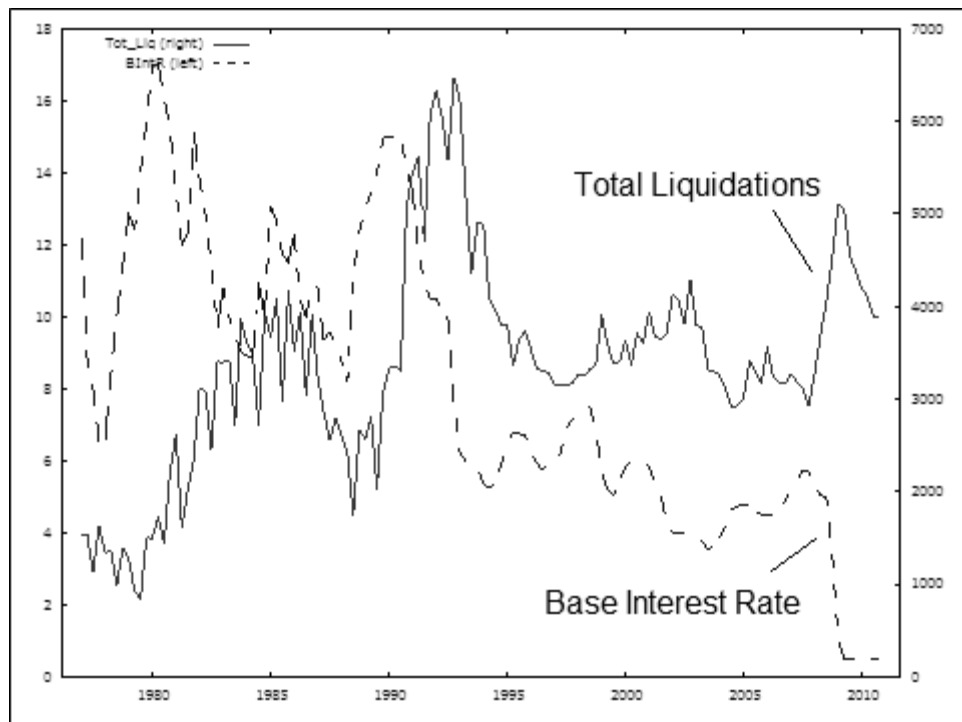


An OLS analysis shows a significant (P Value <0.00002) negative relationship between base interest rates and corporate insolvency where changes in base interest rate explain (unadjusted r^2) 13% of the change in numbers of corporate liquidations. This is the exact opposite of our hypothesis, which taken at face value suggests that reducing interest rates increases levels of failure. However, plotting the residuals over time (dispersions from the line of best fit) reveals some interesting spikes:



The relationship becomes less reliable (the residuals diverge further from the central line) during the three major recessions of our sample period (the oil shock in the late 1970s, the withdrawal from the ERM in the early nineties, and the current crisis beginning in 2008). This suggests that base interest rates are less influential over business failure during recessions. Given that promoting Orderly and Effective insolvency stems from a desire to reform insolvency law during financial crisis, this is disconcerting.

Another valuable observation can be seen if we simply plot interest rates against corporate liquidations:



There is negative trend in interest rates, which may be reflective of the shift in policy from full unemployment to inflation targeting³¹, and a positive trend in corporate failure that may simply be explained by an increase in the number of companies in the country since 1977 (and therefore more companies available to fail). This might

³¹ Blanchard O (2009), p565

make it more reasonable to measure corporate insolvencies as a proportion of active companies, and certainly that would give a better idea of the impact of insolvency as a whole. The problem is that even if the data were available knowing the proportion of companies failing over companies surviving would only be of limited use because it does not describe the size or form of the companies. Walters and Frisby experienced a similar issue with their CVA report:

The Company Register Statistics provides information on the number of companies registered at Companies House and, further, how many of these are public companies. There does not, however, appear to be any statistical analysis of companies according to their size. The statistics for November 2010 indicate that in England and Wales of all the active companies on the register 9,543, out of a total of 2,463,862, were public companies. The DTI Report on Companies for 2005- 2006 provides a number of different analyses of Companies House data but, again and regrettably, not specifically on the size of companies on the register.³²

Ultimately the most significant feature of the underlying regression analysis of the relationship between cost of credit and numbers of corporate insolvencies are the noise and the large and significant constant, strongly suggesting other important factors influencing business failure. In fact, the more detailed the examination of the why and when businesses fail the more the relationship between credit and failure becomes unreliable. Consider, for example, the “blip”³³ in levels of receiverships and at the end of 2004 which has been associated with an attempt to take advantage of the abolition of crown preference, or the impact of the business payment support scheme appearing to reducing corporate insolvencies resulting from the recent crisis such that “a movement out of recession will not necessarily be accompanied by a drop in the level of corporate insolvency.”³⁴ Interest rates are a clumsy tool at best

³² Walters and Frisby (2011), p9

³³ Katz A and Mumford M (2006), p13

³⁴ Frisby S (2011), p357

for influencing business failure because it is not a central driver of what causes business to fail.

In statistical analysis this is known as 'omitted variable bias.' The picture is limited or even distorted by data that has not been considered or to which there is no access. Organisations like the Department for Business Information and Skills (BIS) and Companies House are making increasing efforts to gather and categorise data but the picture is incomplete and the time frames limited. The pioneering insolvency outcomes research explored in Chapters 2 and 3 struggles against similar problems; limited information on positions and classes of creditors, and on secured creditors generally³⁵, a database of insolvency procedures where in almost half of the cases returns to secured creditors went unrecorded³⁶ (leading Frisby to complain of "the paucity of available data on levels of return"³⁷), and a record of CVAs where "it was not possible to estimate the proportion of unsecured debt that was owed to HMRC in the cases on the database."³⁸ Even if full data sets had been available the fact that the work is the first of its kind means that it can only provide a "snapshot".³⁹ There is no way of being certain whether 2004 was an unusual year for administrations with repeating the study in following years, and good reason to suspect it might have been, being so close to the reforms in the law. What is needed is "a rolling evaluation programme [which] will give a better idea of the true impact of the Enterprise Act into the future."⁴⁰ Only when there is sufficient consistently gathered data to conduct proper time series analysis will a clearer picture of the relationships begin to emerge.

³⁵ Walters A and Frisby S (2011), p20

³⁶ Frisby S (2006), p44

³⁷ Frisby S (2006), p54

³⁸ Walters A and Frisby S (2011), p23

³⁹ Frisby S (2006), p44

⁴⁰ Frisby S (2006), p82

The Bank of England Lending Committee, established in 2007 in response to the burgeoning financial crisis, now publishes information on aggregate lending.⁴¹ The data set is too small for the sort of time-series analysis required, and impossible to correlate with base interest rates as the entire data-set occurs during a period of record low rates. Actual costs and quantities of lending are carefully guarded pieces of proprietary information, for obvious reasons. Davydenko and Franks, whose access to proprietary banking data facilitates their production of high quality statistical analysis, have concluded that lending practices are adjusted to “mitigate costly aspects of bankruptcy law [but] bank recovery rates in default remain sharply different.”⁴² The relationship between credit and failure is too complex to render with ideological purity. There are important empirical studies that show the importance of cost of credit to business success, for example de Mel, McKenzie and Woodruff’s studies showing 10% increases in Sri-Lankan microenterprises when one-off grants were made available.⁴³ The reliability of this study rests in its scale and refusal to extrapolate from the micro to the macro. Common sense models are a false friend, particularly when you apply grand theories to small amounts of data. Writing in 2004 Frisby observed that “there is little in the way of empirical evidence on the outcomes of insolvency procedures in general... one might question whether the conduct of such should have preceded a review of the law.”⁴⁴ It is extraordinary to think that two large scale revisions of insolvency law, the acts of 1986 and 2002, were performed without quantitative exploration of how insolvency procedures were actually being used. Part of the problem is the attraction to the uniform application grandiose economic theories. The regression analysis I performed simply

⁴¹ See <http://www.bankofengland.co.uk/publications/other/monetary/trendsinsending.htm> (accessed 10 Oct 2011)

⁴² Davydenko SA and Franks JR (2008), p565

⁴³ de Mel S, McKenzie D, Woodruff C, “One-Time Transfers of Cash or Capital Have Long-Lasting Effects on Microenterprises in Sri Lanka”, *Science* 335 (2012) 962-966

⁴⁴ Frisby S (2004), p253

to describe what has happened in terms of interest rates and liquidation levels was made in the expectation that no particular relationship would emerge. What happened was something much more dangerous. At first glance there appears to be a situation where cheaper credit actually increases rates of failure. It would not be difficult to move from here, supported by evidence that will be explored in the next section of the potential dangers of cheap credit, to argue that increased profit to lenders from higher base cost of lending reduced the need to screen firms and therefore led to economically unviable firms receiving funding and ultimately to more corporate failure. There may even be something to this reasoning, but the essential problem is that there simply is not enough in the crude statistical analysis I performed to support this. I would be making the same error as those claiming cheaper base cost of credit will reduce levels of corporate insolvency by treating a model as a proof, and scattering a little empiricism only as seasoning. As Warren observed, “we should get about the business of asking harder questions, looking for better evidence, and approximating better answers.”⁴⁵ The better approach is to work from the smaller scale, to look directly at the evidence from interviews with stakeholders and analysis of actual insolvency outcomes. There is a clear need for both more detailed record keeping by insolvency practitioners and company house, and an expansion of the insolvency outcome work done to date.

⁴⁵ Warren E (1987), p814

4.4 THE TENSION BETWEEN RESCUE AND LIQUIDATION RETURNS

There is evidently a relationship between regulation of insolvency, the cost and availability of credit, and the levels of business failure. Most likely there are multiple relationships. Cost of credit for the demander is also clearly related to the profitability of credit for the supplier. The contractualist model argues that maximum social welfare through effective insolvency law is achieved through absolute priority for secured creditors, thereby increasing returns for secured creditors and thus availability of credit. Regulation of insolvency beyond mandatory structural rules is therefore considered an impediment to achieving maximum social welfare. This chapter has been exploring some of the limits of this applying this approach as a general rule, largely focusing on its circularity and its unempirical foundation. The relationship between credit and business failure is not straightforward, and difficult to quantify. There have, however, been a number of empirical works exploring the operation of credit in specific markets, especially as statistical techniques and the supporting information technology have improved in recent years. Stronger protection of security has been associated with a reduction in the cost of credit. But, what is the nature of this relationship?

In 2009 Benmelech and Bergmen sought to test the relationship between collateral and the availability of credit, in particular:

Theories based on borrower moral hazard and limited pledgeable income predict that collateral increases the availability of credit and reduces its price by limiting the downside risk born by creditors. [This is because] upon default, creditors can obtain at least a portion of the return on their investment through the repossession and liquidation of pledged collateral.⁴⁶

⁴⁶ Benmelech E and Bergman BK, "Collateral Pricing", *Journal of Financial Economics* 91 (2009) 339-360, 358

They did this with an industry specific study of US airlines, finding that redeployable capital does indeed lower the cost of financing and increase debt capacity. The advantage of the single market study is it produces more accurate results, but the disadvantage is that it is difficult to separate from its context. These results emerge in the context of one of the world's most debtor friendly regimes. It is good evidence, as they state, that creditors must be able to recover at least a portion of their investment and that increasing this proportion most likely increases the willingness to lend, but is it possible to be more precise about what is required to encourage collateral lending?

Bae and Goyal's cross country analysis of legal protection of bank loans on the size, maturity and interest rate spread loan attempts to do this, and finds the consistent result that banks respond to poor debt enforcement by reducing loan amounts, shortening loan maturities, and increasing loan spreads.⁴⁷ What makes Bae and Goyal's study particularly interesting is that, as well as applying the typical LLPV creditors' rights scale⁴⁸(automatic stays, creditor consent for reorganisation, secured creditor priority and replacement of debtor management), they measure for a scheme of property rights concerns issues like corruption, and risk of expropriation or of contract repudiation. They find that while both have a significant positive relationship with willingness to lend, property rights are much more important than creditor rights, leading them to suggest that size restrictions and reluctance to lend are principally driven by uncertain legal environments.⁴⁹ This is reminiscent of the IMF's point about the relative importance of efficiency and creditor friendliness, discussed in Chapter 3.1 and repeated here:

⁴⁷ Bae K and Goyal VK "Creditor Rights, Enforcement, and Bank Loans", *Journal of Finance* 64(2) (2009) 823-860

⁴⁸ From, La Porta R, Lopez-de Silanes F, Shleifer A, Vishny RW, "Law and Finance", *Journal of Political Economy* 106 (1998) 1113-1155, discussed in Chapter 3.1 and the bedrock measure for creditor friendliness.

⁴⁹ Bae K and Goyal VK(2009), p842

The degree to which an insolvency law is perceived as pro-creditor or pro-debtor is, in the final analysis, less important than the extent to which these rules are effectively implemented by a strong institutional infrastructure... effective implementation requires judges and administrators that are efficient, ethical, and adequately trained in commercial and financial matters and in the specific legal issues raised by insolvency proceedings. A pro-debtor law that is applied effectively and consistently will engender greater confidence in financial markets than an unpredictable pro-creditor law.⁵⁰

When insolvency laws are revised they are likely to impact both open property rights generally and creditor friendliness particularly, making it difficult to ascertain which parts are having what impact. This helps explain the results of Djankov et al's⁵¹ work on specialists courts, first discussed in Chapter 3.3, where they found that whilst rich countries' expensive rescue procedures produce an aggregate improvement in creditor returns, middle and low income countries that attempt to mimic their success end up with a more expensive liquidation process:

This suggests that, for small and medium firms, poor countries should avoid debt enforcement mechanisms that involve detailed and extensive court oversight since the administrative capacity of their courts may not tolerate such proceedings. Simpler mechanisms, such as foreclosure with no or limited court oversight and floating charge, which essentially transfer control of the firm to the secured creditor, might be preferred.⁵²

Measures that improve creditor inclusivity and are designed to improve co-operation towards rescue outcomes are of no use if the court cannot be relied upon to provide objective rulings or enforce legal contracts. This helps explain some of the other important results regarding improvements in national insolvency regimes and their relationship to lending post the publication and implementation of the Orderly and Effective guidelines. Haselmann, Pistor and Vikrant's study of lending in transitional

⁵⁰ IMF (1999), 1 - Introduction, p6

⁵¹ Djankov S, Hart O, McLiesh C and Shliefer A (2008)

⁵² *Ibid*, p1147

economies, the very countries intended to benefit from the IMF guidelines, found that the level of formal creditor rights protection is positively associated with the lending volume.⁵³ While they link this to problems of collective enforcement rising from co-ordination failures, the critical factor is the existence in the first place of a strong collateral regime.⁵⁴ The ability to reliably pledge assets at all is the most important determinant of credit supply and a pre-requisite for other creditor friendly measures to have any affect at all.

Similarly, Rodano et al's analysis of data sets during 2005-2006 Italian bankruptcy law reform found that introduction of the reorganisation procedure increased interest rates on loan financing, and that reform accelerating liquidation procedures both decreased firms cost of finance and also relaxed creditor constraints.⁵⁵ They argue that their results show rescue measures are substantially less efficient than improved liquidation procedures, because the "worse repayment incentives outweigh efficiency gains from improved creditor co-ordination."⁵⁶ There are a number of issues with using this result to draw conclusions about the relative value of rescue and liquidation. The first is that although the changes to the law were introduced in a staggered fashion, with the rescue regime introduced in 2005 and liquidation scheme in 2006, the extent to which this truly allows their impacts to be measured separately is debatable. Reorganisations take time. It is unlikely that many reorganisations begun after the introduction of the 2005 law were finished before the introduction of the 2006 law. There are transition costs with the introduction of a new system, and it is unreasonable to players to have a great deal of confidence in a new system just as it is being introduced. The benefits of a new rescue system will

⁵³ Haselmann R, Pistor K, Vikrant V, "How Law Effects Lending", *The Review of Financial Studies*, 23(2) (2010) 549-580, p550

⁵⁴ *Ibid*, p551

⁵⁵ Rodano G, Serrano-Valde N, Tarantino E, "The Causal Effect of Bankruptcy Law on the Cost of Finance", *Job Market Paper* (October 2011) found at <http://ssrn.com/abstract=1967485>

⁵⁶ *Ibid*, p1

only emerge once it is established and having a positive impact on rescue returns (something which is by no means certain to occur, explaining entirely rational hesitancy by financial institutions). Meanwhile, improved secured creditor returns in liquidation are likely to have a much more immediate effect. The liquidation procedure introduced by Italy in 2006 is equally no paragon of pure insolvency efficiency. It introduces a creditor committee, with powers to control the process and veto the continuation of the firm's activity along with the power to suspend the liquidation phase if it approves a settlement agreement proposed "by the same creditors, the trustee, a third party, or the debtor."⁵⁷ This improves creditor control but has more in common with a CVA than a pure liquidation measure, and it would be very interesting to study insolvency outcomes from this new system to determine if calling the rose by another name has had an impact on its scent.

More important than this window is the truly dysfunctional state of Italian insolvency. This is perhaps part of the reason why analysts of Italian insolvency, like Rodano et al here and Brogi and Santella earlier, are so prepared to entertain radical efficiency based solutions. Prior to the 2005 introduction of a new reorganisation procedure the main instrument for firms in distress was liquidation – only 1% used the reorganisation system. This increased from 1% to 10% of total procedures in 2009.⁵⁸ In 1998 La Porta et al scored Italy at 2 out of 4 on the creditor rights scale, and much more importantly with an efficiency of only 6.75 – in the company of nations like Egypt and Peru, below Sri Lanka and Nigeria.⁵⁹ Rodano et al use their results to take the leap to the conclusion that granting a second chance to an entrepreneur in distress will translate into lower incentives for that entrepreneur to

⁵⁷ Rodano G, Serrano-Valde N, Tarantino E (2011), p7

⁵⁸ *Ibid*, p9

⁵⁹ Efficiency of judicial system evaluated by La Porta et al under their rule of law scalings, La Porta R, Lopez-de-Silanes F, Shleifer A and Vishny RW (1998), p1142-1143

behave with care.⁶⁰ It is submitted that their work is a better example of Djankov et al's point that middle income nations with poor legal infrastructures are not able to implement effective rescue procedures, and are better advised to concentrate on improving their foreclosure and collateral enforcement systems until their infrastructure is capable of inspiring the confidence required for rescue.

This also helps explain some of the apparent anomalies that emerge from the creditor/debtor friendly analysis when we examine countries that do have effective infrastructures. Davydenko and Franks identify the United States as having a recovery rate of 70%⁶¹, which alongside higher than expected levels of delistings and fewer acquisitions does not fit comfortably with its reputation as a debtor-friendly jurisdiction.⁶² The creditor friendly United Kingdom has a higher proportion of going-concern reorganisations than debtor friendly France⁶³, and the instances of liquidation in the UK (42.9%) are lower than Germany (56.9%) or France (62.0%)⁶⁴, directly contradicting classical association between creditor control and less frequent use of acquisitions/greater use of liquidation.⁶⁵

Once countries have developed effective infrastructure then the meaning of creditor friendliness becomes more complex. Absolute priority is not optimal because it interferes with rescue, and effective rescue systems grant substantially greater aggregate returns. Bae and Goyal explain how a tension begins to emerge between security and returns:

loan securitization (as well as the growth of loan sales and syndication) fosters financial integration and investor diversification. Integration allows capital to flow between markets, dampening the consequences of shocks to local banks and other lenders. Diversification

⁶⁰ Rodano G, Serrano-Valde N, Tarantino E (2011), p35

⁶¹ Davydenko SA and Franks JR (2008), p581

⁶² Dahiya S and Klapper L (2007), p277

⁶³ Davydenko SA and Franks JR (2008), p567

⁶⁴ *Ibid*, p576

⁶⁵ Dahiya S and Klapper L (2007), p276

facilitates risk sharing and risk management. But both have downsides. With integration, collateral shocks like the recent drop in real estate values in the United States and United Kingdom spread rapidly across the financial system. Diversification may weaken incentives for investors to engage in proper due diligence and credit evaluation.⁶⁶

There is an underlying tension between best chance of rescue returns (recalling that higher probability of viable rescue results in higher rescue returns in the aggregate), and returns achieved through liquidation (as the costs of investigating viability and attempting rescue reduce the size of the pot in the event of failure followed by liquidation). Investment is not simply a battle to lower costs but more generally for greater value. Lower costs can be a part of that, but it is not the entirety. As every employer knows who has sought a healthy, educated workforce, or a place of business not subject to military attack or state seizure, or a bank which is unlikely to suddenly collapse or suffer a run without state intervention, governments can and do provide 'good' externalities which increase the value of an investment:

Regulations which further the public interest will not necessarily impose net private costs on firms. In particular, regulations that seek to correct a market failure, if they work effectively, may result in a net *benefit* to the firms that comply. This will be felt through the price mechanism of the market in question.⁶⁷

Houston et al⁶⁸ have empirically demonstrated a tension between successful rescue and returns to secured creditors in liquidation: achieving higher returns in rescue places a downward pressure on returns in liquidation. The reason for this is that every attempt at rescue impose expenses that reduce the size of the pool in the event that the enterprise is ultimately liquidated. However, the evidence suggests that "a larger probability of default does not mean that the lenders' ex-post losses are greater. With the greater probability of default but greater protection (e.g.

⁶⁶Bae K and Goyal VK(2009), p887

⁶⁷ Armour J (2005), p377

⁶⁸ Houston JF, Lin C, Lin P and Ma Y (2010), 485-512

smaller losses) in the case of default, *lenders' actually losses may either rise or fall.*"⁶⁹ This also implies that a lesser probability of default does not mean the ex-post losses are smaller either. In turn, "across all specifications, stronger creditor rights are correlated with a greater likelihood of financial crisis"⁷⁰, which is related directly to the point Bae and Goyal made about the impact of security on risk management. Davydenko and Franks observe that "banks may respond to poor creditor protection by screening and monitoring borrowers more carefully at loan origination"⁷¹, a hypothesis that was supported in the work of Djankov, McLiesh and Shleifer⁷². Empirical data emerging from studies of reforms in Asia support this by suggesting that this is true in both directions, as greater creditor security leads to less scrutiny:

With improved creditor rights (CR) protection, the losses of the creditor in the state of default decrease. Thus, the marginal benefit of monitoring necessarily declines, implying a lower equilibrium level of monitoring effort by the creditor, and a greater probability of default. This reduction in monitoring is a response by a rational lender to a favourable change in the legal environment which leads to greater protection to the lender should the borrower default.⁷³

Increased security reduces the marginal benefit of screening.⁷⁴ Screening and rescue are both expensive. Lenders may be able to undercut their more responsible colleagues by avoiding screening and taking the chance that the increased probability of failure will not outweigh the reduced costs. They are prepared to do this because the increased security in the insolvency regime has passed the costs of their risk taking on to the other creditors of the insolvent firm. Greater risk taking over time, however, leads to greater failure, and in the long term this sort of behaviour damages the whole market. The reason why the financial sector is prepared to

⁶⁹ Houston JF, Lin C, Lin P and Ma Y (2010), p489, emphasis added.

⁷⁰ *Ibid*, p505

⁷¹ Davydenko SA and Franks JR(2008), p572

⁷² Djankov S, McLiesh C, Shleifer A, "Private Credit in 129 Countries", *Journal of Financial Economics* 84 (2) (2007) 299-329

⁷³ Houston JF, Lin C, Lin P and Ma Y (2010), p489

⁷⁴ *Ibid*

engage in normative management of behaviour, and support law that restricts the ability to avoid the costs of screening, is because it protects the industry from this sort of hit-and-run banking. Developments reflecting this in the UK market and the industry's responses are explored in Chapter 5. Excessive secured creditor priority weakens the connection between stronger creditor rights and the reduced likelihood of systemic crisis⁷⁵, and reducing the risk of systemic crisis is an important part of insolvency law's "major role in strengthening a country's economic and financial system."⁷⁶ Enhanced returns in liquidation can actually have a negative impact on the level of creditor rights in a regime because they distance creditors from the costs of their own activities, and somewhat counter-intuitively they reduce creditor control by trapping them in a race to the bottom.

Stronger creditor rights are associated with higher growth,⁷⁷ but taken too far this growth is like the bubbles at the peaks of the cycle of boom and bust: "the 'dark' side of greater risk taking is that it significantly increases the likelihood of financial crisis."⁷⁸ Financial crisis not only results in a greater number of businesses going bust, and a reduced chance of going-concern sale, but even if the only interest is immediate security returns it is found that attached assets are worth less in a recession. This goes a step beyond considering that "swift and efficient liquidation"⁷⁹, where "the first function of bankruptcy is to allow unpaid creditors to seize the insolvent debtor's assets, sell them and invest the proceeds in other venues"⁸⁰, is not the most important feature of a creditor friendly regime.

Excessive creditor rights are not a problem in a regime that does not have adequate infrastructure or property rights. In such situations lenders cannot be insulated from

⁷⁵ Houston JF, Lin C, Lin P and Ma Y (2010), p504

⁷⁶ IMF (1999), Foreword

⁷⁷ Houston JF, Lin C, Lin P and Ma Y (2010), p485

⁷⁸ *Ibid*, p486

⁷⁹ World Bank (2001), p4

⁸⁰ Brogi R and Santella P (2004), p9

risk and need to invest in screening to gain the sort of informational advantages that allow them to compete in the special conditions of the domestic arena.⁸¹ Put bluntly, it is more expensive and more risky to be a hit and run investor in an environment where you need to spend time learning whom to bribe to stay in business. However, in regimes that have overcome these problems, recognising the potentially harmful impact of excessive security demonstrates that if too much emphasis is placed upon protecting rights in liquidation it will actually harm creditor returns in general.

This concern that excessive creditor rights may provoke crisis may seem incongruous with results like those of Acharya et al, who find “stronger creditor rights in bankruptcy affect corporate investment choice by reducing corporate risk taking.”⁸² This really interesting piece of work identifies the way which fear of secured creditor control impinges on firm’s willingness to take investment risks. It fits with the notion that secured credit shifts the risk of investment from the bank to the company. The temptation is to slide into a debate about what constitutes excessive risk or excessive growth, when the crucial concern is to ensure that no party is able to completely divest themselves of the consequences of risk. Acharya et al bring these issues together as follows:

It may well be that stronger creditor rights may induce managers to reduce risk and to stifle even *non-opportunistic* risk taking that would be beneficial to all claimholders... The existence of stronger creditor rights is not always desirable. The optimal level of creditor rights should balance their positive effect on the supply of credit against their negative effect on corporate risk-taking and on operating performance, as well as on the demand for debt.⁸³

⁸¹ This is referred to as informational advantage by Haselmann R, Pistor K and Vivjrant V (2010), p552.

⁸² Acharya VV, Amihud Y and Litov L, “Creditor Rights and Corporate Risk-Taking”, *Journal of Financial Economics* 102 (2011) 150-166, p150

⁸³ *Ibid*, p165

The essential issue is to find a balance between creditor and debtor rights that encourages engaged risk taking from both sides. For many developing insolvency regimes dealing with the intricacies of this balance is an unnecessary luxury, but once an effective infrastructure is in place then the optimal position is not the one described by insolvency efficiency. Some redistributive measures are necessary to prevent the sorts of hit-and-run banking and short-termism that drives the financial sector into a race to the bottom. This is not about legislating for acceptable levels of risk but rather creating systems that allow the invested parties to effectively determine what does or does not constitute a good risk, and that can only be achieved if it ensures that none of them are fully insulated from the decision.

CHAPTER 5: THE POSITIONING OF BANKS AND OTHER INSTITUTIONAL CREDITORS AS STRATEGIC PLAYERS

5.1 OPERATING IN AN OLIGOPOLISTIC CREDIT MARKET

In a series of empirical papers on English corporate insolvency, Franks and Sussman state clearly that “collateral and liquidation rights are highly concentrated in the hands of the main bank.”¹ Banking in the United Kingdom became oligopolistic in response to the recession of the early 1990s, such that “because a few large banks dominate the UK market, centralization of the management of distressed firms may have allowed them to reduce any excess supply of bankrupt assets.”² An oligopoly is “a market that is only supplied by a few firms”³, whose qualifying feature is that these firms act interdependently. Oligopolies have three important consequences for the market.⁴ First, sellers are price makers, so unlike in a perfectly competitive market they have control over prices and can achieve super-normal profits. Second, sellers behave strategically such that decisions are made taking into account the actions and expected actions of the others. Third, entry and exit to the market may be blocked or limited.

Firms that wish to become banks have been subject to a prior approval regime since the Banking Act 1979, and are now licensed under the Financial Services and Markets Act 2000, which involves “giving a body⁵ the power to screen out institutions which

¹ Franks JR and Sussman O (2005), p65

² Davydenko SA and Franks JR (2008), p592

³ Brown V, “Strategic Competition: Conflict and Co-operation”, in Dawson G, Mackintosh M and Anand P (eds), *Economics and Economics Change: Microeconomics* Pearson, (Harlow: 2006),139-167, p140

⁴ See Morgan W, Katz M and Rosen H (2009), p537

⁵ At the time of writing the Financial Services Authority, but when this changes to the Prudential Regulatory Authority it will make no difference to the described impact of licencing on the market structure.

fail to meet minimum standards.”⁶ The unavoidable consequence of limiting the number of suppliers into the market is to limit competition.⁷ Even without the recession or the regulator, it may simply be the case that the natural shape of the banking industry is oligopolistic. Banking is subject to significant economies of scale, most notably cost buffers required to deal with systemic risk, and larger banks enjoy a natural advantage. Therefore collateral and liquidation rights are highly concentrated in the hands of an oligopoly.

In the classic macro-economic model, oligopolies achieve super-normal profits (a term in economics which means profits above cost) by restricting supply in order to push up price⁸. This would mean that an oligopolistic credit market would have a consistent tendency towards tightening credit availability, particularly during a financial crisis where demand for credit increased, in order to maximise profit. This control over pricing severely undermines the use of free market models to analyse insolvency law because insolvency laws are not regulating a free market: changes in underlying costs of credit and even returns from credit have only a secondary impact in relation to the changing strategic relationship between banks. Concerns about the harm to consumers that arises from an oligopoly’s ability to manipulate price through supply have led to encouragement and maintenance of competition being “frequently cited as one of the principal objectives of financial regulation.”⁹

There are, however, advantages to oligopolies. As Hayek famously observed:

If the state of affairs assumed by the theory of perfect competition ever existed, it would not only deprive of their scope all the activities which the verb ‘to compete’ describes but it would make them virtually impossible.... How many devices adopted in ordinary life to that end would still be open to a seller in a market in which so-called ‘perfect competition’ prevails? I

⁶ Cartwright P (2004), p86

⁷ *Ibid*, p106

⁸ See Morgan W, Katz M and Rosen H (2009), p539 onwards for a full explanation.

⁹ Cartwright P (2004), p46

believe that the answer is exactly none. Advertising, undercutting, and improving ('differentiating') the goods or services produced are all excluded by definition – 'perfect' competition means indeed the absence of all competitive activities.¹⁰

Achieving supernormal profits gives the banking industry the capacity to survive systemic shocks by effectively spreading the cost amongst the consumers (a kind of inversed depositor protection scheme), and also the flexibility to innovate and adapt to changing circumstances. Davydenko and Franks observe that the harm of the recession in the 1990s was exacerbated "by lack of coordination within banks"¹¹ because it restricted their ability to dispose of bankrupt assets; the oligopolisation of the market was, in part, a response to this. Institutional creditors are able to operate strategically, which is to say in the aggregate and playing the long game, for example taking losses on individual failures in order to increase their profitability elsewhere. This suggests that banks have a far more important role in the insolvency process than simply being providers of cheap credit, and that the power of the banking sector in the UK may in turn be one of the stronger factors of the English insolvency regime.

5.2 THE CENTRAL ROLE OF BANKS IN THE DECISION TO LIQUIDATE

The IMF recognise that "an insolvency proceeding is a dynamic process. Unlike many other adjudicative proceedings, which involve an inquiry into historical events, an insolvency proceeding takes place in 'real time': delays in a court's adjudication can have an adverse effect on the value of the assets or the viability of the enterprise."¹²

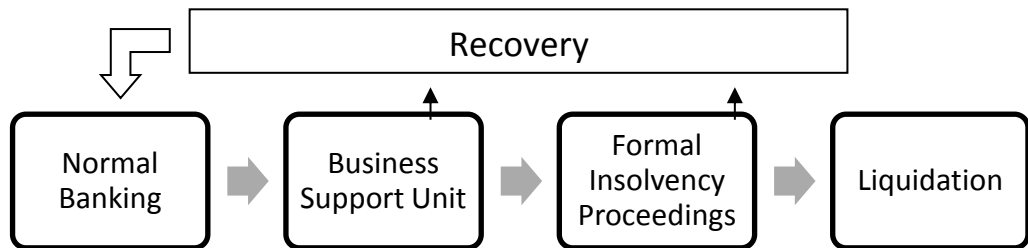
Although they recognise that there is a process, the focus remains on court

¹⁰ Hayek FA (1976), p92, p96

¹¹ Davydenko SA and Franks JR (2008), p592

¹² IMF (1999), 5 – Institutions and Participants, p50-51

adjudication. There is a similar problem in US analysis of insolvency law where the so-called ‘deathbed’ test has stimulated debate because of the fashion in which the focus on imminence of liquidation distorts their evaluation of the business as a going concern.¹³ Focusing on the end is distortive because the insolvency process exists throughout the lifespan of all companies, healthy or otherwise.



If a small or medium size firm breaches the terms of its loan agreement, or the bank’s credit officer determines that high leverage or low profitability indicate poor prospects, the account is transferred to the bank’s ‘Business Support Unit’ (BSU) whose distinct objective is “is to *turn around* the company and send it *back to branch*.”¹⁴ If this fails then it is sent on to a ‘Debt Recovery Unit’ (DRU), or a differently named department with similar function, where formal bankruptcy proceedings begin or the firm will pay off its debts and rebank elsewhere. Rebanking is highly successful (Franks and Sussman find a near 80% survival rate amongst rebanked firms¹⁵), allowing us to safely infer that the BSU/DRU process is effective at distinguishing good firms from bad. A firm only enters insolvency proceedings if not only their current bank, but every other available bank and ABL that they approach rejects them. As Armour and Deakin observe:

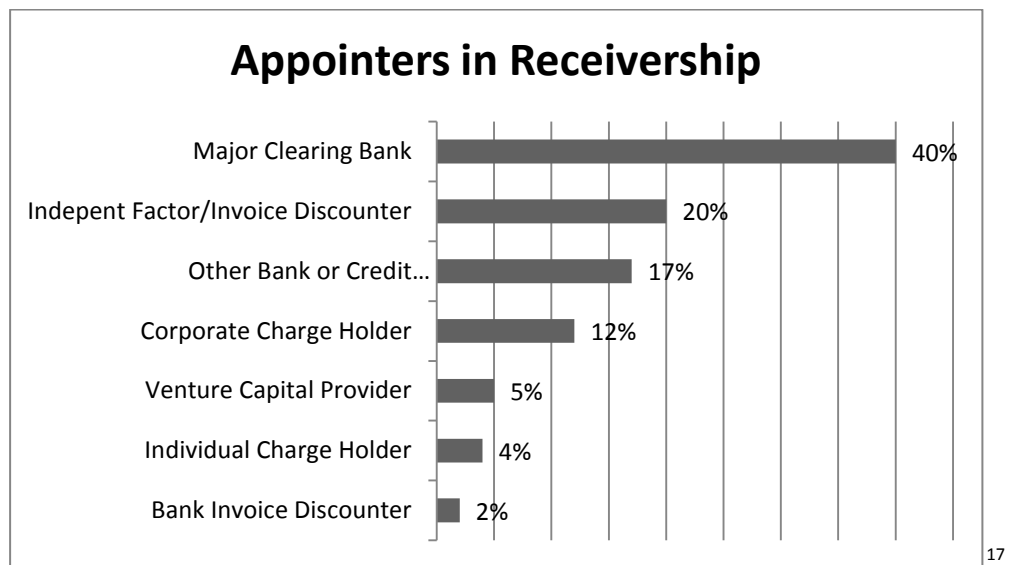
¹³ Bernstein S, Seabury SH and Williams JF, “Squaring Bankruptcy Valuation Practice with Daubert Demands”, *America Bankruptcy Institute Law Review* 16 (2008) 161-265, p184

¹⁴ Franks JR and Sussman O (2005), p74

¹⁵ *Ibid*, p75 footnote 16

Since, under English law, insolvency proceedings may be provoked by a single creditor, we would expect to observe frequent collapse into formal insolvency of large firms. The fact that we do not suggests that non-legal constraints are operating on the parties' behaviour.¹⁶

The important strategic players and the significant drivers in the majority of formal proceedings are the institutional creditors, because they dominate the proceedings that precede formal insolvency proceedings:

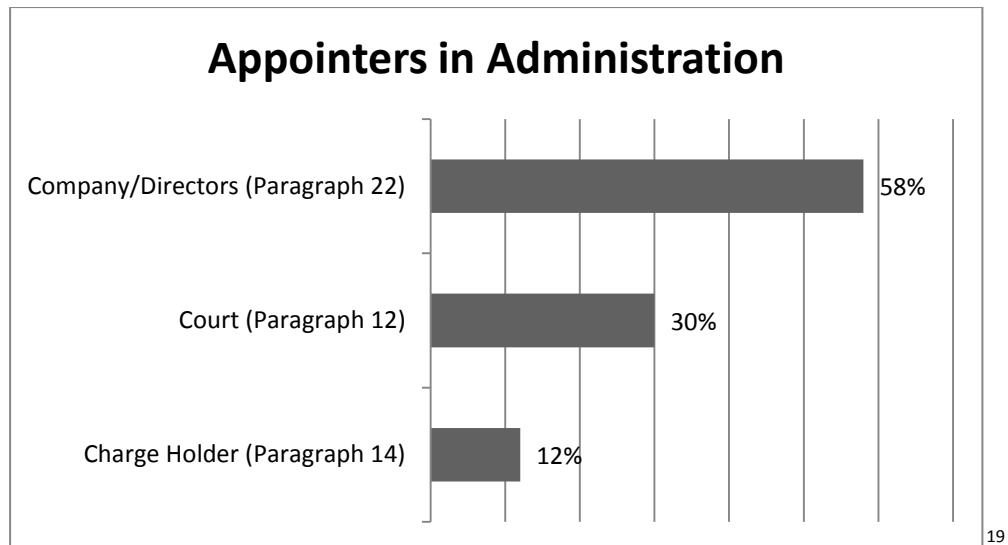


The data on appointment in administrative receivership makes it clear who is steering the ship. Banks appoint nearly 60% of receivers, although the significant role of independent factoring and invoice discounters (another form of institutional creditor) is important and will be discussed momentarily. An individual charge holder is usually (but not always) the director of the company¹⁸, and appoints the receiver only 4% of the time. This should be compared, however, with the data on appointments of administrators:

¹⁶ Armour J and Deakin S (2001), p22

¹⁷ Data for appointments in administrative receivership: Frisby S (2006), p8

¹⁸ Frisby (2006), p8



At first glance this appears to represent a huge shift in who is driving insolvency proceedings post the Enterprise Act. However, Frisby’s interview data demonstrates that this is not illustrative of a change in who drives insolvency proceedings but rather a change in approach by banks, as many director led appointments are actually the result of a period of consultation and negotiation with their charge holders:²⁰

The banks don’t like appointing administrators. They don’t like the fact, first of all, that they’re dealing with a bad debt, but assuming that it has to be done they would much rather not be the formal appointor... Much more likely is that the bank will have introduced the practitioner, or his firm, in the first place and then, if an appointment has to be made, will have persuaded the directors to make it... There’s that psychological backdrop to it, the banks are more comfortable if they can point to a directors’ request.²¹

An important reason for this step into the background by the banks is a growing importance attached to “reputational risk,”²² and the desire not to be seen as responsible for pushing firms under. Taking into account the judicial response to the Farepak mentioned in Chapter 3.3, where the perfectly legal and rational behaviour

¹⁹ Data for appointments in administration, Frisby (2006), p12

²⁰ Frisby (2006), p12

²¹ *Ibid*, p13

²² *Ibid*, p12

of HBOS resulted in approbation and an effective fine, this is clearly a legitimate concern. Banks prefer consensual rescue based outcomes because they seek to “preserve and prolong existing customer relationships”²³, and in the process avoid the inevitable loss of value associated with formal insolvency proceedings:

Thus, the earlier the bank can intervene, the greater prospects it has of limiting its exposure. It follows that major lenders have powerful incentives to pursue informal rescues and increasingly view formal rescue procedures as mechanisms of last resort for salvaging value over and above the break-up value of the company's assets that would be obtained on a winding-up.²⁴

This means that at an earlier stage, long before formal proceedings are considered, “the banks are beginning to look at which of those clients they want in the factoring arm and those that they don’t want are being steered towards the independents. These will probably be the problem clients.”²⁵

So all of a sudden the problems have gone to a home that loves them, doesn’t actually think in a negative way, you know, fretting over the balance sheet and the risk. All these guys care about is whether they’ve got an asset they can cash in if the company goes bad on them. So there is life after death now, and they may go through two or three phases, they could go to [a big independent] then there are other tertiary players whose lower quartile matches their top quartile. So instead of migrating down the same bank’s food chain into a distress portfolio and finally an exit through insolvency, it now migrates down a different quality of funders and at the end of the day, if management hasn’t learned its lesson and turned it around, then it goes bust.²⁶

The lower risk associated with fixed charges means that they will lend more against it, the risk of loss in insolvency directly reflected in lending:

²³ Armour J, Hsu A, Walters A (2008), p157

²⁴ *Ibid*

²⁵ Frisby S (2006), p38

²⁶ *Ibid*

[Asset Based Lenders are prepared to operate] on a rather more racy rate of return. The consequence is that there are costs of jumping out of that relationship, or if you fail, the costs of exit through insolvency. A lot of asset-based lenders are interested in the distressed end of the market and they will fund companies in distress. They will say, 'Right we'll fund it for three months, and if it flies, if we get it out of gaol fine, but if it doesn't we'll have had three months' worth of income, and we'll stick in there because we'll only secure up to 85% of the debt, and there's a 15% 'gap' there, if you like, and we'll take that as a penalty. And when the company's in that position, when it really needs that money, then it will sign up to anything.²⁷

The result has been a fragmentation of secured lending; "asset based lenders are increasingly a part of the market place. Interestingly, they are somewhat less developed than the banks."²⁸ The prominence of independent firms in receiverships appointments, illustrated above, is evidence of their importance. The opinion that independent firms are less developed than banks reflects the discussion in Chapter 3.4.2 about concerns over new entrant phenomenon, where disguised liquidation via administration asset based sales was principally being carried out by smaller firms.²⁹ It is also suggested by Katz and Mumford's finding that poor or absent justification for administration purpose took place in their sample of administrations in 29% of the number of cases but only 3% of the total value of cases³⁰, failure to properly justify administration possibly therefore more illustrative of practice by smaller independent firms. This has led to concerns that independent practitioners will undermine the rescue culture:

the bank is out-manoeuvred, if you like, by other stakeholders who don't have the company's interests as much at heart. We found this with a case last year, quite a big case, where there was a clearing bank who are probably at the forefront of restructuring and trying to work things through, even to the point of putting more money in to sort the problem out. That bank

²⁷Frisby S (2006), p39

²⁸*Ibid*, p9, p18 – second part citing practitioner interview

²⁹*Ibid*, p79

³⁰Katz A and Mumford M (2006), p5

was basically blown out by an asset based lender who said, 'No, we just want the money out now', and who wasn't interested in a restructure at all.³¹

Any rush to legislate, however, would be exceedingly premature – because the position of independent lenders in the market place is evolving. Frisby observes that “the intense competition to lend money that the market is currently experiencing might be persuading receivables financiers to cooperate in an attempt to save the business, through a going concern sale.”³² It is submitted that this is reflected in a harmonisation of business practice: “larger independents have developed approaches not dissimilar to those of the clearing banks in dealing with those of their customers who encounter financial difficulties.”³³ Even smaller ABL's are developing informal workout techniques, such as call centre credit control departments that provide a valuable outsourcing service to SMEs.³⁴

This harmonisation occurs because it is in all players' interests to maximise rescue of viable firms and to quickly and efficiently remove unviable firms. The shift in the structure of the market has not changed these harmonisation incentives. Even with 85% security it is better to recover the 15% gap because the firm continues trading than it is to claim the assets and walk away, not just because of the 15% lost but also the lost opportunity for further business. Firms across the spectrum will always have an incentive to find cost effective means to encourage viability, which means co-operating with other lenders. The fragmentation of secured lending was not such that distressed firms are handed wholesale over to independent lenders but because different types of facility will be carried by the majority of distressed firms; “a loan or overdraft facility will be serviced by a bank, with an independent receivables financier providing further capital through a factoring or invoice discounting

³¹ Frisby S (2006), p35

³² *Ibid*, p40

³³ *Ibid*, p10

³⁴ *Ibid*, p36

facility.”³⁵ This makes co-ordination a necessity. The existence of independent lenders is not as detrimental to the oligopoly argument as it might initially appear.

A very different type of strategic institutional creditor that merits consideration is Her Majesties’ Revenue and Customs (HMRC). The downgrading of HMRC’s priority³⁶ has significantly changed the dynamic of their relationship with insolvency proceedings, which is particularly important as they will “predictably be a potential casualty of all corporate insolvencies.”³⁷ Their position is very different from that of a bank:

HMRC, as an involuntary creditor, cannot withdraw supplies or threaten to repossess them under retention of title or similar contractual clauses and it cannot transact on cash-on-delivery terms. Its continued co-operation and goodwill therefore probably ranks several notches below that of other trade creditors in the corporate psyche.³⁸

Like the financial institutions, however, they are repeat players with the institutional depth to be able to consider long term strategic goals with regards to debtors. This was envisaged as a potential benefit of the changes of priority in the Act, in that the Crown would have “an added incentive to monitor companies for signs of distress, and, if such were picked up, to take appropriate action, perhaps by steering such companies towards taking advice.”³⁹ This does appear to be the case, with interview results suggesting that HMRC are “turning up more at creditors’ meetings... They go through their checklist that somebody has given them, and they are keeping their eyes open.”⁴⁰

³⁵ Frisby S (2006), p33

³⁶ Enterprise Act 2002 s251

³⁷ Frisby S (2011),p355

³⁸ *Ibid*

³⁹ Frisby S (2006), p47

⁴⁰ *Ibid*, p53

Like independent ABL's their place in the new market is just developing, and their objectives may not simply be directed towards maximising returns. This has caused some disquiet amongst practitioners:

I honestly think it boils down to the fact that they bent over backwards for Rover, and they also did that for a couple of football clubs. There have been situations we've seen where they've tried to treat one football club differently to another, and they've been told that they can't do that. If they're supportive towards one club then they can't, six months down the line, treat another one differently, they can't treat one taxpayer differently to the next taxpayer. I think now they're a bit hamstrung by that, they can justify discriminating between their treatment of different taxpayers.⁴¹

HMRC displayed a perfect example of how strategic selection of goals other than short term wealth maximisation can operate in their dealings with Portsmouth Football Club. Here they chose to pursue a liquidation even though there was a more individually profitable rescue offer, as part of their effort to overturn the so called 'football creditors' rule which was harming their tax revenues generally.⁴² Another example is the Business Payment Support scheme, set up in the wake of the financial crisis to assist "companies, partnerships, and individuals by the economic downturn by offering a range of options for those encountering difficulties in meeting Crown debts as they fell due, probably the most common being a form of 'time to pay' arrangement, whereby arrears could be deferred over an agreed period without the incurrance of surcharges."⁴³ The strategic role of HMRC is certainly worthy of further research, and this writer would be reluctant to draw additional conclusions without seeking empirical data from the organisation itself.

⁴¹ *Ibid*, p48-49

⁴² "Portsmouth win High Court fight against tax agency", <http://news.bbc.co.uk/sport2/hi/football/teams/p/portsmouth/8886009.stm>, 5 August 2010 (accessed 10 October 2011)

⁴³ Frisby S (2011), p356

As an involuntary creditor, however, their role in the structuring of financing and determination of the viability of business is arguably limited. As observed above, by the time a distressed firm reaches formal insolvency proceedings it is likely that they will be subject to multiple security interests:

There is so much more secured lending around now that we are finding it rarer and rarer to go into a small/medium sized basic business, a metal bashing business or whatever, and finding that there are any unencumbered assets. We typically find a sale and lease back of property, the book debts have been factored, the plant and machinery has finance on it and the bank will have an overdraft and a charge on any goodwill.⁴⁴

To illustrate how this works, Appendix 1 and Appendix 2 contain the statement of affairs (form s95/99) and final creditor meeting report (form s106) of “Ask PETE Ltd”, a firm that entered voluntary liquidation in 2008 and was finally liquidated in 2011.⁴⁵ The details in these forms will be familiar to anyone who works in the field, and although chosen at random Ask PETE Ltd is largely typical of a service provider. The firm was liquidated with debts of more than £200,000 and a shortfall of more than £115,000. The largest proportion of these debts were to the Royal Bank of Scotland (RBS), held in the form of factored book debts of around £70,000 and a smaller floating charge over equipment. When the firm was liquidated RBS recovered all of the book debts, and the floating charge subject to the reduction for the prescribed part under s176 Insolvency Act 1986. Meanwhile, the firm’s remaining assets were realised for almost £16,000, but the costs of realising the assets left only £3,500 distributed between the preferential and unsecured creditors (including HMRC). By seeking these types of security RBS avoided the need to decide whether to liquidate the firm or not. Everything remaining of real value in the firm was already owned by

⁴⁴ Frisby S (2006) , p34

⁴⁵ This firm was selected at random from Dr Sandra Frisby’s database of failed firms, with her kind permission and assistance. See also Frisby S (2006). Copies of the forms pursuant to a firm’s liquidation are held by Companies House, and are publically available on their website at www.companieshouse.gov.uk.

the bank. It was no accident that RBS arrived in this position, and indeed this will be reflective of general practice. The significant recent development is that instead of all the assets being swept up by one bank, riskier investments are left to independent asset based lenders. However, as their activity begins to strategically harmonise with the clearing banks, they effectively become a part of the oligopoly.

It would be a mistake to assume that the state of play when a distressed firm enters formal insolvency shows that financiers simply gain security over all assets from the outset – or even that they seek to do so. Failure to take into account of the fact that strategies change over the lifespan of a firm was a significant part of the problem with the deathbed test, described earlier in the chapter. There are two reasons why a firm will not have all its assets tied up to secured lending from the outset. Firstly, a firm that is not in distress is in a stronger bargaining position to seek credit with lower security (and ABL is actually a much more expensive form of credit). This is reflected in the interview quote above that describe how when a firm reaches an agreement with an ABL that “when the company’s in that position, when it really needs that money, then it will sign up to anything.”⁴⁶ Secondly, reducing the profitability of the firm with a rigid debt structure reduces potential future returns to the bank, as a prosperous firm is a better consumer of credit. Overleveraging the firm increases the likelihood of its failure. A bank that reduces the survival prospects of its clients is harming its own profitability in the aggregate. This is supported by the evidence regarding which firms are required to give security: “the few firms that are able to obtain loans without providing significant collateral are of high quality, implying effective screening of unsecured borrowers by the bank.”⁴⁷ Strong firms are able to negotiate credit without security. Weak firms hand over security, protecting

⁴⁶ Frisby S (2006), p39

⁴⁷ Davydenko SA and Franks JR (2008), p586

the banks in the event of liquidation but also increasing the likelihood of that liquidation. This is directly linked to the tension between rescue and liquidation explored in more detail in Chapter 4.3.

5.3 THE 'LONDON APPROACH'

The "London Approach" has been described as a "non statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring."⁴⁸ Its roots are in the Bank of England's involvement in resolve the banking crisis in the 1920s, which developed into a role as an honest broker in multi-bank workouts:

In 1990 a number of discussions were held with London-based banks and their professional advisers, as a result of which a set of principles of best practice was formulated. The Bank's strategy was deliberately *not* to reduce these to "rules", but rather to publicise the general nature of the "Approach" through a number of papers by Bank officials, which avoided dealing with specific details. The idea was that these principles would be developed and applied by market participants without any need for "hands-on" intervention by the Bank.⁴⁹

The advantages of a soft law approach include that it can be regularly and swiftly updated to account for changing commercial circumstances, and that it is more likely to be followed by the financial institutions as they have an investment in its development.⁵⁰ Armour and Deakin argue that the London approach has come to operate as a social norm, "a convention [that] may help agents to co-ordinate upon

⁴⁸ Armour J and Deakin S (2001),p31, citing British Bankers Association, Description of the London Approach, unpublished memo (1996) 1

⁴⁹ Armour J and Deakin S (2001),p34

⁵⁰ Armour J (2005), p388-389

sets of strategies which maximise their joint welfare”⁵¹ Normative behaviour was discussed as one of the two main theories for how laws impact upon decision making in Chapter 1.2:

private norms can substitute for publicly supplied and/or enforced legal rules in the context of corporate reorganisation.... The substitution is not, however, complete, and it appears that existence of legal insolvency procedures "in the shadows" plays an important role in underpinning the stability of the observed norms.⁵²

The London Approach norm is even supported by shaming behaviour. The importance of shaming in insolvency law will be a central theme of the next chapter, and is part of the way in which normative standards are enforced and potential prisoner dilemmas overcome. This would involve a meeting behind firmly closed doors with officials of the Bank of England, at which "eyebrows would be raised" at the behaviour in question.”⁵³ It might be argued that to relate this to shaming is a mischaracterisation of the character of the meeting, as prior to 1998 the Bank of England’s regulatory powers meant they had the power to adjust the terms of the Bank’s licence, and as such any changed behaviour was a simple rational penalty response to the threat of dire sanctions. As will be illustrated and explored in the closing third of this thesis, while fear of penalty will certainly be an important factor, it would be a mistake to exclude shame from the equation, even for bankers. These sorts of interpersonal and emotional factors have an enormous impact on how people make decisions. Interviews with practitioners have found that the changes in their duty imposed by the Enterprise Act were less important than the way in which they felt “constrained by professional regulation and reputational concerns to ‘do the

⁵¹ Armour J and Deakin S (2001), p28

⁵² *Ibid*, p50

⁵³ *Ibid*, p40

job properly.”⁵⁴ English insolvency processes seem to be heavily influenced by normative values that favour informal collaborative workouts.

London Approach workouts are organised in two phases. First, a standstill phase in which no enforcement action is taken and existing lines of credit are kept open, with additional working credit where necessary. During the standstill phase a team of accountants are used to investigate the firm’s finance. The report of their results leads to a second phase of negotiation and implementation of a restructuring plan, spearheaded by the lead bank, which in the case of the vast majority of multi-banked firms leads to some sort of financial restructuring.⁵⁵ One notable quality is the emphasis on co-operation between the lenders: “Interviewees emphasised that the more representative the composition of the committee, the more effective it was as a mechanism for reducing negotiating costs.”⁵⁶

In recent years there has been “a sea-change in attitudes on the ground.”⁵⁷ There is an increasing use of the term ‘business recovery professional’ to describe insolvency practitioners, who are now described as operating in a ‘turnaround profession’.

Intensive care units have been introduced “designed to address the problems of financially distressed customers within the clearing banks.”⁵⁸ Specialist in-house teams have been set up, including insolvency professionals on secondment and other industry specialists who “have attempted to intervene at a much earlier point in the cycle of decline.”⁵⁹ The reason for this investment is commercial pragmatism: “There is a certain inexorable logic to the banks’ argument that it makes commercial

⁵⁴ Armour J, Hsu A, Walters A (2008), p164

⁵⁵ Armour J and Deakin S (2001), p34-36

⁵⁶ *Ibid*, p36

⁵⁷ Armour J, Hsu A, Walters A (2008), p150

⁵⁸ *Ibid*

⁵⁹ Frisby S (2006), p21

sense for them to support troubled customers, and clearly enlightened self-interest would dictate this approach.”⁶⁰

English Insolvency law is known for its “traditional deference to the professional and commercial judgment of insolvency practitioners”⁶¹, and even amidst the introduction of the Enterprise Act a debtor in possession approach was rejected due to a preference that it should be “left to private sector lenders to vet administration proposals and support only those with a sufficient chance of success.”⁶² The emphasis has always been on market-led solutions, with the availability of strong state institutions as neutral arbitrators facilitating collaboration (be they the Bank of England or courts of law). Collaborative structures allow the majority to overcome holdout minority creditors. This facilitates out-of-court restructuring⁶³ and in turn increases bargaining power outside of bankruptcy⁶⁴, which may involve smaller creditors being pushed out of the picture but appears to give the best chance of maximised recovery for all parties. Furthermore, creditor led solutions reduce the opportunity for debtors to abuse rehabilitation procedures to gain stays on debt while retaining control where there is no realistic prospect of rehabilitation.⁶⁵ What the evidence in this chapter, alongside particularly the data from Chapters 2 and 3, shows is that the creditors are leading the law towards a focus on investment in rescue. Indeed, it would not be unreasonable to posit that the Enterprise Act was inspired by the developing culture in the industry, rather than that the culture developed from the Act, given that the London Approach had been focusing on workouts for a decade prior to the law’s introduction.

⁶⁰ Frisby S (2006), p62

⁶¹ Frisby S (2004), p265, citing *MTI Trading Systems Ltd v Winter* [1998] BCC 591

⁶² Dennis V (2007), p120

⁶³ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p9

⁶⁴ Davydenko SA and Franks JR (2008), p573

⁶⁵ IMF (1999) ‘4 – Rehabilitation Procedures’, p39-40

One hears anecdotal evidence of the sentiment that the London Approach has had its day, thanks in part to the financial crisis and also because of the difficulties of co-ordination due to the increased role of independent lenders. Furthermore, with the increased number of players and the greater geographic space they occupy, it is arguable that 'club' models of restructuring have had their day as the ability to impose reputational sanctions is diminished by the reduced likelihood of repeated interactions. There are three reasons why this writer believes that the London Approach will survive, although probably rebranded and certainly with changes in practice and principle. The first is that any disruption caused by the independent lenders is to some degree due to disruption caused by the fact that the market has changed quite recently, similar to the way in which HMRC is finding its feet after being de-prioritised, and the market will harmonise as best practice is established. As it does so repeat interactions will increase and the impact of reputational sanctions will be re-established. Second, this is hardly the first time that the London Approach has had to evolve since its birth in the 1920s. Flexibility and ability to adapt to changes in the market are perhaps the most fundamental advantage of soft commercial law. Finally, the London Approach exists because it is profitable for all parties. Collaboration is not something they are being forced into, but rather a strategic choice that is increasing their returns. As long as institutional lenders remain in such a position of power then there is every reason to believe that they will continue to work together to maximise their ability to determine viability and co-ordinate appropriate rescue.

Is this a victory for the insolvency efficiency model? The central point of this chapter seems to be that sophisticated parties do a good job of resolving debt restructurings when left to their own devices. If this is the case, then why not remove rescue proceedings, enforce absolute priority and leave the banks to it? To do so would

reduce the levels of going-concern recoveries and in turn reduce recoveries for the financial institutions, as described in chapters 2 through 4. The London Approach has developed in tandem, in response to and directly influencing the development of our insolvency laws. The shadow of the law in which this sophisticated and highly effective system of debt restructuring has emerged is a law that has rescue, co-operation and inclusivity at its heart. The availability of specialist courts and insolvency professionals who are able to exercise their discretion in the application of formal insolvency proceedings better facilitates effective private ordering than a system of absolute priority, which is why we have the first and not the second.

CHAPTER 6: THE HISTORY OF INSOLVENCY AS QUASI-CRIME

6.1 A HISTORICAL PERSPECTIVE ON MANAGING DISORDERLY INSOLVENCY

In Chapter 1 disorderly workouts were defined as being where an illiquid or insolvent borrower is driven into liquidation even though they are worth more as a going concern. Effective workouts were then those that maximised the returns from the process. In chapters 2 and 3, I presented evidence that part of the strength of creditor friendly English law lies in its range of options, the availability of specialist courts, and opportunities for inclusive workouts. I then explored the relationship between finance and workouts, and argued that provided there is adequate property rights protection and legal infrastructure in place there is a point after which secured creditor priority actually begins to harm secured creditor returns because of its behavioural impact upon the market. The crucial question, however, is how much secured creditor priority is to be sacrificed?

At the end of Chapter 3 I explored the example of the Pre-Pack. Pre-packs have a good record in terms of creditor returns, going concern rescue and maintaining employment. They are also subject to heavy criticism and are unpopular among unsecured creditors. This may seem irrelevant, as pre-packs can be pushed through regardless (indeed that is one of their key strengths). I suggested that as well as damaging public confidence in the law, short to medium term pre-pack survival rates were being reduced due to creditor exclusion. Pre-packs are a clear example of the way in which decisions made in the insolvency context do not follow a simple cost

function analysis. If we begin to unpack the features of this decision making, and the reasons why popular opinion finds pre-packs so unfair and found Farepak so disgusting, it begins to give an answer to the question of where the optimal balance between secured creditor priority and debtor/creditor inclusivity lies.

This chapter begins the process of exploring inclusivity by considering the history of insolvency laws, from pre-history to the birth of the 20th century, in terms of this struggle for order and finding a balance between protection for both debtor and creditor. It highlights the historical quasi-criminal nature of bankruptcy and how social stigma, shame and outrage regarding commercial failure impact upon both commercial decision-making and law-making, in order to show that this very tension is still very much in operation today. Recognising this, and offering specialist support in the courts and from insolvency professionals, as well as taking relatively inexpensive steps to redress the impression of unfairness, can have significant benefits for the likelihood of an orderly workout.

It is hard to look past the lurid detail of ancient insolvency law, and this makes it seductively easy to dismiss ancient problems as being irrelevant to modern times. Regimes considered “typical of primitive law in general”¹ allowed limbs to be removed in proportion to debt, eyes to be gouged out, children to be sold into slavery and wives to be raped. When ancient laws are described as being “written in blood”², the writer is characterising the past as savage or primitive in order to contrapose either the writer’s period or his ambition as modern and therefore superior. Consider this passage in Francis Regis Noel’s 1919 account of the superiority of modern Anglo-Saxon debtor leniency:

¹ Levinthal LE, “The Early History of Bankruptcy Law”, *University of Pennsylvania Law Review* 66 (1918) 1-28, p8

² Noel FR, *A History of the Bankruptcy Law*, General Books (Milton Keynes: 2009), First published 1919 by CH Potter co., p8

In semi-civilized parts of the earth harsh treatment of debtors persists. It is well established in Peru and the adjacent countries of East India a creditor is given full sanction in disposing of a debtor, his wife and children. Extreme cases are recorded in which a debt was satisfied by the creditor violating with impunity the chastity of the debtor's wife.³

There is something tellingly anachronistic in Regis Noel's horror at the prospect of the violation of the chastity of the debtor's wife ranking ahead of the routine mutilation that was another part of the legal codes he references. Strip away the agenda of trying to justify some radical difference between our times and those which have gone before us, and we find societies throughout history struggle with the problem of debt and credit. In their study of ancient land law, Ellickson and Thorland warn that although "English struggles are presented as if they are without parallel... the peoples of ancient Mesopotamia, Egypt and Israel grappled with comparable issues some 3,000 years before the English Normans did."⁴ Although the fundamental problems of insolvency remain the same there is an unfortunate habit to dismiss the past as savage and the modern as exceptional.

Nonetheless, somewhere on the journey from *homo antecessor* to *homo sapiens* the concept of debt and credit must emerge. Before they existed there would be no need for a system to manage their default, but such a system might easily predate the existence of money, or even recorded history. Levinthal's argument that "credit is an institution that lives by virtue of man's confidence in his fellow-man's good faith, and good faith and the primitive man are strangers"⁵ seems to belie that sort of social interdependency that was essential to even the earlier forms of man. Any form of co-operation requires a means to deal with those who take without returning, so how far back into pre-history was a time when man did not require a

³ *Ibid*, p7

⁴ Ellickson RC and Thorland CD, "Ancient Land Law: Mesopotamia, Egypt, Israel" *Chi-Kent Law Review* 71 (1995-1996) 321-414, p324

⁵ Levinthal LE (1918), p6

mechanism for managing the behaviour of those who make promises they are unable to keep? The words commerce and credit should be interpreted in the widest possible sense when Keay and Walton observe that “as commerce has developed so have the laws regulating the credit relationship. By necessity, these laws have had to deal with the consequences of a person being unable to pay his or her debts.”⁶ Given that even the simplest forms of social life develop some means for punishing default it seems insolvency is an inherent problem of social grouping.

Economic analysis is useful here. Economic theory “requires only that scarce resources must be allocated among competing uses.”⁷ The fundamental problem of insolvency is insufficient resource to satisfy obligation, and so the interpretation of its emergence invites economic analysis. In his application of economic theory to primitive law Posner concluded that violence is twinned to a need for strict liability due to the information costs of distinguishing the fraudulent from the unlucky.⁸ Violence against transgressors maintains the credible threat of vengeance, which acts as a deterrent to other potential wrongdoers. As societal infrastructure improves retribution against the person is supplanted with systems that permit the “aggressor to pay the victim of his aggression”⁹, which fits Levinthal’s explanation for why over time “execution for debt came to be directed against the property of the debtor rather than his person.”¹⁰ It also, rather conveniently, fits the desire to describe the development of the law as a constant process of excluding the primitive and replacing it with the modern.

Posner thus argues that this evolution from execution against person to execution against property can only occur when a society has developed sufficient legal

⁶ Keay A and Walton P, *Insolvency Law: Corporate and Personal*, 2nd Ed, Jordan (Bristol: 2008), p7

⁷ Benson BL (1989), p2

⁸ Posner RA, *Economics Analysis of the Law*, 7th ed, Aspen (New York: 2007), p261

⁹ *Ibid*, p262

¹⁰ Levinthal LE (1918), p10

infrastructure to support property and contract rights.¹¹ But those regimes whose violence has led insolvency lawyers to classify as primitive have often been highly sophisticated:

Mesopotamia and Egypt rightly are regarded as cradles of civilization. By 3000 B.C., before any other society, the peoples of these lands had separately developed systems of writing, were capable of living in cities, and were beginning to engineer earthworks and other massive construction projects that for millennia would awe travellers from abroad.¹²

Far from operating strict liability, the major ancient legal systems contained means to distinguish between the dishonest and the unfortunate insolvent. Levinthal argues that discharge for the honest was not a fundamental feature of the law¹³ but the fact is that it exists in some form in all insolvency laws, for example the Code of Hammurabi protected the life and freedom of the unlucky,¹⁴ and Solon cancelled the debts of agriculturalists struggling due to the harsh economic climate.¹⁵ Early systems of discharge may have been imperfect but the violence of early law was not due to a strict liability required by primitive societies. Violence was not even the principle characteristic, and a much more sophisticated system of regulation tended to be in operation. It would be hasty to assume that lower information costs have absolved us from the economic needs that led to violence being used to manage insolvency.

Roman law is credited with being the birthplace of modern insolvency systems, “the origin and fountain-head of all bankruptcy proceedings”¹⁶, and it is not difficult to see an attempt to glorify modern law’s civility by making it appear parallel to Roman law’s supposed conquest of primitive savagery. Thus Roman laws end up being

¹¹ Posner RA (2007), p262-263

¹² Ellickson RC and Thorland CD (1995-1996), p328

¹³ Levinthal LE (1918), p3

¹⁴ *Ibid*, p15

¹⁵ Ellickson RC and Thorland CD (1995-1996) , p402

¹⁶ Levinthal LE (1918), p14

described in terms of a steady reduction in savagery from the literally Draconian Athenian criminal code in 623BC that “classified debt with murder and laziness as a capital crime”¹⁷ to the rules of *cessio bonorum* under Augustus that permitted a form of discharge for the honest debtor.¹⁸ The degree of violence through the rise and fall of Rome is nowhere near as simple as this. Capital punishment for thieves and bankrupts during the reign of Draco was no unthinking act of violence. The aim was to stimulate industry by deterring crime.¹⁹ Solon’s revision of Draco’s laws in 594BC, in which he abolished servitude for debt and the engagement of the body for security, may have been because he “considered debt a misfortune, rather than a crime”,²⁰ but it was also influenced by Egyptian law and the idea that the attachment of private debt to the person was a usurpation of the state’s prior rights to use their citizens as soldiers, labourers or slaves. Beneath the headlines of dismemberment in the infamous law of the 12 Tablets lies a complex tiered system of punishment and shaming designed “to arouse the compassion of his relatives and friends... [such that only] in case of fraud or obstinate refusal the death penalty was inflicted.”²¹ The development of Roman law was just as much a complicated mess of efforts to find the right balance between deterrence and economic support as any other era of insolvency law.

Having incorrectly categorised Roman insolvency law as a steady progression towards a romanticised precursor to English law, it is then necessary to group the period between the fall of Rome and the first bankruptcy statute of Henry VIII into one long period where laws are “peculiarly similar to those of the most primitive

¹⁷ Noel FR (1919), p8

¹⁸ Levinthal LE (1918), p16

¹⁹ *Ibid*, p14

²⁰ *Ibid*, p15

²¹ Noel FR (1919), p8

period.”²² The dark ages are something that gets skipped over on the way to the emergence of the Law Merchant as a kind of next step on the way from the Romans to the British, “a distinct body of law which grew up and around the customs and practices adopted by traders across continental Europe.”²³ For the insolvency historian the Dark Ages saw a collapse of social order and an era where insolvency law became principally a mechanism to assert the power and moral authority of the state through the mechanism of punishment. As Roy Goode describes:

Life for the medieval debtor was likely to be nasty, brutish and short. Just as the charging of usury by moneylenders was regarded as contrary to the laws of God and was punished accordingly both by the church and by the powers temporal, so also falling into debt was considered mortal sin.²⁴

Certainly for the non-historian this is a period characterised by long periods of war, destruction, and pestilence. Most notable the long slump of the 15th century in an era where, by the end of the 16th century, the population of England had fallen to half of its pre-Black Death peak, and “with scarcely an exception all available indices of production and exchange weakened.”²⁵ One might expect a society facing the rising information costs consequent to a collapsed infrastructure to move to strict liability and creditor controlled punishment – and there may be some evidence of that – but what can be seen is the law desperately trying to maintain confidence in the economy through brutal punishment of bankrupts. One cannot presume the existence or direction of causality here, but note that “credit trade again became unusual”²⁶ and that in times of recession credit would quickly collapse.²⁷ Violence in insolvency law emerges as a response to broader social pressures, and the desire to

²² Levinthal LE (1918), p19

²³ Dennis V (2007), p2

²⁴ Goode R (2004), p827

²⁵ Hatcher J, “The Great Slump of the Mid-Fifteenth Century”, in Britnell and Hatcher (eds) *Progress and Problems in Medieval England*, Cambridge University Press (Cambridge: 1996), 237-272, p240

²⁶ Levinthal LE (1918), p19

²⁷ Hatcher J (1996), p244

categorise business failure as a moral offence rather than recognising the inherent vulnerability of commerce.

The introduction of creditor-friendly English law and the rise and fall of capital punishment for bankruptcy neatly demonstrates the way in which the same economic and social vulnerabilities persist for all credit based societies. 34 & 35 Henry VIII c4 (1542) is typically recognized as the first English bankruptcy law, and was focused on helping creditors recovering from those who were made bankrupt. The problem was determining to whom this law should apply. When, in 1571, Elizabeth I limited the crime of bankruptcy to merchants and traders, it was considered unjust that they should be condemned for an action another man could do with impunity. In any event “creditors early began to make use of the bankruptcy law against honest but unfortunate debtors, even though by its terms the Henrician law was not intended apply them.”²⁸ Making the all too familiar error of confusing an increase in bankruptcies with a failure in deterrence, the 1604 Act of 1 James I c15 enhanced punishment to allow the bankrupt to have one ear nailed to the pillory and then cut off, and also “practically absorbed into the bankruptcy law the case of simple non-payment of debt... but the act-fiction still clings to it. The debtor's *conduct*, not his financial condition, is still the technical basis of his bankruptcy.”²⁹ Draco and James might have profited from comparing notes.

The Pitkin Affair, an Enron-like scandal that provoked a storm of outrage, motivated parliament to take the final steps in the 1706 Act 4&5 Anne, which made fraudulent bankruptcy a capital offence where one was fraudulent simply for failing to appear

²⁸ Kadens E, “Last Bankrupt Hanged: Capital Punishment for Bankruptcy in 18th Century England”, found at ssrn.com/abstract=1446818 (accessed 10 Apr 2011) , p15, also published in a shorter form as Kadens E “The Last Bankrupt Hanged” 59 *Duke Law Journal* 7 (2010) 1229-1309

²⁹ Trieman I, “Acts of Bankruptcy: A Mediaeval Concept in Modern Bankruptcy Law”, *Harvard Law Review* 52(2) (1938)189-215, p196-197

before a commission and disclose all assets after failure to pay a debt.³⁰ This had been preceded, however, by an attempt to soften the law between 1678 and 1698 in bills that began English law's recognition that "honest bankruptcy is not a contradiction in terms but a phenomenon of daily occurrence"³¹ and "that the debtor was far more likely to hand over his assets if he knew he was getting something in return."³² The original 1706 act took the hugely important step of introducing discharge for bankrupts in order to induce their co-operation. It was intended to "offer the debtor a carrot to balance against the existing sticks"³³, and early drafts of the law included a provision to grant the bankrupt a small allowance of "up to five per cent of their net estate to enable them to begin again."³⁴ This eminently practical measure was designed to encourage debtors to participate in the formal bankruptcy structure, and as such had the predictable effect of a surge in bankruptcy proceedings: "In 1705, an estimated 159 commissions were opened; in 1706, the number was 567."³⁵ But the legislators had not sufficiently taken into account the enduring quality of the fiction of the "act of bankruptcy" and the perception of business failure as a moral failing.

Therefore, instead of welcoming this as a sign that the statute was working as intended and encouraging debtor co-operation, a rise was once again interpreted as a failure of deterrence. After only one year the discharge provision was modified so that it required a majority vote from four-fifths of the creditors.³⁶ Commentators were likely satisfied to see the subsequent collapse in the number of commissions, as the law now reverted to all stick, no carrot, total creditor control and the widest possible definition of fraudulent bankruptcy. Predictably to the student of insolvency

³⁰ Kadens E (2010), p2

³¹ Trieman I (1938), p190

³² Kadens E (2010), p21-22

³³ *Ibid*, p22

³⁴ *Ibid*, p36

³⁵ *Ibid*, p37

³⁶ *Ibid*, p38

law and economics, the revised 1706 act was a near complete failure. Not only could one or two significant creditors keep the undischarged bankrupt imprisoned indefinitely out of spite, but it became commonplace for creditors to expect bribes before they would sign the discharge certificate.³⁷ Meanwhile, when push came to shove, most believed capital punishment to be too severe a penalty, such that in the century that the law was in force only four men were hanged:

Imposing capital punishment for fraudulent bankruptcy was a spectacular failure because it did not prevent the frauds at which it was aimed, but also because the fact that it was so rarely enforced permitted other frauds to flourish... The threat of death turned out to be so useless that the fist the legislators thought would keep debtors in line ended up being an empty glove.³⁸

Thus began another withdrawal from both harsh punishment and the broad application of the notion of fraudulent bankruptcy. Trieman argues that the law experienced a fundamental shift: "Instead of dealing primarily with the legal phenomenon involved in the debtor's *conduct*, it seeks to regulate the economic situation that arises out of the debtor's financial *condition*."³⁹ 1 George IV (1820) replaced capital punishment with transportation or hard labour, and imprisonment for debt was virtually ended with the Debtors' Act of 1869. The stage was set for the birth of 20th century commerce, but the image of the fraudulent bankrupt remains vivid in the social consciousness.

³⁷ *Ibid*, p59

³⁸ *Ibid*, p40 then p69

³⁹ Trieman I (1938), p200

6.2 THE SOCIAL DIFFERENCE BETWEEN A BANKRUPT AND AN INSOLVENT, THE IMPORTANCE OF SHAME AND THE IMPOTENCE OF PUNISHMENT

There is a social difference between a bankrupt and an insolvent.⁴⁰ Insolvency is a condition, and hopefully a temporary one, where your assets are less than your debts. One makes oneself a bankrupt through one's actions. The notion of being bankrupt being a different thing from being unable to pay your debts has been integral to much of insolvency law. The Roman right of *Bonorum Venditio*, for example, was granted after the insolvent had committed an 'act of bankruptcy' such as hiding from creditors or taking no steps to pay a debt on demand.⁴¹ Thus someone might be bankrupt without actually being insolvent. The honest bankrupt cannot escape by claiming he lacks intent as the act demonstrated the intent, and thus "provided the *actus reus* and the *mens rea* of the crime of bankruptcy."⁴² To be a bankrupt is treated in itself a mark of dishonesty.

As creditor influence increased so those things that constituted an act of bankruptcy steadily expanded to include simple non-compliance with creditors, such that "what is evidently nothing more than an insolvent condition, occasioned perhaps through no culpable conduct on the part of the debtor, is classified together with such overt conduct of a fraudulent nature as fraudulent conveyances and fraudulent evasion of creditors."⁴³ The law is trying to manage the consequences of insolvency and distinguish between the honest and the dishonest. However, it associates insolvents with bankrupts and stigmatises the unfortunate and the fraudulent alike. To be

⁴⁰ In contemporary English Law the terms are now used to distinguish personal bankruptcy from corporate insolvency, for reasons undoubtedly connected to the desire to de-stigmatise business failure. Thus, for English lawyers at least, the social distinction is different from the legal one.

⁴¹ Levinthal LE (1918), p13

⁴² Kadens E (2010), p11

⁴³ Trieman I (1938), p197-198

fiscally bankrupt is to be morally bankrupt; “the status of bankruptcy commenced with some positive and intentional act on the part of the debtor, and that, such an act having been committed, the solvency of the debtor was unimportant.”⁴⁴ This notion of situational fairness being grounded in character and identity is borne up in other fields, for example in Kahneman, Knetsch and Thaler’s work on fairness, finding that people felt a carpenter had a greater right to pass along cost in price than a wholesaler or a company.⁴⁵ Whether we consider a situation to be fair or not is deeply rooted in a judgement of the person’s character, and our judgement of their character will in turn be impacted upon by the fairness of their conduct.

The historical severity of punishment is one manifestation of a consistent negative perception of bankrupts. Another is the frequent use of shaming in insolvency law. Bankrupts have been made to wear ridiculous clothing or put baskets on their heads in public, to bang their buttocks on a rock before a heckling crowd, or stand naked in court, alongside an “official contemptuous discourse, which labelled bankrupts as ‘deceivers,’ ‘frauds,’ ‘offenders,’ ‘cheaters,’ and ‘squanderers.’”⁴⁶ The practice of ‘sitting in harna’ in India or ‘fasting on’ in Ireland publically shamed the debtor to pay up before his creditor starved to death on his door, “enforced rather by the sentiment of the community than by the law.”⁴⁷ The notion of society acting in the shadow of the law has been a consistent feature of this thesis, but of course laws develop in the shadow of society as well, and these two parts of enforcement cannot be separated.

Benson observes that customary systems of law maintain order even in societies lacking a government, are often “quite complex, systemically covering all types of

⁴⁴ *Ibid*, p195

⁴⁵ Kahneman D, Knetsch JL and Thaler RH, “Fairness and the Assumptions of Economics”, *The Journal of Business* 59 (4) (1986) 285-300, p293

⁴⁶ Efrat R (2006), p366

⁴⁷ Levinthal LE (1918), p7

torts and breaches of contract relevant to the society”⁴⁸, and have persisted throughout history including societies like medieval Iceland and the 18th century Wild West. Bankruptcy strikes at the heart of several qualities important in civilised society: the importance of making good your promises to those who have trusted you, of honesty towards members of society, of responsible management of personal means, and not becoming the ‘grasshopper among the ants’⁴⁹. The bankrupt “was seen not only as stealing money on which his creditors might be relying but more importantly as stealing their confidence.”⁵⁰ Primitive societies used a mixture of the threat of violence to illustrate stigma, and the application of community shaming to encourage a return to social norms before stigmatization becomes necessary.

As civilisation grew it became harder for communities to internally shame, and this led to the development of state mediation in the Roman Empire. Roman law was neither the most creditor controlled nor the least violent, but it did employ increasingly sophisticated state intervention in the enforcement of collective proceedings by creditors. Collective proceedings allow the creditor to co-operate for mutual benefit, as he no longer needs to waste resources “to anticipate and outwit his fellows.”⁵¹ State intervention is not a pre-requisite. Contrast 19th century Chinese law, which left distribution entirely in the hands of creditors, and medieval Jewish law which put all authority in the hands of an official administrator.⁵² There are, however, certain attractions to an enhanced state role. A government can employ economies of scale through the creation of a specialist commercial court and sheriffs to instigate and enforce judgements, reducing the information cost of distinguishing

⁴⁸ Benson BL (1989), p21

⁴⁹ Efrat R (2006), p368- 369

⁵⁰ Kadens E (2010), p8

⁵¹ Levinthal LE (1918), p13

⁵² *Ibid*, p5, p26-28

the honest from the dishonest.⁵³ It can mediate the impact of creditor fraud - collusion between fraudulent debtor and favoured creditors is a common problem in creditor friendly regimes, 17th century England being an excellent example⁵⁴ - and enforce collective proceedings in the presence of potential prisoner's dilemmas. Finally, it can compensate for the breakdown of community shaming. As civilisation spreads and becomes more complex "people have less need to use membership in a close-knit village or hierarchical institution as a method of coordinating economic production"⁵⁵, which has the consequence of reducing the community's ability to shame its members. In a civilisation that spans the seas the bankrupt might simply disappear. A centralised government has a much better chance of bringing home to debtors the consequences of their defaults. Thus the benefits of state infrastructure might conceivably outweigh the costs to efficiency where they effectively manage the behavioural consequences of the bankruptcy stigma.

Traditional punishment (violence, financial sanction, imprisonment) is not an effective deterrent for bankruptcy. Recent research has not found any particular correlation between the public perception of bankrupts and rates of bankruptcy filing.⁵⁶ This directly contradicts a common notion that bankruptcy stigma increases during periods of financial downturn. Nor is the retributive focus of outrage "well-suited to the deterrence."⁵⁷ While people may deliberately lie, defraud and cheat, the greater proportion of insolvency is more to do with debtors having a "'head in the sand' mentality"⁵⁸ about their problems or simple poor performance.⁵⁹

Businessmen generally fail not because they are bad people but rather because they

⁵³ Posner RA (2007), p262-263

⁵⁴ Kadens E (2010), p18-19

⁵⁵ Ellickson RC and Thorland CD (1995-1996), p352

⁵⁶ Efrat R (2006), p393

⁵⁷ Kahneman D, Schkade DA and Sunstein CR, "Shared Outrage and Erratic Awards: The Psychology of Punitive Damages", *Journal of Risk and Uncertainty*, 16 (1998) 49-86, p73

⁵⁸ Dennis V (2007), p12

⁵⁹ Dahiya S and Klapper L (2007), p270

are bad at business. Being a bad person may be bad for business but it is not the determinative factor.

While shame encourages compliance, promoting better spending habits and even encouraging insolvents to settle debts before they become bankrupts, stigmatization can actually have a negative effect and lead to the party rejecting the social rules that have rejected him.⁶⁰ The archaic use of the word stigma was for a brand burned into the skin of slave or a criminal, and one can see how the name “bankrupt” could come to operate in the same way. The difficulty is that the line between shaming and stigmatization is a fine one. Sherman has found that while individuals with high interdependencies, such as working married men, found arrest shameful and were rehabilitated, groups upon whom arrest had a counter-deterrent effect were

disproportionately unemployed (in four studies) and disproportionately black (in three). They were people who had lived with a great deal of stigma; their reaction to further shame was rage and vindictive escalation of violence rather than remorse. In Sherman's interpretation, 'Defiance is a means of avoiding shame in the face of any effort to cut one down to size, including arrest'⁶¹

Rather than being a “more direct means of compelling payment”⁶², violence in insolvency law was intended to operate indirectly to provide the bright light beneath which the shadows of shame provide the real disciplining effect. It is perhaps easy to be dismissive of the importance of shame, particularly compared to financial ruin or physical dismemberment. But shame is an incredibly powerful emotion “rooted in the processes through which we internalize how we imagine others see us.”⁶³ Efrat observes that “communities’ cohesiveness made it possible for these publicly

⁶⁰ Murphy K and Harris N (2007), p908

⁶¹ Makkai T and Braithwaite J, “Reintegrative Shaming and Compliance with Regulatory Standards”, *Criminology* 32(3) (1994) 361-386, p364, citation from Sherman LW, *Policing Domestic Violence*, Free Press (New York: 1992), p203

⁶² Levinthal LE (1918), p7

⁶³ Wilkinson R and Pickett K, *The Spirit Level*, Penguin (London: 2010), p41

humiliating and labelling practices to be powerful in generating deep fear of bankruptcy in the minds of the people.”⁶⁴ Modern neuroscience has even made it possible to objectively quantify the impact of shame, as demonstrated in a large scale meta-study by Dickerson and Kemeny:

Tasks that include a social-evaluative threat (such as threats to self-esteem or social status), in which others could negatively judge performance, particularly when the outcome of the performance was uncontrollable, produced larger and more reliable cortisol changes than stressors without these particular threats.⁶⁵

Cortisol is a steroid hormone produced in response to stress that increases blood sugar and suppresses the immune system. Stress levels interfere with decision making, and the ability to measure cortisol levels makes it possible to quantify stress responses to different social stimuli. People are physiologically wired to respond in a negative fashion to shame and threats to our social status to the extent that it will override other concerns like achieving the best possible financial return. An insolvency law that ignores this will find itself unable to reconcile effective rescue with creditor control because creditors will repeatedly appear to act irrationally by rejecting superior commercial outcomes: “Models of decision-making cannot afford to ignore emotion as a vital and dynamic component of our decisions and choices in the real world.”⁶⁶ This is what is happening when we express confusion that creditors have rejected a rescue option that would have brought them better returns, or are baffled when creditors are outraged by a pre-packaged sale that preserves a going concern is chosen ahead of a profitless liquidation.

⁶⁴ Efrat R (2006), p371

⁶⁵ Dickerson SS and Kemeny ME, “Acute Stressors and Cortisol Responses: A Theoretical Integration and Synthesis of Laboratory Research”, *Psychological Bulletin* 130(3) (2004) 355-391, p337, cited by Wilkinson R and Pickett K (2010), p38

⁶⁶ Sanfey AG, Rilling JK, Aronson JA, Nystrom LE and Cohen JD, “The neural basis of economic decision making in the ultimatum game”, *Science* 300 (2003), 1755-1758, p1758

Shame, stigma, and the underlying desire to believe that success and failure are due principally to the moral quality of the parties have influenced insolvency law throughout its history. This is why “the insolvency of a company inevitably generates dismay and, in many cases, resentment.”⁶⁷ The dismay is a stress response to socially threatening behaviour. The desire for punishment is aimed at redressing this feeling of injustice and threat but it can directly conflict with the commercially superior outcome, demonstrated in the feelings of the disappointed Farepak creditor who stated:

I think the bosses of Farepak need to be made accountable and go down the legal system for what they have done. I don't think they should be allowed to ever do business again with the general public, and I think they should be punished through the justice system for that they have done, because with effect, they have stolen 150,000 members' monies and they should not be swept under the carpet, they should be made accountable for what they have done, but that's how I feel about it.⁶⁸

Equally this observation by the British insolvency practitioner:

I think also there's something about the British psyche, as compared to the American psyche, which views it as, 'Well, if the directors have run the business like that and now I'm the one out of pocket, there's no way I'm letting them keep their company!'⁶⁹

An orderly insolvency law must take into account the quasi-criminal quality of insolvency. Its heritage is in the act of bankruptcy that taints the most innocent insolvent. If the insolvent is presumed to be morally at fault for the failure of the business, it may seem defacto inequitable that their business is rescued. This must be taken into account both because it brings an additional element to creditors objectives beyond simply best financial returns, threatening viable rescues due to the

⁶⁷ Frisby S (2011), p350

⁶⁸ From an interview with a Farepak 'victim', Spalek B and King S, "Farepak victims speak out: an exploration of the harms caused by the collapse of Farepak", Centre for Crime and Justice Studies", Kings College London, (London: 2007), found at http://www.crimeandjustice.org.uk/opus392/FAREPAK_Full_report.doc (accessed 18 Nov 2012), p34

⁶⁹ Frisby S (2006), p64

impression of injustice, and also because stress, shame and stigmatisation undermine the decision making process. The orderly insolvency law protects creditors, debtors and employees not only from each other but also from themselves.

CHAPTER 7: UNSECURED CREDITORS' ROLE IN MARKET DISCIPLINE AND THE LIMITED BENEFIT OF PERFECT INFORMATION

7.1 FAREPAK AND CHRISTMAS VOUCHERS

The desire to protect unsecured creditors, particularly those who appear to be innocent victims of a business failure, can have a major impact upon whether an insolvency regime remains Orderly and Effective. It also has a significant impact on decision making around insolvency. The case of Farepak is a useful illustration of how this can happen.

I think the bosses of Farepak need to be made accountable and go down the legal system for what they have done. I don't think they should be allowed to ever do business again with the general public, and I think they should be punished through the justice system for that they have done, because with effect, they have stolen 150,000 members' monies and they should not be swept under the carpet, they should be made accountable for what they have done, but that's how I feel about it.¹

Farepak was a "Christmas hamper" firm, a family business established by Bob Johnson in 1968 and run by his son at the time it went into administration. Agents collected money from up to 150,000 clients every month in return for vouchers. These vouchers could be used at a selection of retailers or exchanged for hampers of festive food, allowing customers to spread their Christmas costs over the year. Farepak would reimburse the retailers for the price of the vouchers after Christmas, allowing them to profit from the extended credit they had received from their customers.

¹ From an interview with a Farepak 'victim', Spalek B and King S (2007), p34

In early 2006 High Street stores began to demand payment upfront rather than offering credit, responding to the failure of a similar voucher firm the year before. Farepak's parent company, European Home Retailing, attempted to extend its borrowing. HBOS plc, its bank, refused the new business plan and called in the company's overdraft. The firm remained silent about its difficulties and continued to accept voucher payments to help pay off the parent company's debts, up until October 2006 when administrators were brought in.²

Farepak customers lost on average £400. This has been called "a national tragedy and emergency" by MPs and Frank Field, Labour MP for Birkenhead, attacked the role of HBOS in a Commons debate, stating that they should "bear a heavy responsibility for the misery caused."³ Spalek argues that Farepak "is symptomatic of the social harms perpetuated under the current economic climate of deregulation and the liberalisation of markets, where there are many sites of trust that can be potentially exploited by unscrupulous or unethical organisations."⁴ The exposure of consumers to the consequences of business failure is once again being tied to moral failure.

Farepak highlights a number of interesting issues regarding price, investment and insolvency. First, consumers did not have a clear idea of the risk they were taking with their investment. As Spalek observes, "the Farepak scandal raises some serious questions about the knowledgeable consumer model... [the] view of the consumer as a rational being, who will assess potential risks and ask appropriate questions to gather information."⁵ Instead participants followed the scheme through or with friends, family and work colleagues and the company took "advantage of the social

² For Reporting on the Farepak insolvency: <http://news.bbc.co.uk/1/hi/business/6124406.stm>, <http://news.bbc.co.uk/1/hi/business/6159672.stm>, http://www.thisismoney.co.uk/news/special-report/article.html?in_article_id=414074&in_page_id=108. See also the website for the campaign representing Farepak customers at <http://www.unfairpak.co.uk/> (accessed 11 Mar 2012)

³ <http://news.bbc.co.uk/1/hi/business/6124406.stm>

⁴ Spalek B "Corporate harm and victimisation: The case of Farepak", *Criminal Justice Matters* 71(1) (2008) 8-10, p8

⁵ *Ibid*, p9

bonds of trust developed between individuals.”⁶ The creditors relied on the fact that this was a socially normal way to invest, rather than fully investigating the security of the investment.

Second, the bank operated strategically and it is their withdrawal of the overdraft facility that triggered the failure of the firm. This is evidence of the important role of banks in business failure, which was explored in Chapter 5.

Third, the failure of Farepak had the result of suddenly changing the customers’ understanding of the value of the vouchers they were holding. The customers considered themselves to be savers rather than creditors, and had not incorporated the risk of their activity into their decision making because ‘saving’ was perceived to be an inherently prudent activity:

These consumers had attempted to be prudent with their money and their savings, by saving with what they thought to be a reliable and safe company... so that they could have the sort of Christmas that they were hoping to experience. This aspect of the financial impact of the scandal transcends the financial dimension.⁷

Fourth, as highlighted earlier, the failure of the company was considered unethical and scandalous, precisely because of the perceived virtue and vulnerability of the creditors. The Insolvency Service took action on behalf of the creditors against the directors of the firm, but in June 2012, at the High Court, Smith J exonerated the directors of blame and instead focused on the conduct of the bank:

“They in effect forced the directors to carry on in September and October collecting deposits, that at a time when they believed there would be an insolvent solution,” he said. An extra £10m came in from customers, £4m of which went into Farepak’s bank account and £6m of which was used to keep on trading, which would be to the benefit of HBOS when the firm was

⁶ Spalek B (2008), p9

⁷ Spalek B and King S (2007), p7

eventually sold after going bust. HBOS knew that those deposits would be paid and would be lost if their expected solution went out and that the only beneficiary of those deposits would be HBOS," the judge added " An extension of Farepak's overdraft by £3 to £5m from HBOS might have kept Farepak going," the judge said, "but the bank was not prepared to do this". The directors' efforts "failed over the period between March and October 2006 on the flinty ground of HBOS, which had a policy of playing hardball, of which it appeared to be proud, and conceding nothing," he said. "It seems to me that what happened there, whilst apparently legally acceptable, might not be regarded in the public's eyes as being acceptable."⁸

This decision was briefly referred to in Chapter 3.3 as an example of an exercise of judicial discretion that is disorderly because it causes commercial uncertainty. Lloyds Banking Group, which acquired HBOS in 2009, then accepted that it had "wider responsibilities"⁹ in spite of a lack of legal obligation. It sought to meet this responsibility by adding an extra £8m to the compensation it offered to the Farepak savers, leading to the extraordinary return of 50p in the pound back on their lost investment.¹⁰ The returns the Farepak savers received were much greater than those to which they had a legal right, and the bank accepted a public sanction from the court having been told that they had done no legal wrong. The desire to intervene and protect vulnerable unsecured creditors undermined the orderliness of the insolvency regime.

This chapter explores the difficult place of unsecured creditors in an Orderly and Effective insolvency regime, starting with an exploration of the impact of consumer protection upon consumer decision making and then following this with a willing-to-pay experiment that demonstrates that dangers of protecting unsecured creditors.

⁸ Farepak collapse: Judge partly blames HBOS bank", 21 June 2012, <http://www.bbc.co.uk/news/business-18540914> (accessed 17 August 2012)

⁹ "Farepak compensation boosted by extra £8m from Lloyds", BBC, 6 July 2012, <http://www.bbc.co.uk/news/business-18743363> (accessed 17 August 2012)

¹⁰ "Farepak customers to receive half of money owed", BBC, 10 July 2012, <http://www.bbc.co.uk/news/business-18782300> (Accessed 17 August 2012)

This leads back into the question of who is the consumer of insolvency laws, and how we are to best improve their participation in achieving orderly workouts.

7.2 CREDITOR PROTECTION AND THE CONSUMERS' ROLE IN MARKET DISCIPLINE

Classical economic theory holds that consumers select goods and services to meet a pre-existing set of preferences. Expected utility theory holds that the “utilities of outcomes are weighted by their probabilities”¹¹, such that “subjective probability of a given event is defined by the set of bets about this event that such a person is willing to accept.”¹² Thus the more information a consumer has about risk, the better able they are to match goods to their internal preferences. Modern consumer regulation, built on this theory, seeks to promote “realistic consumer expectations based on reliable information.”¹³ The 2000 Cruickshank report stated that:

Knowledgeable consumers provide the best incentive to effective competition. With the right information, consumers can take responsibility for their own financial well-being, shop around and exert the pressures on suppliers which drive a competitive and innovative market.¹⁴

The European Community believes that “consumers, through better information, are able to make informed, environmentally and socially responsible choices,”¹⁵ and the 2001 Financial Stability Forum observed that keeping the consumer informed was essential for “the stability of the financial system and to protect less-financially-sophisticated depositors.”¹⁶ This is reflected in the World Bank principles for Orderly and Effective insolvency:

Principle 19: The law should require the provision of relevant information on the debtor. It should also provide for independent comment on and analysis of that information. Directors

¹¹ Kahneman D and Tversky A (1979), p265

¹² Tversky A and Kahneman D, “Judgement under Uncertainty: Heuristics and Biases”, *Science* 185 (1974) 1124-1131, p1130

¹³ Howells G (2005), p355

¹⁴ Cruickshank D (2000), para 50

¹⁵ EC Commission, *Healthier, safer, more confident citizens: A Health and Consumer Policy Strategy* (2005) at 10, cited by Howells G (2005), p351

¹⁶ Financial Stability Forum, *Guidance for Developing Effective Deposit Insurance Systems* (September 2001), found at http://www.financialstabilityboard.org/publications/r_0109b.htm (accessed 30 November 2012) p42, Public Policy Objective 3(a)

of a debtor corporation should be required to attend meetings of creditors. Provision should be made for the possible examination of directors and other persons with knowledge of the debtor's affairs, who may be compelled to give information to the court and administrator

Principle 25: require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise.¹⁷

The concept of the less-financially-sophisticated depositor that the Financial Stability Forum wished to protect is interesting. Behavioural economics has consistently demonstrated that most decision making regarding risk is made intuitively, and that even those with extensive training in statistics are prone to bias when making intuitive decisions¹⁸. Tversky and Kahneman have shown that “people rely on a limited number of heuristic principles which reduce the complex tasks of assessing probabilities and predicting values to simpler judgemental operations.”¹⁹ Howells argues this weakness in the human mind leaves us fundamentally ill-suited to evaluating financial situations²⁰, and similarly Campbell and Cartwright suggest that few possess the financial acumen to make informed choice.²¹ For the consumer, “choice becomes torment.”²² If even those with both high levels of sophistication and training in finance and probability are bad at making investment decisions, will compelling the sharing of accurate financial information make insolvency regimes more effective?

As discussed in Chapter 2, the Enterprise Act sought to make changes to “tip the balance firmly in favour of collective insolvency proceedings - proceedings in which all creditors participate.”²³ A significant part of the reasoning behind remodelling

¹⁷ World Bank (2001), p10-11

¹⁸ Tversky A and Kahneman D (1974), p1130

¹⁹ *Ibid*, p1124

²⁰ Howells G (2005), p358-360

²¹ Campbell A and Cartwright P, “Deposit Insurance: Consumer Protection, Bank Safety and Moral Hazard”, *European Business Law Review* (1999) 6-102, p99

²² Howells G (2005), p354

²³ Productivity and Enterprise: Insolvency - A Second Chance Cm 5234 (London: HMSO, 2001), para. 2.5

administration and removing receivership was that “receivers were insufficiently accountable to the unsecured creditors”²⁴, resulting in waste and excessive liquidation. The result is that unsecured creditor compliance is of much greater importance in the modern law, for example, it is pivotal in CVAs where “for the most part, proposals will be directed to them and aimed at persuading them that the CVA will in some respects improve their prospects of a dividend.”²⁵ Creditor involvement, however, is often “more apparent than real.”²⁶ Frisby observes that “creditor meetings are always very poorly attended... [It is] strongly suspected that when reports, proposals and progress reports were sent out these were dispatched without ceremony to a cylindrical filing cabinet under the desk which is emptied daily.”²⁷ Efforts to increase creditor involvement do not appear to have worked in the way that was hoped.

Katz and Mumford speculate lack of unsecured creditor involvement is due to there being “little cost-benefit incentive”²⁸ to getting involved. Another possibility is lack of information: “unsecured creditors will not routinely be provided with the kind of company information available to directors and floating charge holders.”²⁹ Any benefit of involvement must both extant and perceived. Finally, lack of creditor involvement may involve a lack of confidence in the system, as “whether an extra few pounds will do anything to improve the somewhat jaundiced view that unsecured creditors have... remains to be seen.”³⁰ Frisby, however, argues that unsecured creditor inclusiveness was

²⁴ Armour J, Hsu A, Walters A (2008), p159

²⁵ Walters A and Frisby S (2011), p23

²⁶ Katz A and Mumford M (2006), p47

²⁷ Frisby S (2006), p54

²⁸ Katz A and Mumford M (2006), p47

²⁹ Frisby S (2004), p258

³⁰ Frisby S (2006), p56

an unrealistic and counterproductive aim in the first place. Creditors are not an homogenous assembly and creditors' meetings are not focus groups. In reality, the only consensus likely to emerge is a desire to recover as much of the outstanding debt as possible. In this regard there may be inherent conflicts of interest which cannot be resolved by application to the court and which, if allowed to support litigation, will simply drive up the costs of administration at the expense of everyone with anything at stake.³¹

Interviews with bankers have raised questions about "the value of sending out reams of paper to those without any financial stake in the business, who, as a consequence of this financial disenfranchisement, would almost certainly ignore them."³²

Unsecured creditor inclusivity was enhanced to attempt to provide greater oversight of secured creditors and in doing so provide them with a greater degree of protection, but there appear to be grave concerns that unsecured creditors are not playing their part. The reasons this is happening, however, is in part because of an erroneous understanding of how unsecured creditors perceive business failure, how they make decisions around it, and what causes them to make a decision one way or the other.

Some of the most interesting exploration of the impact of consumer protection from insolvency on the behaviour of consumers has been in the field of banking failure. Arguments that failed banks should be treated like any other type of insolvent firm³³ appear to have fallen before Directive 94/19/EC and the introduction or refinement by all Member States of the European Union of schemes of depositor protection. In the United Kingdom, the Financial Services Compensation scheme, introduced in the Financial Services and Markets Act 2000, ensures that customers of failed banks have their first £85k of deposits guaranteed (this was increased after the Northern Rock

³¹ Frisby S (2004), p265

³² Frisby S (2006), p54

³³ Dowd K, *Laissez-Faire Banking*, Routledge (London: 1993)

crisis). Why are bank savers protected while Farepak savers need a little extra-judicial intervention?

The standard answer to this question is that depositor insurance is a consumer protection device but this is incidental to its role in the reduction of systemic risk:³⁴ the fear of a “domino-like failure of other institutions and even the collapse of the financial system itself.”³⁵ The special nature of fractional reserve banking is often cited as justification for this fear. Given the highly leveraged nature of modern companies, fractional reserves are not sufficient to distinguish banks from other types of business. The systemic importance of banking to the economy in general is undeniable, and banks do seem to have “a special place in the public psyche, and a special trust attached to them”³⁶, but banking exceptionalism risks encouraging observers to ignore the obvious similarities between essentially analogous corporate failures. Non-banking industries are just as subject to systemic failure, leading to insolvencies that are due to causes exogenous to the individual qualities of the firm, and this is particularly the case in an economy where businesses are so reliant on debt. Similarly, depositor protection by another name, say ‘creditor protection’, could be applied to all corporate insolvency, or to protect any other class creditors or circumstances that also appear to occupy a special place in the public psyche. A law that compensated voucher holders of failed retail firms like Farepak would be one example, and in fact there are a number of measures that exist to protect consumers in the event of insolvency, which will be returned to at the end of the chapter.

Remaining for the time being, however, in the analogous world of banking regulation, it has proved difficult to effectively draft depositor-protection type laws that clearly define who is and is not to be protected. The current UK depositor

³⁴ Campbell A and Cartwright P (1999), 98

³⁵ Cartwright P (2004), p18

³⁶ *Ibid*, p193

protection scheme is defined as 'explicit', which is to say that clear exposition of level of protection offered³⁷ which instils consumer confidence and thus prevents bank runs.³⁸ This is contrasted with 'implicit' schemes, decided on a case by case basis, which are accused of causing "considerable uncertainty."³⁹ The Government response to the Northern Rock crisis, where an attempted merger over the weekend was followed by a declaration of enhanced protection on Monday, fits with the characterisation of implicit response⁴⁰ even though an explicit scheme was nominally already in place. In a miserable epitaph to the Financial Services Authority's 'Non-Zero Failure Regime' the greater part of the financial sector is simply too big to fail, and any explicit scheme is fatally undermined the moment it seems the government might change its mind. A voucher protection scheme could easily fall to this sort of public pressure, which may in part explain why the High Court felt compelled to push HBOS into paying out further money to the Farepak creditors.

Restricting protection of unsecured creditors, however, is not simply a question of saving money. Any scheme of depositor protection must "weigh the benefits of public policy intervention against the costs of distorting risk-taking incentives through such intervention"⁴¹, which is normally described as the "moral hazard."

Begg describes this succinctly:

You are sitting in a restaurant and remember you left your car unlocked. Do you abandon your nice meal and rush outside to lock it? You are less likely to if you know the car is fully insured against theft.⁴²

³⁷ Campbell A and Cartwright P (1999), p96

³⁸ Cartwright P (2004), p195-196

³⁹ Campbell A and Cartwright P (1999), p96-97

⁴⁰ Cartwright P (2004), p196

⁴¹ Haldane A and Scheibe J, "IMF Lending and creditor moral hazard", Bank of England Working Paper no. 216 (April 2004), p9

⁴² Campbell A and Cartwright P (1999), p98

A depositor is less likely to pay attention to the condition of their bank if their deposit is protected. This is self-evidently also the case for a creditor of a non-banking company whose investment is protected. In the context of banking the impact of this moral hazard was observed in Argentina in the 1980s, where after the government reinstated depositor insurance “depositors sought out those institutions that were thought most likely to fail as they paid the best rates of interest.”⁴³ Haldane and Schiebe found evidence of correlation between IMF lending of last resort and increased bank returns, although they noted other efforts at quantification have produced mixed results.⁴⁴ Truman has attacked the notion of moral hazard, observing that “unsubstantiated theoretical propositions and anecdotes provide an insufficient intellectual foundation for dramatic changes in international financial policy.”⁴⁵ The experiment in the second part of this chapter aims to add a little further substantiation to the moral hazard question.

A behavioural analysis of moral hazard has to make the following observation: if I am not the sort of man to abandon a good meal, then having car insurance may increase the likelihood that I stay but it is not going to make any difference either way. If deposit insurance increases the likelihood that I fail to verify the solvency of the bank by 0.1%, then how much do I care? As Cartwright observes, ensuring the consumer knows they are protected is insufficient to definitely alter their behaviour.⁴⁶ The crucial difference is that payment is drawn from those resources remaining to the firm, and not some separate government fund or insurance policy.

Extending this logic back to unsecured creditors of non-banking firms may explain why they do not receive the sort of legal protection bank savers do. If trade creditors

⁴³ *Ibid*, p99

⁴⁴ Haldane A and Scheibe J (2004), p7

⁴⁵ Truman (2001), ‘Perspectives on external debt crisis’, speech before the Money Marketeers, New York, cited by Haldane A and Scheibe J (2004), p9

⁴⁶ Campbell A and Cartwright P (1999), 99

and consumers are protected then they will not take care in their investments. Concerns about market discipline do not appear to have tamed the pity of Smith J towards the Farepak savers. Professor Tribe garners “further discontent with the unsecured creditors’ lot”⁴⁷ from the law reports reflecting popular concern about factors like the way in which administrator’s fees can swallow up the last of the pie before trade creditors get a slice. Keay and Walton describe it as a “sad fact of life that these creditors receive little or nothing in many bankruptcies and liquidations.”⁴⁸ Part of the justification for the system of priority is that it allows private ordering. The “secured creditor is accorded priority because he bargained for it”⁴⁹, and this process of bargaining in the shadow of insolvency law⁵⁰ imposes market discipline upon firms and consumers alike. Players exposed to the risk of failure are more likely to pay attention to their investments, bringing price towards use value and allowing the market to accurately assess risk. The Farepak customers were, in law, fully exposed to the folly of their savings choice, yet they did not incorporate the risk into their decision making and ultimately were spared the full consequences of their decisions. Where does this leave creditor exposure and the system of priority as a tool for market discipline? What is the place of creditor decision making in the orderly workout?

⁴⁷ Tribe’s Bankruptcy and Insolvency Blog, bankruptcyandinsolvency.blogspot.com, entry 21 March 2011, [accessed 27 March 2011]

⁴⁸ Keay A and Walton P (2008), p471

⁴⁹ Goode R (2005), p59

⁵⁰ See Chapter 1.2

7.3 THE EXPERIMENT

In order to explore these questions I performed an experiment. Ninety-five volunteers, predominantly graduates and post-graduates, were presented with an on-line narrative presenting increasing levels of insolvency risk to a firm from whom they wished to buy a record voucher: a fictional record shop known as “Vaxxi”. The first question, “what is the maximum you would pay for a £10 record voucher”, may seem a little strange. Anyone who has bought one knows that it costs £10. Yet these sorts of ‘Willing to Pay’ (WTP) tests are a staple of research into cognitive valuation⁵¹, both as a fundamental element of cost modelling and because they can provide accurate predictions even in the absence of real money transfers.

When a price is below the willing to pay threshold, the artefact is purchased. For some respondents this is confusing:

I found it interesting that you wanted the participants to quantify how much they would spend on a voucher. For me it was an either or scenario. I would expect to pay £10 for £10 of goods or I wouldn't purchase the gift voucher at all, I couldn't put a value (e.g. £8) because either I would buy the voucher or I wouldn't. (Respondent 6)

This sort of experiment has a good record of producing reliable results, however, and the question was used to filter sixty respondents who both completed the questionnaire and specified that they would pay £10 for the voucher. The use of the £10 voucher was intended both to connect to the relevant events, and an exploitation of the phenomena of anchoring and coherent arbitrariness.⁵² People are better at scaling to an arbitrary value than determining absolute value. By establishing a subset prepared to pay £10 for the voucher in normal conditions, we

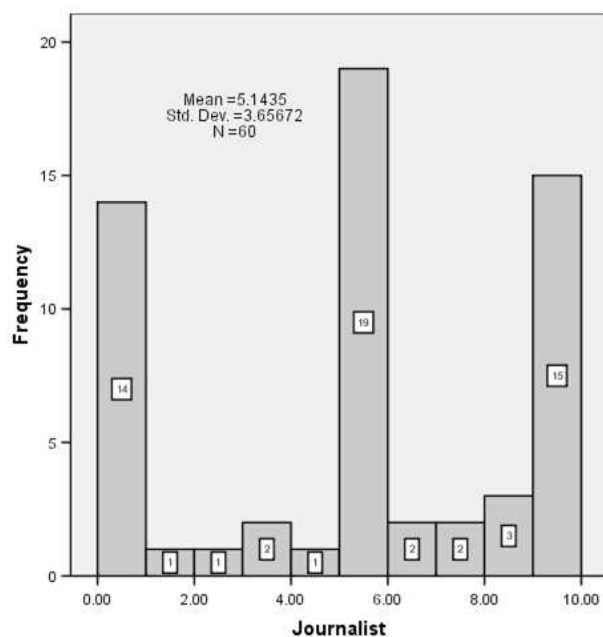
⁵¹ Ariely D, Loewenstein G, Prelec D (2003), p98

⁵² *Ibid*, p74

can have a higher expectation that their responses will be “locally coherent”⁵³ and therefore more easily comparable.

Participants were then asked the maximum they would pay if they heard from a respected journalist that the record shop might go bust over the weekend. Reliance on hypothetical choices does present methodological problems but, as described by Kahneman and Tversky⁵⁴, there is little that can be done to overcome this limitation without encountering other problems.

What would you be prepared to pay if you hear that Vaxxi may be about to go bust?



Three groups emerge. Group A are effectively indicating their withdrawal from the transaction. Once risk is highlighted Group A WTP becomes 0. For some this was a because the record voucher was intended as a gift:

⁵³ *Ibid*, p75

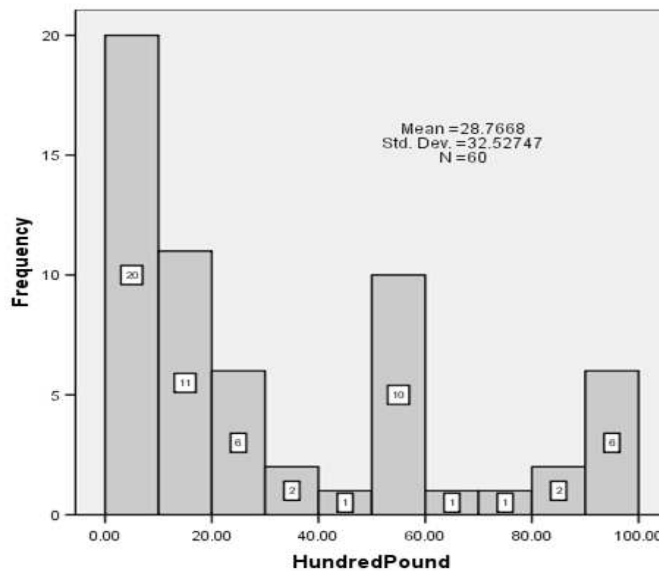
⁵⁴ Kahneman D and Tversky A (1979), p265

It's a present for a friend; the potential for any hassle over redemption outweighs any of the financial issues. The point of a gift is to make them feel good; any kind of hassle, no matter the sum involved would defeat the purpose of the gift. (Response 94)

Group B has adjusted to take into account the risk of failure. Why is the risk of failure quantified at £5? Why is it not distributed more evenly across the spectrum according to relative risk aversion? This suggests the arbitrary nature of the decision. Consumers are “unable to retrieve personal values for ordinary goods”⁵⁵ and so decide that if they have to take risk into account, they may as well halve the price. Players have no other market to adjust their behaviour around.

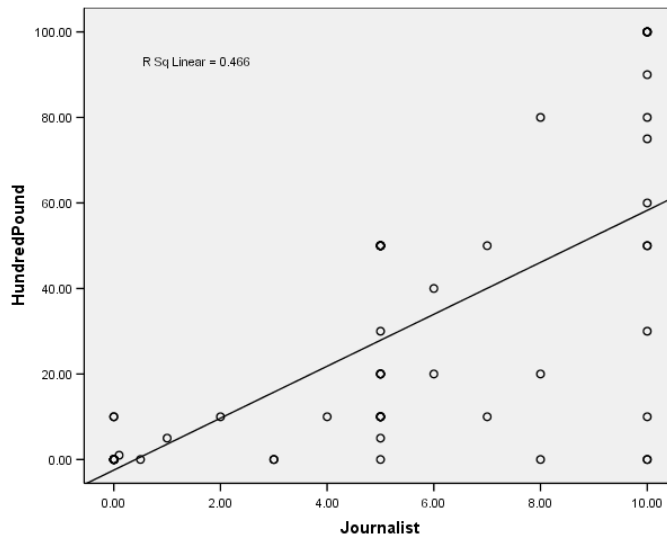
Group C are still WTP £10. It was possible that some players would consider £10 trivial. In anticipation of this I asked for players WTP for a £100 voucher.

What would you be prepared to pay for a £100 voucher?



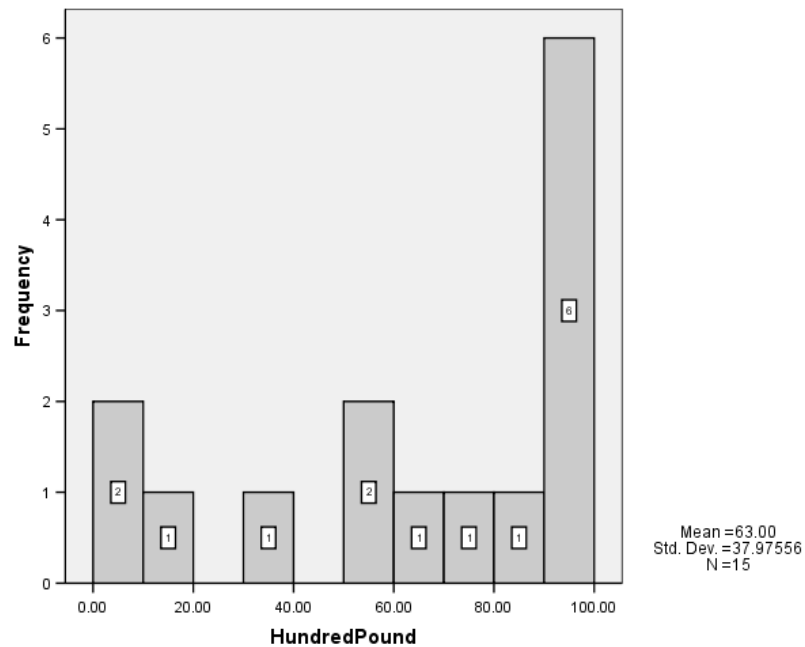
Distribution
skews left for
£100 voucher

⁵⁵ Ariely D, Loewenstein G, Prelec D (2003), p77



Moderate positive correlation but significant movement amongst those who would pay £10 for a £10 voucher under risk.

Some of the movement here may well be from players who simply considered the notion of a £100 voucher to be ridiculous, but there is a significant shift, with a third no longer willing to buy and more than half only willing to pay less than £20 for the £100 voucher under risk. There is particular volatility in amongst players who previously said they would pay £10 even under conditions of risk:

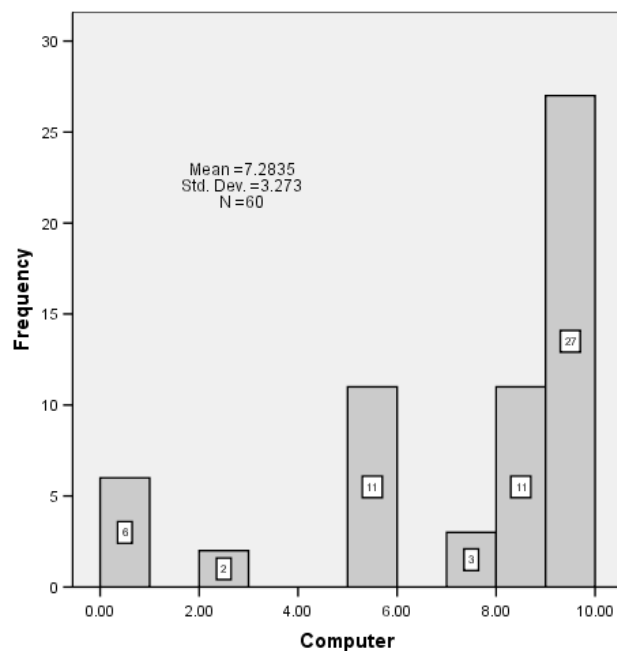


This suggests, unsurprisingly, that magnitude of investment is a factor which increases sensitivity to risk. Note that the full sample diagram maintains Group

A/B/C type peaks; “while people are adjusting their valuations in a coherent, seemingly sensible, fashion to account for duration, they are doing so around an arbitrary base value.”⁵⁶ The response to magnitude is explained by Kahneman and Tversky: “Psychological response is a concave function of the magnitude of physical change... thus the difference between a gain of 100 and a gain of 200 appears to be greater than the difference between a gain of 1,100 and a gain of 1,200”⁵⁷

Players were now told that they had consulted a super-computer that had told them with absolute certainty that there was only a 20% chance of the shop failing.

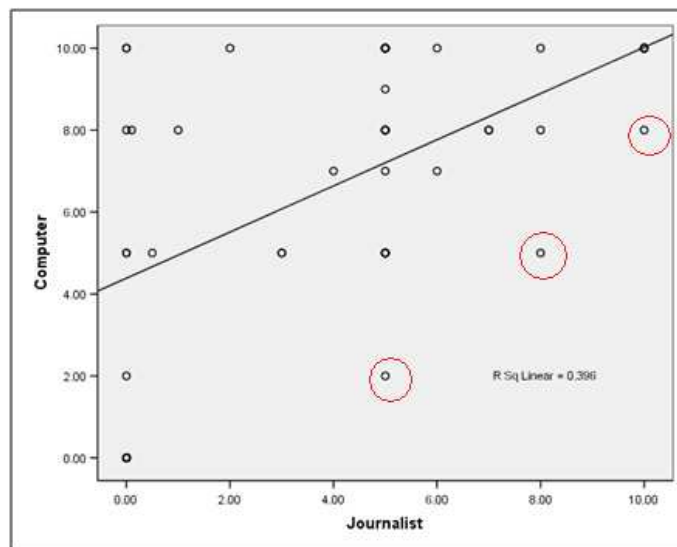
How much will you pay with a certain 20% chance that the firm will fail?



I hypothesised before the experiment that this would result in a peak in the £8 valuation, a reasonable application of neo-classical utility maximisation theory. Utility should be weighted by probability. While there is a movement to the £8 point, there is also a significant movement of players into Group C. Group C valued the £10

⁵⁶ Ariely D, Loewenstein G, Prelec D (2003), p101
⁵⁷ Kahneman D and Tversky A (1979), p278

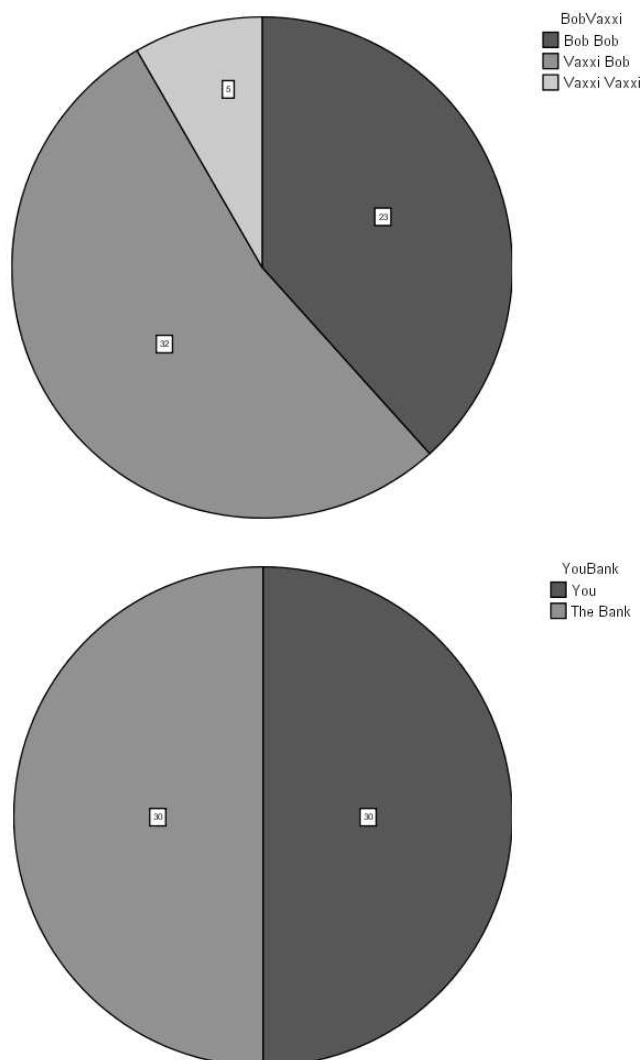
voucher under a 20% risk of failure at £10. We might expect movement from the Group B risk evaluators to the £8 valuation but what is particularly interesting is the drop in Group A withdrawals from fourteen players to six. Of these players two moved to £10, two to £8, three to £5 and one to £2. These players appear to have withdrawn from a purchase because of the uncertainty, rather than the risk of loss *per se*.



Finally, note the three circled players were willing to pay less once they knew the (relatively low) risk of failure. Obviously this is too small a number to indicate a trend, but it is an important reminder that consumers will not idly follow expected patterns. This is not *de facto* an irrational choice (the player furthest to the right may simply trust computers more than journalists), but it does seem to demonstrate rather arbitrary behaviour by the participants. The relatively weak correlation becomes even weaker if we remove changes caused by Group A being prepared to re-enter the market now that risk can be calculated and simply concentrate on the impact upon players who remained in the market. Increasing the information does not seem to be enforcing an underlying preference for vouchers adjusted by risk. Risk averse players do not necessarily remain risk averse, and vice versa.

The next two questions explored participant’s perceptions of their legal rights. Having given the gift voucher to their friend, they were told that “Bob” had used the voucher to order a CD. They were asked if they thought that when Bob went to the closed down store and tried to take the CD he ordered from a mixed pile he had a legal right to do so, and whether he should have such a right.

Who has the right, and who should have the right, to ordered CDs after the shop has failed?



Two things are striking about these results. The first is that nobody from the sample believed that the record shop both owned (legally) the CD and should (normatively)

keep the CD. Second, even amongst those that correctly believed that Vaxxi had the legal right,⁵⁸ only five of the thirty-seven thought that this was how the law should be. Following on from this, players were asked about their own record voucher, still in their possession, and whether out of the creditors of the record shop they or the bank should be paid back first. The dead fifty-fifty split indicates as much ambivalence about the law as the split in the first question.

In the context of depositor protection, it has been suggested that “if customers are not aware of what protection is offered, they are likely to assume that there is none.”⁵⁹ Nine out of the twenty-three (39%) who thought Bob had the right were prepared to pay the full £10 when they heard the rumour of failure (Group C). Sixteen out of the thirty-seven (47%) who thought the record shop had the right to the CD did the same. Full information about risk is not impacting upon price.

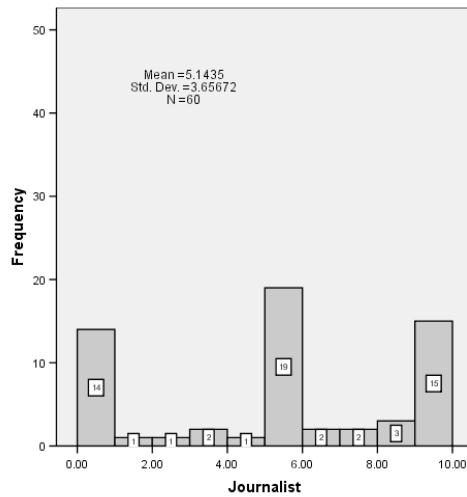
In the final question time leapt forward a year, and they were given another opportunity to buy a £10 record voucher from a shop that a journalist had suggested was about to fail. The difference this time is that the government has intervened with an explicit creditor protection scheme, and have “set up a fund so that anyone who owns this sort of voucher with a firm that goes bust will get their money back.” The following graphs speak for themselves: protected consumers do not pay attention to risk.

⁵⁸ Bob is seeking a property right in an unascertained good and will be disappointed by s16 Sale of Goods Act 1979 and *Re London Wine (shippers) Ltd* (1986) PCC 121 CD

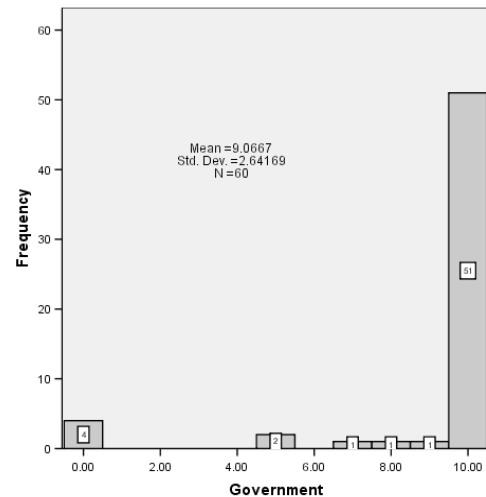
⁵⁹ Campbell A and Cartwright P (1999), p100

How much would you pay with a government guarantee of a refund in the event of failure?

Without Guarantee (Question 2)



With Guarantee



To summarise, players asked what they would pay for a £10 record voucher when exposed to possible failure displayed apparently arbitrary decision making rather than apparent probability * cost decisions, where passing a risk threshold (which was a lower proportion for a higher amount) caused them to withdraw rather than proportionately adjust their willingness to pay. Where their ownership was threatened their legal rights did not match their expectations or their ideas of the social norms, but as soon as they were protected they ceased to give either risk or norms much consideration and simply stated a willingness to pay £10. This could be expected to have a dolorous effect on market discipline.

Instead of rationally analysing risk, consumers respond to proximity and magnitude. The majority will pay £10 for a £10 voucher, because the anchoring is straightforward (of the ninety-five participants, only fifteen suggested other prices). If there is an immediate threat of danger (the journalist) many either withdraw from the market

altogether or mediate their investment, unless the investment is too small for them to care. If the amount they imagine they will lose is big enough, then even a more distant threat of failure will do exactly the same thing (the £100 record voucher): “The subjective assessment of probability resembles the subjective assessment of physical quantities such as distance or size... [which] leads to systematic errors.”⁶⁰ I am reminded of Father Ted explaining the difference between a small cow and one which is far away.⁶¹

The market for vouchers has certainly changed:

How many people still buy CDs? How many people still go to a record shop? I wouldn't ever consider buying a Vaxxi voucher in reality because I don't know anyone who still buys music that way! (Spotify, iTunes etc) (Response 6)

Some part of this will be due to the failure of firms like Farepak, or music, games and video chain Zavvi where “people who got Zavvi vouchers as Christmas presents discovered they weren't being accepted in stores after it went into administration in December [2008].”⁶² Another example is the pre-packaged sale of the fashion chain Jane Norman which resulted in “onerous”⁶³ conditions being placed upon the redemption of their gift vouchers, and the recent entry of Comet into administration resulting in the “suspension”⁶⁴ of vouchers.

Events like this increased the “imaginability”⁶⁵ of failure and put off some consumers who would otherwise have bought vouchers. Yet organisations like iTunes and many other department stores still successfully sell vouchers. The assumption that this is

⁶⁰ Tversky A and Kahneman D (1974), p1124

⁶¹ A UK Channel 4 Situation Comedy broadcast from 1995-1998

⁶² “Zavvi giftcards and vouchers”,

http://www.bbc.co.uk/blogs/watchdog/2009/01/zavvi_giftcards_and_vouchers.html (accessed 20 August 2012)

⁶³ “Hurry to use Habitat and Jane Norman Gift Vouchers”,

<http://www.moneysavingexpert.com/news/shopping/2011/07/hurry-to-use-habitat-and-jane-norman-gift-cards> (accessed 15 November 2012)

⁶⁴ “Comet gift vouchers suspended as chain collapses into administration”,

<http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/9653058/Comet-gift-vouchers-suspended-as-chain-collapses-into-administration.html> , (Accessed 15 Nov 2012)

⁶⁵ Tversky A and Kahneman D (1974), p1127-1128

simply because consumers do not have sufficient information is dangerous, and akin to the workman blaming his hammer because it cannot saw wood. It is reasonable to conclude both that:

- a) Enhanced protection of unsecured creditors, like Farepak voucher holders, presents similar risks to the moral hazard concerns that accompany depositor protection in banking regulation, and thus has broader systemic consequences.
- b) Increased information does not appear to lead consumers to incorporate the risk into their decision making in accordance with expected utility theory, thus undermining the validity of the information paradigm to consumer regulation and the model for Orderly and Effective insolvency.

Clearly protecting people like the Farepak customers is more complex than it might initially appear. The desire to protect the vulnerable against the harsh consequences of business failure has led to some difficult legal contortions. This is manifest in the effort to divide unsecured creditors into trade creditors, who as commercial entities are expected to negotiate in the shadow of the law, and consumers, who are not. The Consumer Credit Act 1974 was introduced to provide protection of individual debtors, both by regulating the business practices of the credit industry in general and controlling the “form, content, terms and enforcement of regulated consumer credit agreements.”⁶⁶ The act largely seeks to protect smaller, non-commercial transactions. The most important revisions regarding insolvency are s56, which deals with antecedent negotiations (such as a hire purchase agreement) by creating agency between the negotiator and the creditor, to the effect that it gives “non-excludable

⁶⁶ Sealy LS and Hooley RJA, *Commercial Law: Text, Cases and Materials*, 4th Ed, Oxford University Press (Oxford: 2009), p1146

rights to the debtor or hirer against the negotiator in respect of breaches of express conditions and warranties or of actionable misrepresentation⁶⁷, and s75, which makes the provider of credit jointly and severally liable for items with a cash price between £100 and £25,000. The Consumer Credit Directive that came into force on the 1 February 2011 expanded this to cover arrangements where the cash price of the item exceeds £30,000 but the credit amount does not exceed £60,260 and specifically mentions the case of liability for the creditor where the supplier is insolvent. This difficult dance of definition and value limits is the exact same challenge faced by drafters of depositor protection for banks. How do you balance systemic risk with moral hazard and the protection of the vulnerable? The answer in mainstream insolvency law has been to devise the construct of the consumer and then apply arbitrary limits to what constitutes non-commercial consumption.

Another example of recent developments in creditor protection are the new rules set out in Chapter 5 of the Client Assets Sourcebook⁶⁸, issued 31 October 2012, which have tightened the rules and particularly reporting requirements regarding client money by financial firms. Client money is money a firm holds or receives that is not immediately due or payable, and they must be placed in a separate interest bearing account so that it is identified and segregated in the event of insolvency. The reason for the tightening of the rules is the financial crisis, and particularly the failure of Lehman Brothers to properly segregate client money from mixed funds. Tightening up the rules is about consumer protection but also about restoring confidence in banking and financial services.

⁶⁷ Harvey BR and Parry DL, *The Law of Consumer Protection and Fair Trading*, 6th ed, Butterworths (London: 2000), p316

⁶⁸ Statutory Instrument 2012/65

Perhaps the most famous ruling regarding the protection of consumers in an insolvency context is the case of *Re Kayford*.⁶⁹ A mail order business had created a separated account into which customer's money had to be paid. When the company became insolvent the customers' money was protected by the creation of a trust over the separate account. In his ruling, Megarry J observed that he was concerned for "members of the public, some of whom can ill afford to exchange their money for a claim to a dividend in the liquidation"⁷⁰, and that as such the establishing of a separate account was an "entirely proper and honourable thing for a company to do... I wish that, sitting in this court, I had heard of this occurring more frequently."⁷¹ Yet the Cork Committee did not choose to institute statutory reforms that would oblige firms to hold consumer pre-payments in separate accounts, in much the same way that financial services firms would later be required to hold client money. Finch explains why, even if efficiency and removal of capital issues are ignored, such a statutory rule would fail on the grounds of fairness:

The problem for proponents of consumer protection lies in any contention that consumers are in a worse position than all unsecured trade creditors. The small unsecured trade creditor who is not in a continuing relationship with a debtor company may be very poorly positioned... the case in fairness for special treatment of consumers as a general class seems not to be made out.⁷²

Similar problems would face a hypothetical rule designated a part of the prescribed part to be paid by consumers. Some creditors are protected for social reasons, whether to protect individuals deemed worthy (eg. high street consumers) or organisations deemed important (eg. banks). A difficult cost-benefit analysis is made to weigh the social value of the entity against the social cost of the moral hazard

⁶⁹ *Re Kayford Ltd* [1975] 1 WLR 279

⁷⁰ *Re Kayford Ltd* [1975] 1 WLR 279, Megarry J at 282

⁷¹ *Ibid*

⁷² Finch V, *Corporate Insolvency Law: Perspectives and Principles*, 2nd Ed, Cambridge University Press (Cambridge: 2009), p665

created. High street consumers are protected because they command sympathy in the public eye, confidence in financial services is preserved through protection of client money because of their importance to the economy, and trade creditors are left to hang because at the end of the day someone has to lose. The distinction between the vulnerable consumer and the rational trade creditor is an artificial cover for this difficult process of prioritising. This is only a problem if we fall for the idea that vulnerable creditors are protected because they are unable to make informed choices. Individuals are incapable of purely rational decision-making. If that was the basis of protection then everybody should be protected from their inability to make informed choice. One suspects certain large financial institutions might have benefited from being protected from their inability to make informed choices as well.

Orderly and Effective insolvency cannot rely on creditors to choose the best monetary returns outcome. If it is not simply a lack of information but also cognitive failings when it comes to managing information and making the best decisions, then a rescue orientated system needs a means to reduce the impact of expectation and emotional involvement from the creditors without isolating them from the consequences of their actions. As Posner observes, “human behaviour exhibits *systemic* departures from rationality. Cognitive psychologists, economists, and economic analysts of law have presented evidence that most of us commit a variety of systemic cognitive errors.”⁷³ If these cognitive errors are systemic then they require a systemic response. This is where, in an insolvency regime that already has a good infrastructure and strong property rights, small inclusivity measures could have significant benefits.

⁷³ Posner RA (2007), p17

CHAPTER 8: THE USE OF ADR TECHNIQUES AND REINTEGRATIVE SHAMING TO IMPROVE INSOLVENCY OUTCOMES

8.1 THE NORMATIVE ROLE OF THE ADR CULTURE IN ENGLISH LAW

I have argued that in an insolvency system with a good infrastructure and strong property rights, inclusivity encouraged by an element of redistribution is a strength that improves creditor returns by increasing the likelihood of rescue. I even went so far as to argue that inclusivity measures could improve pre-packs, in many ways the pinnacle of the non-inclusive English rescue measure. This may be ringing alarm bells for the reader, particularly one who finds the word “redistribution” ideologically disagreeable in the first place. It should not. The types of changes I recommend are already being adopted by commercially savvy operators. The intention in this chapter is to share some of these ideas and give a clearer idea of why they work to improve orderly insolvency.

This chapter aims to demonstrate the sorts of measures I mean when I talk about inclusivity, and some practical suggestions that might improve insolvency outcomes by increasing creditor compliance. By compliance I mean willingness to co-operate in effective workout, whether that means directors accepting the firm is unsalvageable or creditors appreciating that a penny in the pound really is the best they are going to get. It does so by building on the exploration of the role of punishment, shame and stigma in insolvency laws in Chapter 6, and the handling of information and

consumer decision making in Chapter 7. The suggestions focus on marginal changes that will achieve small improvements in process, and include the use of mediation techniques and mediation training by insolvency professionals (including within financial institutions), encouraging opportunities for directors to explain why the failure happened and for stakeholders to describe its impact, and the power to require an apology. The objective is to improve returns by reducing the instances where stakeholders choose to pursue impossible rescues or liquidate viable enterprises, be it due to hubris, anger, or simple mistake. This is not a communitarian argument, in that I am not arguing that insolvency law should consider these factors for some reason beyond maximising financial returns, nor is it concerned with the emotional wellbeing of participants beyond the extent to which it improves effective wealth maximisation. It will be argued, however, that a small expenditure on considering the emotional context of decision making will ultimately pay off in increased aggregate returns.

It may be difficult to see, *prima facie*, the place of ADR and re-integrative shaming in the insolvency process. Opportunities for litigation are deliberately limited by the use of moratoria, and the multiplicity of groups and interests makes it difficult to visualise the scenario in the same fashion as a simple two party civil litigation. The Enterprise Act sought to enhance creditor participation in insolvency proceedings:

The Government's intention is to sponsor insolvency proceedings which are inclusive, in the sense that they afford all creditors participation rights and under which all creditors can look to the presiding insolvency practitioner to both represent their interests and to account if he fails to do so. Whereas collectivity *per se* simply binds creditors, inclusiveness offers them a pro-active role in the procedure itself.¹

¹ Frisby S (2004), p250

Yet one might also question the need for encouraging creditor compliance given that many insolvency procedures involve little creditor decision making, and perhaps dismiss inclusivity as more of a communitarian concern and therefore a distributive goal in itself rather than being something that improve outcomes.

Three rebuttals are offered to these concerns. First, this chapter is focused on low cost measures that achieve marginal increases on those occasions when they apply. They do not need to be universally applicable to be useful. Second, CVAs need creditor votes and the Administration + CVA combination is the most viable approach available for successful rescue. Measures that improve the chance of favourable voting and effective design of CVAs are worth investigating. Third, this thesis is more concerned with insolvency laws operation on bargaining within its shadow. These recommendations are more to do with changes in the culture and approach to informal workout than with substantive changes to the law.

What is it about English law that makes it such an effective commercial mechanism? Perhaps the single most important cultural change to English civil law was the enactment of the Woolf Reforms² with the introduction of the Civil Procedure Rules in 1998. These wide ranging rules represented “a fundamental change in the culture of civil litigation”³ and are considered “one of the real success stories in the history of English Law.”⁴ Drawing on concerns that English adversarialism was having a deleterious effect on the justice system, Woolf emphasised the value of Alternative Dispute Resolution (ADR) “claiming that it saved scarce judicial and other resources, was usually quicker and cheaper, and often achieved a more mutually satisfying

²The Woolf Reports: *Access to Justice – Interim Report* (June 1995), <http://www.dca.gov.uk/civil/interfr.htm> (accessed 23 Nov 2012), *Access to Justice - Final Report* (June 1996), <http://www.dca.gov.uk/civil/final/index.htm> (accessed 23 Nov 2012)

³ Loughlin P and Gerlis S, *Civil Procedure*, 2nd Ed, Cavendish (London: 2004), p7

⁴ Sedly S, Foreward in Loughlin P and Gerlis S (2004)

outcome for the parties than litigation”⁵ Rule 1.4(1)(e) of the CPR states that the court “encourage the parties to use an alternative dispute resolution procedure if the court considers it appropriate and facilitating the use of such procedure.” There is a fist in the glove. Failure to consider ADR can activate the court’s discretion regarding costs under the Senior Courts Act 1981 s51(1), thus a 10-15% reduction in costs order was held to be a proportionate response for not considering ADR⁶, and even a failure to take a reasonable position in mediation has resulted in an adverse costs order.⁷ The result is that lawyers are obliged to consider alternatives to litigation and only go to court if there is no other reasonable alternative.⁸

How is this relevant to insolvency law? CPR rule 2.1(2) excludes insolvency proceedings from the rules, but same lawyers being required to embrace ADR are the ones advising parties long before litigation is considered, and the purpose of the reforms was to change the whole culture of English law. This means they are more likely to consider alternative approaches to dispute resolution, with the attendant advantages described by Lord Woolf above. Taken as a whole, and supported by the following arguments in this chapter, this change in culture informs my submission that greater inclusivity has made English law more effective at achieving greater returns in insolvency. The focus of modern English civil law is on resolving disputes before they reach the court. This is as effective in insolvency as it is anywhere else.

⁵ Loughlin P and Gerlis S (2004), p6

⁶ *Straker v Tudor* [2007] EWCA Civ 368

⁷ *Earl of Malmesbury v Strutt and Parker* [2008] 118 Con LR 68

⁸ *Cowl v Plymouth City Council* (2001) *The Times*, 8 January 2002

8.2 INFORMAL WORKOUTS AND AUGMENTED DECISION MAKING

The importance of informal workouts is clearly recognised in the Orderly and Effective model of insolvency; “corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability”⁹.

But the emphasis is still on the information paradigm notion that if consumers have all the information they will make the best choice. The principles consistently return to the importance that the law “require the provision of relevant information on the debtor”¹⁰ or “require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise.”¹¹ These are important principles but they do not address the whole problem.

Chapter 7 both explored and demonstrated serious limitations to the information paradigm, but there is strong evidence that information sharing has significant positive benefits to the insolvency process. Houston et al’s empirical investigation of the subject finds the benefits of information sharing to be universally positive, including “higher bank profitability, lower bank risk, a reduced likelihood of financial crisis, and higher economic growth.”¹² IMF policy regarding information sharing reflects the London Approach, and they state that “decisions about the debtor’s longer-term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties to a workout.”¹³ As suggested in Chapter 6 normative behaviour in banking was demonstrated to favour strategic co-operation amongst clearing banks and financial institutions. As well as providing structural benefits that improves insolvency performance across the board, Houston

⁹ World Bank (2001), p11

¹⁰ *Ibid*, p10

¹¹ *Ibid*, p11

¹² Houston JF, Lin C, Lin P and Ma Y (2010), p485

¹³ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p14

et al's research suggests that information sharing reduces the potential harm of higher first claim security: "Stronger creditor rights lead to higher volatility, while greater levels of information sharing reduce volatility [and] helps mitigate the positive effects that stronger creditor rights have on risk taking."¹⁴ Reconciling the two disparate findings – the value of information sharing as opposed to the weakness of the information paradigm – requires a better understanding of how people make decisions based upon the information they have.

Neuroscientists Campbell, Whitehead and Finkelstein¹⁵ have found that decision making occurs in two stages: first, pattern recognition looking for similarities between the current situation and our past experiences, and second, emotional tagging where the emotions associated with the patterns enable us to judge the importance of the current event. Both components are essential because without emotional context "we become slow and incompetent decision makers even though we retain the capacity for objective analysis."¹⁶ The process happens "almost instantaneously"¹⁷ and once the pattern is fixed it is very difficult to shift from this initial frame.

Inappropriate self-interest, the presence of distorting attachments and misleading memories are "red flag conditions"¹⁸ that can lead to incorrect pattern recognition and thus bad decisions and inappropriate emotional responses. Business failure contains a surfeit of opportunity to encounter these red flag conditions. The name 'bankrupt' is a stigma. It is a brand marking your "deceitful, quasi-criminal conduct in entering into bankruptcy"¹⁹, which can encourage distrust on the part of creditors

¹⁴ Houston JF, Lin C, Lin P and Ma Y (2010), p496

¹⁵ Campbell A, Whitehead J, Finkelstein S, "Why Good Leaders Make Bad Decisions", *Harvard Business Review* (Feb 2003) 60 – 66)

¹⁶ Campbell A, Whitehead J, Finkelstein S (2003), p63

¹⁷ *Ibid*

¹⁸ *Ibid*, p66

¹⁹ Efrat R (2006), p369

and potentially inappropriate shame on the part of the debtors. Although firms themselves are not emotional the people that run them are:

There's something in the psyche of directors of SMEs, call it pride or stubbornness, whatever you like, but they try solve their own problems for far too long and the problems just get worse and worse. And they can be very good at robbing Peter to pay Paul, if you follow, they'll keep the bank quiet for as long as possible, they'll even throw in their own money to pacify some of the more important creditors, what they don't do is get independent advice until there's a winding up petition threatened. And that means that there are a lot of very hacked-off creditors out there, so that the chance of persuading them to go for a CVA is zero.²⁰

Even for those that pride themselves on their objectivity emotional tagging is an essential component of effective reasoning, and the emotions associated with making mistakes have been shown to interfere with reasoning and the ability to detect and prevent further errors.²¹

The barrier concept developed by Mnookin describes two key factors that prevent successful negotiation.²² The first factor concerns strategic barriers, where players refuse to co-operate and share information even to their own advantage for fear of giving an exploitable advantage to the other side. The second factor is cognitive bias, which Bush considers as follows:

[During] cognitive processes by which people assimilate information, there are regular and identifiable 'departures from rationality' that lead to distortion and misinterpretation of the information received... Because of cognitive biases, each party is incapable of reading the information provided by the other side including offers and demands accurately and objectively. Therefore, each is likely to analyze this information with a false and distorted

²⁰ Frisby S (2011), p366

²¹ Ichikawa N, Siegle H, Jones N, Kamishima K, Thompson WK, Gross JJ, Ohira H, "Feeling bad about screwing up: emotion regulation and action monitoring in the anterior cingulate cortex", *Cognitive Affective and Behavioural Neuroscience* 11(3) (2011) 354-371

²² Mnookin RH., "Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict", *Ohio State Journal on Dispute Resolution* 8 (1993) 235-249, strategic barriers p239-242, cognitive barriers p243-246

perspective that, once again, leads them to miss opportunities for deals entirely, or make deals that fail to realize all possible joint gains.²³

Business failure occurs in a scenario where mistakes most likely have been made and a sense of embarrassment, shame or disappointment heightened, creating a higher probability of cognitive bias, just as the bankruptcy stigma will aggravate distrust and exacerbate strategic barriers to negotiation. Essentially, “those facing financial difficulty are not best placed to assess their own situation. The stresses and strains that inevitably accompany financial problems may cause undue panic, or alternatively a ‘head in the sand’ mentality.”²⁴ Bankruptcy is not conducive to good decision making.

Where parties have an unhelpful initial framing or informal unassisted negotiations have broken down, the key is to find a mechanism that helps overcome their barriers to negotiation. It is not simply a question of providing parties with all the information, but providing it in a fashion that helps them overcome their initial impressions and the emotional response they provoked. In management theory Campbell et al suggest that:

For important decisions, we need a deliberate, structured way to identify likely sources of bias – those red flag conditions – and we need to strengthen the group decision-making process... the simple answer is to involve someone else – someone who has no inappropriate attachments or self-interest... That person could challenge her thinking, force her to review her logic, encourage her to consider options, and possibly even champion a solution she would find uncomfortable.²⁵

Formal mediation can improve inter-party decision making in a similar fashion to the way deliberate structures can improve internal decision making. In a typical

²³ Bush RA, “What Do We Need a Mediator For? Mediation’s Value-Added for Negotiators”, *Ohio State Journal of Dispute Resolution* 12 (1996) 1-36), p10 then p11-12

²⁴ Dennis V (2007) p12

²⁵ Campbell A, Whitehead J, Finkelstein S (2003), p64

mediation the mediator will briefly speak to the parties together before taking each individual party separately in a series of individual sessions and encouraging them to explore how the dispute arose, what they hope to achieve in a settlement and what they would be prepared to do in order to settle. Meetings are entirely confidential, the mediator is a neutral third party, and offers are only passed to the other room under the explicit instruction of the parties. ADRg, an association of accredited mediators, claims an 80% success rate in achieving binding agreements through mediation.²⁶ Bush states that “mediation is best understood as, in essence, a process of “facilitated or assisted, negotiation” in which the mediator facilitates the parties’ own negotiation process.”²⁷ Central to this is improving parties’ ‘informational environment’ where the mediator seeks to “improve the flow of information and reduce the effects of false or biased assumptions.”²⁸ The process helps parties reconsider how they have understood the problem.

Having access to better information may not be sufficient to dislodge inaccurate initial framing, particularly in the context of strong emotion, and here the format of formal mediation is helpful. It has been demonstrated that “mediation produces high levels of satisfaction and compliance, and that these levels are typically much higher than those generated by court processing of similar cases.”²⁹ This has been linked with what is known as ‘procedural justice theory’, where the means by which an outcome is achieved is shown to have value to the participants. Early research into procedural justice theory emphasised consumer preference for the process control available in adversarial rather than inquisitorial justice because it gave a greater opportunity to put what they felt was important in front of a judge.³⁰ This

²⁶ ADRg, Mediation Training Programme Course Manual, ADR Group (Bristol: 2012), p1.

²⁷ Bush RA (1996), p3

²⁸ *Ibid*, p14-15

²⁹ *Ibid*, p16

³⁰ Thibaut J, Walker L, Latour S, Houlden P (1973)

goes beyond a perceived greater chance of a positive result: “parties usually prefer the consensual processes, even where the outcomes they receive in these processes are unfavourable.”³¹ McEwen and Maiman³² have demonstrated that parties are attracted to process advantages like the opportunity to express how they feel about what has happened, attention being paid to what clients feel are the key issues, and facilitating client involvement in shaping an agreement. In their analysis of the Asian financial crisis, Radalet and Sachs observe that “the market has reacted most positively to initiatives that bring creditors and debtors together”³³ Within the insolvency context this feeling of procedural fairness may help offset the impression of unfairness that can often accompany business failure, and consequently improve poorly framed decisions: those decisions made in the heat of the moment, without a full appreciation of the facts or the consequences, and that tend to form the first impressions that are so hard to get rid of.

That formal mediation has these benefits is all well and good but as observed at the beginning of the chapter the opportunities for formal mediation may be more limited in an insolvency context because of the multiplicity of players and the consequent problem of co-ordination, and the limited opportunities for litigation once moratoria have been put into place. If legislation was passed to require mediation between parties to a failing business, “the mere fact that the court has mandated that the parties participate in mediation might suggest that the court should have the means to enforce the mandate through a participation in good faith requirement, or by enforcing a mediated agreement”³⁴, not only resulting in rapidly escalating costs and complexity but also bringing it within the auspices of the courts, which reduces its

³¹ Bush RA (1996), p18

³² McEwen CA and Maiman RJ, “Small Claims Mediation in Maine: An Empirical Assessment”, *Maine Law Review* 33 (1981) 237 -268

³³ Radalet S and Sachs J (2000), p111

³⁴ Alfini JJ and McCabe CG, “Mediating in the Shadow of the Courts: A Survey of the Emerging Case Law”, *Arkansas Law Rev* 54 (2001) 171-206, p172-173

independence and thus its force. If the most important negotiations - those that are most likely to determine the life or death of the firm - are those that take place during an informal workout, then formal mediation appears to have little utility to the process as a whole. There is nothing, however, to prevent insolvency practitioners, workout specialists and clearing banks from adopting techniques of formal mediation into their procedures for informal workouts.

These professionals are already in a valuable position to assist stakeholders to an insolvency. Heath, Larrick and Klayman observe that decision making in conditions of duress is often impaired because "a particularly important form of missing information is the absence of experience with highly unusual events. Bank examiners rarely see a bank fail, nuclear technicians rarely see a meltdown, and airline personnel rarely witness a crash."³⁵ For most participants the failure of a business they run or in which they have invested will be an uncommon or even unique event. It is submitted that even the most experienced serial phoenixer benefits from the perspective and experience of an insolvency professional. The use of insolvency practitioners is known to facilitate smooth run downs, and forestall problems of set-off and other complexities³⁶, similarly it has been observed that preparation of a CVA is usually too technical for directors to prepare without the assistance of an Insolvency Practitioner.³⁷ It is not controversial to suggest insolvency contains many opportunities for inexperience impairing decision making. However, although administrators, bankers and lawyers have extensive experience of business failure from which the parties might profit, clients are unlikely to be in the right

³⁵ Heath, C, Larrick RP, and Klayman J "Cognitive Repairs: How Organizational Practices Can Compensate For Individual Shortcomings", *Research in Organizational Behavior* 20 (1998) 1-37, p14

³⁶ "For a smooth run-down, or a sale of the business, it's better to have an insolvency practitioner in place." Frisby S (2006), p36-37

³⁷ Dennis V (2007), p98

psychological position to make proper use of that information until incorrect pattern recognition and consequent emotional tagging has been dealt with.

The most practical recommendation to assist with this issue is not a change in the law or a requirement for formal mediation, but simply the recommendation that it become common practice for insolvency and turnaround professionals to receive some training in mediation techniques. This would not have to represent a significant investment. A simple two day training course might help them to gain a broader understanding of how to overcome faulty initial framing and also recognise and advise when formal mediation might be useful to resolve specific conflicts early in the process. This sort of small adjustment to practice may not be glamorous but would only need to improve a small proportion of outcomes to reap significant rewards.

8.3 THE USE OF REINTEGRATIVE SHAMING TO RECOVER THE SENSE OF FAIRNESS

The importance of an impression of fairness, and the idea procedural fairness can improve decision making, is supported by research into the notion of a preference for fairness by economists using the 'ultimatum game.' In a typical example the proposer has \$20 and may choose how to split this money with the responder. The responder may then decide to accept this offer, so that both take the money as the proposer decided, or reject the offer, in which case both players get nothing. The game theoretic solution to this is that the proposer should offer the lowest amount possible and that the responder should accept any positive offer.³⁸ Initial empirical testing, however, discovered that this is not what people do.³⁹ Further tests by Kahneman, Knetsch and Thaler found that:

Most allocators offered more than a token payment, and many offered an equal split. Also, some positive offers were declined by recipients, indicating a resistance to unfair allocations and a willingness to pay to avoid them... Fair allocations are observed even under conditions of complete anonymity and with no possibility of retaliation. Of the 161 students, 122 (76%) divided the \$20 evenly.⁴⁰

Fairness is taken to imply that some "opportunities for gain are not exploited."⁴¹

Perhaps players act upon an underlying sense of fairness, or perhaps it is for fear of future reprisals due to being recognized as being unfair. Either way, as long a creditor is focusing on the difference between the money he invested and the return offered rather than the superiority of rescue to liquidation, and perceiving this as a

³⁸ Stahl, *Bargaining Theory*, Economic Research Institution (Stockholm: 1972)

³⁹ Guth W, Schmittberger R and Schwarz B. "An experimental analysis of ultimatum bargaining" *Journal of Economic Behaviour and Organisation* 3 (1982) 367-388

⁴⁰ Kahneman D, Knetsch JL and Thaler RH (1986), p289, then p291

⁴¹ *Ibid*, p286

negotiation between himself and the debtor rather than a situation they are both facing together, he is likely to reject the offer as unfair.

Kahneman et al's discussion of fairness has some resonance with the honour system Posner proposes enforces the credible threat of vengeance in primitive legal systems.⁴² It may also help explain the disproportionate importance placed on the *parri passu* principle in English law. This was written into the law with the 1542 Statute of Bankrupt's requirement that proceeds from bankruptcy are to be distributed among creditors "rate and rate alike, according to the quantity of their debts"⁴³, and a "fundamental principle of insolvency law."⁴⁴ Yet Goode immediately follows this claim by highlighting the range of exceptions to *pari passu*, principally in the form of priorities and costs, and the extent to which *pari passu* is at all descriptive has been questioned:

The *pari passu* principle is rather less important than it is sometimes made out to be, and does not fulfil any of the functions is rather less important than it is sometimes made out to be, and does not fulfil any of the functions often attributed to it. It does not constitute an accurate description of how the assets of insolvent companies are in fact distributed. It has no role to play in ensuring an orderly winding up of such companies. Nor does it underlie, explain, or justify distinctive features of the formal insolvency regime, notably, its collectivity. The case-law said to support the *pari passu* principle serves actually to undermine its importance. And the principle has nothing to do with fairness in liquidation.⁴⁵

Whether it has ever really operated as described or not, the notion of *parri passu* being fundamental to law grants an impression of underlying fairness. This in turn has an importance to player compliance. Where creditors have the impression that a result is unfair then they can go to extraordinary lengths to see bankrupts brought to

⁴² Posner RA (2007), p261

⁴³ Statute of Bankrupts (34 & 35 Henry VIII c4) (1542)

⁴⁴ Goode R (2007), p56

⁴⁵ Mokal R, "Priority as Pathology: The *Pari Passu* Myth", Cambridge Law Journal 6(3) (2001) 581-621, p583-584

justice – consider the fortune creditors spent in the Pitkin Affair to hunt down and haul back a co-conspirator who had fled to Italy, in order to achieve a pitiful additional return of a little more than a shilling in the pound⁴⁶. This is only an act of rational maximisation if vengeance/fairness has some additional value not yet recognised. The argument that they are acting to discipline the market is a hollow defence of a neo-classical model of the creditor, although it is often proposed, as the game theoretic analysis points to a prisoner’s dilemma: market discipline is a public good and the optimal path in this one-shot game is to get the most you can for yourself and let someone else pay to discipline debtors.

Instead parties to the insolvency are at least in part responding to fundamental physiological responses to threat. A neurological study by Sanfey et al found that low ultimatum game offers triggered anger and disgust responses in the brain⁴⁷, and Burnham⁴⁸ connects this to the work by Clutton-Brock and Parker⁴⁹ which shows that “negative reciprocity is used by dominant animals to resist subordinate members from indulging in a behaviour that threatens the fitness of the dominant members.”⁵⁰ In Burnham’s own work he demonstrated that increasing the testosterone levels of men participating in the ultimatum game increased the frequency of rejection of low offers. This demonstrates that “ultimatum game rejections are caused, at least in part, by psychological mechanisms.”⁵¹ Posner himself speculated that there might be some genetic factor, and it certainly seems that our creditors are physiologically pre-programmed to enforce social fairness/vengeance mechanisms even in

⁴⁶ Kadens E (2010), p29

⁴⁷ “not only do our results provide direct empirical support for economic models that acknowledge the influence of emotional factors on decision-making behaviour, but they also provide the first step toward the development of quantitative measures that may be useful in constraining the social utility function in economic models. Models of decision-making cannot afford to ignore emotion as a vital and dynamic component of our decisions and choices in the real world.” Sanfey AG, Rilling JK, Aronson JA, Nystrom LE and Cohen JD (2003), p1758

⁴⁸ Burnham TC, “High-Testosterone Men Reject Low Ultimatum Game Offers” *Proceedings of the Royal Society B* 274 (2007) 2327-2330, p2327

⁴⁹ Clutton-Brock TH and Parker GA, “Punishment in Animal Societies”, *Nature* 373 (1995) 209-216

⁵⁰ Burnham TC (2007), p2327, citing Clutton-Brock RH and Parker GA (1995)

⁵¹ Burnham TC (2007), p2329

environments where they cannot possibly benefit from them. This fits growing evidence of the importance of social and emotional factors in white collar crime,⁵² as well as Kaden's description of creditor controlled English law as a vehicle for vengeance:

Creditors wanted revenge, or they wanted the bankrupt to suffer, or they wanted him to serve as an example. Creditors wanted the debtor to pay his "victims" figuratively as well as literally, and they wanted to make sure that bankruptcy was viewed with such horror and that community pressure alone would deter others. At a certain rather visceral level, punishing was more important than ensuring cooperation.⁵³

This thesis has highlighted many examples of insolvency proceedings provoking strong emotional responses. Frisby observes "the insolvency of a company inevitably generates dismay and in many cases resentment among a variety of stakeholders in the corporation."⁵⁴ Regardless of the criminality of otherwise of the insolvent's conduct, the failure of a company can feel criminal; recall the outrage of the Farepak customer in Chapter 7 who declared that the directors they "should be punished through the justice system for that they have done, because with effect, they have stolen 150,000 members' monies."⁵⁵ Recall also that the courts responded in kind to the revocation of the overdraft by HBOS.

The criminologist Braithwaite argues that "the key to crime control is cultural commitments to shaming... societies with low crime rates are those that shame potently and judiciously; individuals who resort to crime are those insulated from shame over their wrongdoing."⁵⁶ Reintegrative shaming brings together interdependent groups so that they are able to express their disapproval to the

⁵² Murphy K and Harris N (2007), p913

⁵³ Kadens E (2010), p75

⁵⁴ Frisby S (2011), p350

⁵⁵ From an interview with a Farepak 'victim', Spalek B and King S (2007), p34

⁵⁶ Braithwaite J, *Crime, Shame and Reintegration*, Cambridge University Press (Cambridge: 1989), p1

wrongdoer, that all parties are able to gain a greater understanding of the reasons for and consequence of the crime, and that the wrongdoer has the opportunity to accept responsibility and express remorse. The result is a reduction in recidivism by offenders and a greater incidence of victims achieving emotional closure (including a reduced desire for vengeance). Although principally used as a technique for the management of youth offending, with notable success in New Zealand, research has shown its application to other crimes like “tax cheating and drunk driving.”⁵⁷ It is more likely to be effective in “conditions of high interdependency between the disapprover and the disapproved”⁵⁸, being where parties “participate in networks wherein they depend on each other to achieve valued ends.”⁵⁹ It is easy to see how business relationships can develop the same qualities.

Chapter 6 explored the important historical role of shame in the management of bankruptcy. Distinguishing innocent insolvency from fraudulent bankruptcy⁶⁰ has always been and remains exceptionally difficult, and even when the state determines innocence the creditor is likely to continue to consider themselves a victim. Becoming a bankrupt is “deceitful, quasi-criminal conduct in entering”⁶¹, for which rape, dismemberment, slavery and hanging have all been considered reasonable retaliation, suggesting we should not underplay the seriousness of the emotional consequences of business failure. Creditors of a failing firm like it or not, are participating in a network where they depend on each other to achieve the best possible outcome. Appreciating the parallels with the use of reintegrative shaming techniques in criminal law can help us assist creditors in achieving best returns.

⁵⁷ Murphy K and Harris N (2007), p903, see also Grasmick HG and Bursik RJ “Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model”, *Law and Society Review* 24(3) (1990) 837-861

⁵⁸ Makkai T and Braithwaite J (1994), p362

⁵⁹ *Ibid*, p375-376

⁶⁰ The normative interchangeability of the terms “bankruptcy” and “insolvency” is discussed in Chapter 6’s exploration of bankruptcy stigma.

⁶¹ Efrat R (2006), p369

A highly successful application of reintegrative shaming has been the use of family conferences in New Zealand Criminal Law “replacing court processing of juveniles with conferences attended by citizens who care most about the young offender.”⁶²

Community judgement is as old as the oldest of insolvency laws. Posner’s analysis of medieval Icelandic lay judges described how, operating in a society that was “virtually stateless”⁶³, the claimant and the defendant would gather relatives and stand before a lay judge in a system of informal arbitration. The court had no power to enforce its ruling, but judgement was made before and with the participation of kin. Posner suggests that the presence of family would have a cooling effect, and the ruling would be enforced by the threat that kin would be ‘rallied’ to enforce it. The experience of the trial itself can satisfy the participant’s desire for justice.

Family conferences achieve this by bringing the parties and their families together with an independent arbitrator, whose objective is to “leave open multiple interpretations of responsibility while refusing to allow the offender to deny personal responsibility entirely... the strategy is to focus on problem rather than person, and on the group finding solutions to the problem.”⁶⁴ Let us remind ourselves that in our dilemma the problem is twofold: first, there is not enough money left for the parties to achieve full payment, and it is preferable for them to choose some money over no money at all; second, that the creditors desire for revenge and/or fairness prevents them for doing this. Bringing the parties together helps creditors to focus on the actual problem (do you want £500 or nothing?), rather than the ultimatum they feel they have been given (I have taken £9,500 and offer you £500, will you accept this bargain?): “focusing on the problem rather than the wrongdoer, in the context of a community of care and understanding for the wrongdoer, creates the structural

⁶² Makkai T and Braithwaite J (1994), p363

⁶³ Posner RA (2007), p262

⁶⁴ Braithwaite J and Mugford S, “Conditions of Successful Reintegration Ceremonies: Dealing with Juvenile Offenders”, *British Journal of Criminology* 34(2) (1994) 139-171, p146

conditions conducive to reintegrative shaming.”⁶⁵ Put more simply, putting people in a room together can help them understand the situation as it really is and concentrate on achieving the best possible outcome.

It may not seem credible that the creditors of a bankrupt will be particularly interested in understanding the bankrupt, or that a creditor meeting might seem an acceptable substitute for criminal punishment. Yet victims who see perpetrators go to trial:

Often emerge from the experience deeply dissatisfied with their day in court. For victims and their supporters, this often means they scream ineffectively for more blood. But it makes no difference when the system responds to such people by giving them more and more blood, because the blood-lust is not the source of the problem; it is an unfocused cry from disempowered citizens who have been denied a voice. Reintegration ceremonies have a [dimly recognized] political value because, when well-managed, they deliver victim satisfaction that the courts can never deliver.⁶⁶

Victims of crime often feel both shame and fear. While this is more intuitively evident for victims of violent crime, someone who has invested money and lost it will feel a mixture of foolishness and uncertainty that undermines the credit economy.

The obvious window for this sort of approach in the insolvency process is the creditor meeting. Creditor meetings are often regarded to be a waste of time, not least because you cannot be sure how many creditors will actually turn up. They were a compulsory part of the administrative receivership procedure, but the new administration procedure offers a list of exceptions to the occasions where a creditor

⁶⁵ Makkai T and Braithwaite J (1994), p380

⁶⁶ Braithwaite J and Mugford S (1994), p148

meeting must be held as part of an administration⁶⁷, such that the administrator need not hold such a meeting where:

- (a) He thinks creditors will be paid in full; or
- (b) There is insufficient property to make a distribution to unsecured creditors; or
- (c) The company cannot be rescued as a going concern; or
- (d) A better result for the company's creditors as a whole than would be likely on winding up cannot be achieved.

An interesting quality of the list of exceptions is that although it will be relatively common for an administrator to be able to justify not calling a creditor meeting, it remains compulsory in any rescue attempt (and equally should creditors holding 10% of the debt request one within the requisite period)⁶⁸. World Bank guidelines suggest that “directors of a debtor corporation should be required to attend meetings of creditors.”⁶⁹ Not holding a creditor meeting reduces the apparent cost of the administration, and so one can understand the attraction of not having one where the creditor's opinion will have little impact on the outcome, but the simple act of bringing the parties together and having them talk to each other has the potential to have a dramatic impact on creditor compliance. This is perhaps another example of something that appears to be an essentially communitarian element to English law having a practical commercial benefit.

⁶⁷ Insolvency Act 1986 Schedule B1 s51(2)

⁶⁸ Insolvency Act 1986 Schedule B1 s52(2)

⁶⁹ World Bank (2001), p48

8.4 LETTER WRITING AND APOLOGIES

This process of recognising and addressing the interpersonal barriers to negotiation can begin prior to any creditor meeting. Wenzel's work on letters written to Australians requiring that they pay a fine for breaking the tax code found that:

The explicit or implicit principles for the design of reminder letters appear to be (1) brevity and conciseness, and (2) firmness and pressure. The former are based on the assumptions that taxpayers do not properly read, understand or act upon longer letters, and, taxpayers value, and have indeed a right to, have their compliance costs (which includes the reading of letters) kept to a minimum.⁷⁰

These principles will not be unfamiliar to the professional administrator, who acts under the acute awareness that every procedural cost incurred reduces the limited pot from which creditors can be repaid. Yet Wenzel demonstrated that by adding to the letter elements that were informational; "Why are we sending you this letter? Why can't we be more specific in this letter? Why do we impose penalties?"⁷¹, or interpersonal; "We acknowledge that times can be difficult, we do not want to make things more difficult for you"⁷², both significantly increased compliance with the demand and reduced levels of complaint. Wenzel's research did not encompass the effect of combining informational and interpersonal aspects, but in the absence of further work it is reasonable to infer that the two would not cancel each other out. Extrapolating from Wenzel's recommendations, initial communications with parties should include:

- Information regarding their rights and responsibilities
- An expression of sympathy for their situation

⁷⁰ Wenzel M, "Principles of Procedural Fairness in Reminder Letters: A Field Experiment", Centre for Tax System Integrity, Australian National University, Working Paper No 42 (2002), p1

⁷¹ *Ibid*, Appendix, p33

⁷² *Ibid*, Appendix, P34

- A description of how and why the situation came to pass
- An explanation of the harm being experienced by the other parties
- An opportunity for the parties to express what impact the bankruptcy has had on them and their feelings about it, which should be seen by the other parties.

There are a number of elements of the English insolvency process where it is possible to see how the reintegrative effects of information sharing could be taking place, for example CVA proposals includes “an explanation as to why in the directors’ opinion a voluntary arrangement is desirable for the company and why creditors are expected to concur with the arrangement.”⁷³ Small additional measures like those described above cost almost nothing but the aggregate of the marginal benefit would be significant.

Having applied interpersonal elements to correspondence, brought parties face to face, and possibly even used mediation, the insolvency professional may still find that parties cannot agree. At this point it is worth investigating the value of an apology. An effective shaming ceremony climaxes with an apology. An apology allows the separation of the identity of the bankrupt from that of the insolvent: “an individual splits himself into two parts, the part that is guilty of an offence and the part that disassociates itself from the delinquent and affirms a belief in the offended rule.”⁷⁴ Having to apologise can be a real punishment for the director of a company. As Makkai and Braithwaite observe “management are exquisitely sensitive to criticism.”⁷⁵ In an environment where parties have been able to discuss the causes and consequences of the ‘crime’ relieves the perpetrator of the stigma of bankruptcy

⁷³ Dennis V (2007), p100

⁷⁴ Goffman E and Manning P, *Relations in Public*. New York: Basic Books, (New York: 1971), p113, cited by Braithwaite J and Mugford S (1994), p150

⁷⁵ Makkai T and Braithwaite J (1994), p377

(recalling that failure can be a traumatic experience for the bankrupt as well), and allows the creditor to disassociate the director as a person from the bankrupt as a construct. Crucially, it indicates and perhaps even induces the “desire to put things right”⁷⁶ that creditors so long for, and which is the highest indicator of future reform. This also provides a unique opportunity to maintain creditor control at the heart of insolvency law. Matching punishment to creditor outrage due to the two main ways in which one measures the size of something. Category scales “consist of a bounded set of ordered responses, as in the familiar format of many opinion surveys”, whereas magnitude scales have “a meaningful zero and no upper bound.”⁷⁷ While humans are excellent at comparing one thing with another (this rock is heavier than the other rock) they are poor at estimating magnitude (this rock weighs 15kg), and highly susceptible to arbitrary anchoring. People are incapable of putting a price or a value to something without some frame of reference, and more disturbingly are highly susceptible to accepting entirely incidental values as the basis upon which to anchor their response⁷⁸. This is part of the reason why governments have struggled to match punishment to the outrage caused by bankruptcy. It is surprisingly and counter-intuitively difficult for a jury to scale the difference between being made to wear a basket as a hat in public, having an ear nailed to a pillory, or being hung by the neck until dead (all punishments for bankruptcy at different periods in history, as described in Chapter 6).

Kahneman et al’s work on punitive damages in jury trials, proposes an alternative:

⁷⁶ Murphy K and Harris N (2007), p910

⁷⁷ Kahneman D, Schkade DA and Sunstein CR (1998), p53

⁷⁸ See Tversky A and Kahneman D (1974). Also of interest is William Poundstones application of the principle to *Liebeck v McDonald's*. Here a claimant in the US to win \$640,000 in damages for spilling coffee on herself, after her lawyer managed to anchor the jury to the notion that McDonald’s should be punished in proportion to their international profits. See Poundstone W (2010), p3-4, 17-21, 276, 278, discussing the damages award in *Liebeck v. McDonald's Restaurants, P.T.S., Inc.*, No. D-202 CV-93-02419, 1995 WL 360309 (Bernalillo County, N.M. Dist. Ct. August 18, 1994)

Like other internal states that vary in intensity, outrage and punitive intent can be expressed either on category scales or on magnitude scales. For example, respondents could be asked to evaluate the outrageousness of different actions on a category scale ranging from “not outrageous” to “extremely outrageous.”⁷⁹

One might envisage a system which allowed, at the completion of a creditor meeting, creditors to vote on a ‘punishment’ for the directors. They might, for example, be given a range of options, starting with a ‘standard’ option which should be something along the lines of a formal written apology. They would be then be given the option to scale it up for ‘severe’ or ‘very severe’ cases, which should include the likes of a public apology to be published in the press or even some degree of community service, but also in the other direction for ‘mild’ or ‘very mild’ cases where fault is deemed not to lie with the bankrupt and a written apology might be replaced with a joint statement of fact or creditors might vote that a portion of the remaining fund be returned to the debtor to help them start over again (like the element of discharge removed from the law of 1706).

It is essential to not that this process would not give creditors the power to prevent a pre-pack or overrule the administrator. That would be unacceptably expensive. This process simply gives creditors an outlet for their outrage. An apology can be highly effective. In the context of violent crime it has been observed that “apology from the man who disrespected her is the most powerful way of resuscitating this self-esteem and community shaming of the disrespecting behaviour is also powerful affirmation of the respect for her as a person.”⁸⁰ Bankruptcy is not rape and the writer is not attempting to diminish the crime by making such a comparison. Bankruptcy and business failure, however, do impact upon the self-esteem of the parties, and because of the cognitive difficulties with scaling described above and the physical

⁷⁹ Kahneman D, Schkade DA and Sunstein CR (1998), p54

⁸⁰ Braithwaite J and Mugford S (1994), p155

process of responding to status threats the value of reintegration still applies. There is evidence of this approach being tested in English law already. In response to the Farepak insolvency, a small scale insolvency with relatively minor losses that was called “a national tragedy and emergency”⁸¹, Spalek reports that:

A National Reporting Centre in the City of London police service has recently been established, offering a listening service to victims, where victims can also ask questions about what resources are available to help them, and where victims can also act about the progress of any investigations that are being conducted.⁸²

In terms of moving creditors to a place where they could come to accept (correctly) that receiving almost 50p in the pound was considered a "fantastic result"⁸³ this was an excellent approach to take. What this means for Orderly and Effective insolvency regimes is that qualities like specialist courts, the use of formal and informal spaces as appropriate, ‘victim’ support and redistributive intervention for unethical behaviour, rather than being an undesirable delay that increases costs and reduces insolvency efficiency, actually improve efficiency. They do this because they improve the pricing mechanism by reducing the incidence and impact of systemic cognitive error. More research, ideally experimental empirical work, would be required to determine the best form and language for such a process but giving creditors a conduit to express and see some impact from their sense of injustice would be valuable. An insolvency law that pays attention to the public sense of injustice will also more efficiently place resources in those best placed to use them.

There are two final points that are important to make. First, creditor inclusion is not necessary for successful insolvency proceedings, as demonstrated by Pre-packs. As

⁸¹ “Q&A: The Farepak Hamper collapse”, 7 November 2006, <http://news.bbc.co.uk/1/hi/business/6124406.stm> (accessed 23 Nov 2012)

⁸² Spalek B (2008), p8

⁸³ “Farepak customers to receive half of money owed”, BBC, 10 July 2012, <http://www.bbc.co.uk/news/business-18782300> (Accessed 17 August 2012), citing Suzy Hall, director of the Unfairpak campaign.

emphasised in the discussion of what drives creditor returns in Chapter 4, the single most important factor is strong property rights and the rule of law. The question for regimes that already have strong property rights and the rule of law is what will make for the very best creditor returns possible.

It is submitted that the medium term survival of pre-packs would be improved if small measures were taken to improve creditor inclusivity. It is clearly important not to interfere significantly with the efficiency benefits of a clean pre-pack by introducing measures like a possible creditor veto or a new prescribed part.

However, optional expansions to the SIP 16 process such as a personal letter from the directors explaining why they feel this is the best option, how it compares to liquidation (similar to what is done with a CVA), and if it is the case that they regret the impact on unsecured creditors, may well make a difference to the success of the phoenix firm after the sale is completed. This is not about whether creditor inclusion is necessary but whether creditor/debtor exclusion is optimal. I believe I have submitted enough to demonstrate that it is not.

Second, some people are almost as horrified by the use of the term “punishment” as they are by the term “redistribution.” This is with good reason. Punishment is a strong word, and redistribution itself often means harsh interference with private property. Entrepreneurship is generally considered to be a good thing, and there is research to demonstrate that the prospect of sanctions and punishment of debtors impacts on people’s willingness to start businesses. Fan and White discovered a 35% increase in the probability of households owning businesses in US states with unlimited bankruptcy exemptions.⁸⁴ Armour and Cumming’s cross country study of the forgivingness of bankruptcy regimes shows a significant effect on self-

⁸⁴ Fan W and White MJ, “Personal Bankruptcy and the Level of Entrepreneurial Activity”, *Journal of Law and Economics* 46 (2003), 542-567

employment rates⁸⁵. Punishment that marginally improves rescue rates at the cost of significant reductions in entrepreneurship would clearly be self-defeating.

It is important when considering this chapter not to place too much weight on the use of the word punishment. Armour and Cumming's forgivingness is measured by levels of discharge and exemption available, all things that have substantial financial and personal consequences. Although this research draws on the language and the theory of punishment, the central conclusion is that it is mild and re-integrative punishment that is most effective. This is a long way from cutting off people's ears, sending them to prison, or confiscating their property. Directors may be exquisitely sensitive, and an apology may be a real punishment. But it is not credible to think it would have a significant impact on start-ups if new directors know that one day they might have to apologise for losing creditors money. The point of recognising that, even in business, decision-making is not simply a question of rational maximisation but that there is also an important personal dimension, is to take advantage of what we know about personal decision-making. Like any new husband quickly learns, a willingness to explain what happened, listen to the consequences, and apologise for any harm caused, can have significant benefits. This lesson is equally applicable in business.

⁸⁵ Armour J and Cumming D, "Bankruptcy Law and Entrepreneurship", *American Law and Economics Review* 10(2) (2008), 303-350

CONCLUSION

The International Monetary Fund¹ and World Bank² Guidelines promoting Orderly and Effective insolvency were written in the wake of the Asian financial crisis with a view to promoting stable economies that were attractive to overseas investment. Given that the IMF recommendations reflected long standing characteristics of English Insolvency Law³, not to mention our status as *forum de jour* for incorporation⁴ and “brothel”⁵ for corporate insolvency, it seems almost tautologous to describe English law as Orderly and Effective. This thesis sought to address certain assumptions about the reasons why English law is effective at maximising returns to creditors.

Understanding how English insolvency law impacts upon investment and business turnaround is particularly relevant in the current economic climate, where businesses are struggling for credit and in many cases simply struggling to survive. This thesis has argued that changes in the Enterprise Act to increase inclusivity and credit pro-activity⁶ have improved returns to investors in distressed firms, contrary to a significant body of law and economics theory that suggests that distribution and wealth maximisation operate in tension to one another. English law’s effectiveness is not because of some ruthless pursuit of allocative efficiency via priority for secured creditors, but rather sensitivity to creditor driven solutions and provision of frameworks that facilitate collaborative, inclusive solutions.

¹ International Monetary Fund Legal Department, *Orderly and Effective Insolvency Procedures Key Issues*, (IMF: 1999)

² World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, (World Bank: 2001)

³ Brierly P and Vlieghe G (1999), p170

⁴ Armour J (2005), p386

⁵ Walton P (2011), p2, footnote 10, quoting Bertrand des Pallieres. See also “London risks become the bankruptcy brothel for Europe”, The Guardian, 21 Jan 2010, <http://www.guardian.co.uk/business/2010/jan/31/insolvency-uk-law-bankruptcy-foreign>

⁶ Frisby S (2004), p250

The ideal of efficient insolvency has been hugely influential, particularly through the work of law and economics scholars such as Jackson, Baird, and Rasmussen, who have “dominated the field in the past 20 years.”⁷ It draws on the concept of allocative efficiency and the first welfare theorem, which suggests that conditions of perfect competition will always achieve a pareto-optimal outcome⁸. Coase theorem⁹ then suggests that it is only where there is market failure that assets will fail to end up in the hands of those best able to use them. This has been applied by insolvency efficiency proponents, at their most extreme, to suggest that “the first function of bankruptcy is to allow unpaid creditors to seize the insolvent debtor’s assets, sell them and invest the proceeds in other venues”¹⁰, removing the concept of state-led rescue from the law altogether.

The accepted role of the state is enforcing collectivism, particularly through the mechanism of stays in order to prevent a “grab race.”¹¹ This is a type of market failure known as a prisoner’s dilemma where the equilibrium is not the optimal solution. Beyond collectivism in this limited sense, any distributions made by law are inefficient where they do not reflect “the kind of contract that creditors would agree to if they were able to negotiate with each other before extending credit.”¹² Being inefficient they are considered ultimately unjust, as they cost more to society as a whole than having the parties who directly benefit decide.¹³ This leads to the conclusion that the only just role for insolvency law is to reduce the cost of credit.¹⁴

⁷ Keay AR and Walton P (2008), p25

⁸ Anand P (2006), p222

⁹ Coase R (1960)

¹⁰ Brogi R and Santella P (2004), p9

¹¹ IMF (1999), 2- General Objectives and Features of Insolvency Procedures, p12

¹² Jackson TH (1986), p17

¹³ Schwartz A (1998), p1817-1818

¹⁴ *Ibid*, p1819

In turn the economic and social heartache caused by business failure is not properly a question for insolvency law.¹⁵

This approach has received a great deal of criticism, including that it makes “use of theoretical constructs to reach policy conclusions without any attempt being made to verify by empirical evidence the premises upon which they are based”¹⁶, and that their economic analysis of the law is stuck in 19th century notions of laissez-faire economics¹⁷; that ultimately their answers are “too clear-cut and glib”¹⁸ and based upon a weakness for the seductive quality of easy answers¹⁹. Yet the analysis remains enormously influential in the Orderly and Effective model, and particularly the notion that distributive or communitarian measures are made at the cost of efficiency and thereby wealth maximisation. Legal regimes may choose to protect workers or prescribe a part to be distributed to unsecured creditors, but in doing so they reduce returns to secured creditors and thereby increase the cost of credit and reduce investment. The “secured creditor is accorded priority because he bargained for it”²⁰, and his ability to enforce his claim as a creditor reduces the risk of giving credit and therefore “increases the availability of credit and the making of investment more generally.”²¹

Empirical exploration of how English law is Orderly and Effective reveals a number of flaws in this analysis. The notion of orderliness demands that insolvency regimes ensure the allocation of risk in a “predictable, equitable, and transparent manner... [so as not to undermine] willingness to make credit and other investment

¹⁵ Jackson TH (1986), p25

¹⁶ Goode R (2011), p72

¹⁷ Pettet B (1995), p143

¹⁸ Keay A and Walton P (2008), p27

¹⁹ Warren E (1987), p797

²⁰ Goode R (2005), p59

²¹ IMF (1999), 2 - General Objectives and Features of Insolvency Procedures, p3

decisions.”²² The efficiency model suggests that this is simply a question of preventing a grab race, after which participants will proceed to make the decision on the basis of a simple cost function and pick the alternative that grants them the greatest utility. Even if this is accepted, the notion that freedom of choice in a scenario that allows optimisation of utility will lead to the maximisation of monetary is not a safe assumption. Utility does not directly translate into price. The enormous leap of faith required to imagine that it does is illustrative of the extent to which insolvency efficiency proponents’ proposals are “driven by normative values”²³, in particular a fierce belief in aggregate rationality and efficient markets.

An orderly insolvency law must take into account the “quasi-criminal”²⁴ quality of insolvency, because participants in an insolvency are driven by a great deal more than monetary values. The ancestry of insolvency is in the act of bankruptcy²⁵, which taints the most innocent insolvent. Business failure “inevitably generates dismay and, in many cases, resentment, among a variety of stakeholders in the corporation”²⁶, and decisions made under conditions of stress and shame are very different from those made when calm and collected (and often lead to very different outcomes than stakeholders would objectively prefer).²⁷ Overcoming this problem requires a deliberate and structured means to identify bias based upon strengthened group decision-making processes.²⁸ Specialist courts, highly trained insolvency professionals and procedures that require formal processes force a more considered response to failure. It is essential to note that collaborative rescue procedures are only likely to be beneficial if the appropriate legal infrastructure and strong property

²² IMF (1999), “2 - General Objectives and Features of Insolvency Procedures”, p3

²³ Warren E (1987), p812, in this case talking specifically about the work of Baird, although she makes it clear she considers his co-conspirators, such as Jackson, equally culpable.

²⁴ Efrat R (2006), p369

²⁵ Trieman I (1938)

²⁶ Frisby S (2011), p350

²⁷ Dickerson SS and Kemeny ME (2004), p337

²⁸ Campbell A, Whitehead J, Finkelstein S (2003), p64

rights are already in place. Countries that are still struggling with judicial corruption, significant economic change or political change, or inadequate rule of law generally, will most likely simply saddle themselves with a more expensive liquidation procedure.²⁹ However, once effective and efficient rule of law is in place and has had some time to inspire confidence in its durability, the most effective insolvency law is not one of absolute secured creditor priority but one that best enables inclusive creditor and debtor led solutions.

A central pillar of the insolvency efficiency application of Coase Theorem is process independence. Process independence suggests that the means by which allocations are achieved is unimportant. This has been strongly refuted by procedural justice theory where preferences for adversarial over inquisitorial justice, regardless of outcome, have been established because it gave a greater opportunity for stakeholders to put what they felt was important in front of a judge.³⁰ McEwen and Maiman³¹ have demonstrated that parties to litigation are attracted to process advantages like the opportunity to express how they feel about what has happened, attention being paid to what clients feel are the key issues, and facilitating client involvement in shaping an agreement, which provides an alternative explanation to the finding that during the Asian financial crisis “the market has reacted most positively to initiatives that bring creditors and debtors together”³² This is the heart of inclusivity.

An effective insolvency law, as defined by the IMF, is one that operates “to protect and maximise value for the benefit of all interested parties and the economy in

²⁹ Djankov et al (2008), p1146

³⁰ Thibaut J, Walker L, Latour S, Houlden P (1973)

³¹ McEwen CA and Maiman RJ (1981)

³² Radalet S and Sachs J (2000), p111

general”³³, an objective that is achieved not only through rescue of viable businesses but also by the fashion in which unviable firms are liquidated. English law aims to achieve best returns for creditors, but public interest communitarian values were also explicitly recognised in the Cork Report.³⁴ A strict insolvency efficiency approach would consider this to be inefficient:

[B]argaining succeeds with respect to money: Renegotiation after insolvency will shift tangible wealth to the estate when it is efficient to do so but not otherwise, whether or not a mandatory rule is present... bankruptcy systems should function to maximise the monetary value of the estate.³⁵

On this basis it would be a reasonable hypothesis that changes like the prescribed part, which *prima facie* reduce returns to secured creditors, in turn fail to maximise the monetary value of the estate and are therefore ineffective. Exploration of empirical data regarding insolvency suggests that this is not the case. The Enterprise Act has improved gross returns, and whilst the improvement in gains has been for the time being cancelled out by increased costs returns are now being realised significantly faster.

Chapter 3 identified three hypotheses for why the shift to an administration based system in the Enterprise Act might be producing better overall returns. First, reduction in secured creditor control might have been offset by infrastructural improvements to the efficiency of the judicial system, but given that the data available comes from the period of transition from the old law to the new – during which infrastructure changes are more likely to create additional cost than benefit – this is not a particularly strong argument. Second, the argument that the Enterprise Act made no significant practical difference to the position of secured creditors is

³³ IMF (1999), “2 - General Objectives and Features of Insolvency Procedures”, p3

³⁴ Goode R (2011), p75

³⁵ Schwartz A (1998), p1809

refuted by interview evidence, particularly the changed position of HMRC has had a significant strategic impact and there is a great deal of evidence of a cultural shift in practice amongst clearing banks. Regarding the third hypothesis, however, there is evidence that absolute secured creditor priority does not improve secured creditor returns in a linearly positive fashion, and that surrendering some element of control actually results in greater returns. There is evidence of a tension between levels of security and probability of rescue³⁶, which leads to uncertainty: “a larger probability of default does not mean that the lenders’ ex-post losses are greater. With the greater probability of default but greater protection (e.g. smaller losses) in the case of default, *lenders’ actually losses may either rise or fall.*”³⁷ Returns are not simply a linear function of the level of security.

Part of the reason for the misconception about how insolvency law operates to maximise wealth is due to an apparent difficulty with probabilistic reasoning. Wealth maximisation for the economy in general, and for repeat players like institutional creditors, is not a question of returns in the individual case but what gets the best returns in the aggregate. In any individual case it is impossible to know in advance whether a rescue effort will achieve better returns than a liquidation, and impossible to be certain afterwards whether the chosen path achieved the best outcome. In the aggregate and all other things being equal, an administration housed CVA is the most effective device for wealth maximisation, a process that depends on inclusivity and includes interventionist distribution. In a situation where it is uncertain if a business is viable, the best strategy is administration, because only a small proportion of them have to succeed to cover the costs of those that fail. This is not simply because of the highly favourable returns from trading CVAs, but also that asset sales via

³⁶ Houston JF, Lin C, Lin P and Ma Y (2010), p504

³⁷ *Ibid*, p489, emphasis added.

administration may be preferable to direct liquidation (such that it has been argued that CVLs are becoming redundant³⁸ and removing the procedure altogether in favour of a “single gateway.”³⁹) For a repeat player the gains made from a successful trading CVA are so much better than a liquidation that the additional cost of attempting is worth the speculation in any case where viability is possible. This was envisaged by the framers of the act:

The imposition of wider accountability on the insolvency practitioner was designed to increase the realizable value of the company's assets by addressing the problem of perverse incentives; the streamlining of administration was designed to make the procedure more flexible and easily accessible, and to reduce costs. The expectation of policymakers was that this twin approach would promote corporate rescue and, by increasing *gross realizations* and reducing the *costs* of formal rescue, produce better *net outcomes* for creditors across the board.⁴⁰

The important addition is that by reframing the concept of orderliness to include the need to manage stress and shame issues surrounding business failure and their impact upon decision making, it is clear that the perverse incentives that the effective law manages are not only materialistic but also normative. The administration housed CVA is considered “the only genuine *insolvency* rescue mechanism”⁴¹ in the post Enterprise Act regime, and is predicated both upon a requirement of the creditors’ active approval of the rescue plan,⁴² and equally upon a statutory distribution to unsecured creditors⁴³ (which has the consequence that all parties to a trading CVA achieve some degree of return). The long term survival of a firm depends on maintaining relationships with creditors, and also helping parties make decisions in their best interests under adverse conditions, whether they are the bank or the taxman, suppliers or customers. Getting the cooperation of the

³⁸ Katz A and Mumford M (2006), p48

³⁹ Frisby S (2006), p81

⁴⁰ Armour J, Hsu A, Walters A (2008), p161

⁴¹ Frisby S (2006), p63

⁴² Frisby S (2011), p377

⁴³ Enterprise Act 2002 s252

unsecured creditors increases the chances of the rescue, and so once again it is worthwhile introducing inclusivity if it improves the chance of a wealth maximising rescue.

The trick is to have enough inclusivity to engage important stakeholders without exposing the process to excessive cost or the irrationality of non-institutional creditors. The final chapter of this thesis sought to argue that implementing techniques learned from mediation, addressing questions like the potential need for an apology and giving both parties an opportunity to explain their side of the story and hear the impact, would improve insolvency outcomes by improving stakeholder decision making. The advantages of the proposed techniques is that they are of sufficiently low cost that even a small increase in aggregate returns would more than pay for them.

A common characterisation of English law is that it is laissez-faire in that it “operates with a regard to those practices that develop within the commercial world.”⁴⁴

Institutional creditors operate as oligopolies, strategically co-ordinating to get the best results, and part of how this has manifested is in the London Approach: an institutionalised norm derived “from the legal system, as well as from the activities of trade associations and professional bodies.”⁴⁵ Insolvency practitioners feel “constrained by professional regulation and reputational concerns to “do the job properly.”⁴⁶ English insolvency process seems to be heavily influenced by normative values that favour informal collaborative workouts, and all the evidence points towards a preference for maintaining relationships⁴⁷ and preserving reputation⁴⁸, alongside a willingness to make significant investment on the chance of successful

⁴⁴ “la traditionnelle attitude du législateur anglais de « laissez-faire » à l’égard des pratiques développées spontanément par le monde du commerce.” Santella P (2002), p9

⁴⁵ Santella P (2002), p30

⁴⁶ Armour J, Hsu A, Walters A (2008), p164

⁴⁷ *Ibid*, p157

⁴⁸ Frisby (2006), p12

rescue. It is submitted that the private sector's preference for inclusivity is strong evidence that it is wealth maximising.

If normative strategic co-operation out of court is so successful, what is the place of formal insolvency? First and foremost, the critique of contractualism does not undermine the importance of preventing grab races and enforcing collectivism. However, collectivism must also be a forum for augmented negotiation, with measures to improve communication and information sharing (the SIP 16 is an excellent innovation in this direction), and providing professional assistance to participants. Parties in particular will be more likely to comply if they have had the opportunity to say how they have been affected, to hear why decisions have been taken, and feel they have some substantive role in decision making. There is also an enormous normative value to state authority, providing institutional certainty around which private players can order themselves. This must, however, be distinguished from outcome certainty. The court is in an important position to provide oversight by removing rogues and fools from the process, overruling in cases of irrationality or bad faith and thus improving confidence in insolvency professionals, but should not engage in the uncertain business of diagnosing the reasons for commercial failure on the grounds of public interest.

The rapid increase in the use of empiricism in insolvency law has finally given law and economics an opportunity to emerge from the 19th century, and that naturally opens many avenues for future research. As Warren put it "we should get about the business of asking harder questions, looking for better evidence, and approximating better answers."⁴⁹ There is a pressing need to improve the empirical base from which we draw conclusions about the impact of insolvency law.

⁴⁹ Warren E (1987), p814

The first line of research that must be pursued is an expansion of the existing insolvency outcomes research⁵⁰ so as to produce a time-series analysis of outcomes rather than the current “snapshot.”⁵¹ This would, amongst other things, make it possible to identify the impact of adaptation to the new regime, increase the sample size to sufficient that smaller increases in returns could be judged statistically significant, and explore how outcomes have changed as incidences of administrative receivership have been phased out.

A second worthwhile investigation would be a broader empirical investigation of the strategic role of HMRC, and how they are using their new position of champion of the unsecured creditor. This might best be achieved ethnographically, embedding a researcher in order to explore perspectives and approaches, and ideally quantify levels of investment and return.

A third and potentially very interesting avenue would be the use of experimental economics to examine the impact of inclusivity on compliance, similar to the work by behavioural economists to explore the nature of decision making under conditions of risk. A simple example of this sort of approach was given in Chapter 7’s exploration of willingness to pay, but with funding for more sophisticated group based experiments it would be possible to test and quantify the degree to which offering an apology improves compliance, or whether explaining the reasons why a business failed makes consumers look more favourably upon a pre-pack, or indeed explore any number of process based questions.

Rapid developments in our ability to quantify and empirically explore commercial questions make this an exciting time for insolvency theory. Institutional creditors

⁵⁰ Frisby S (2006), Armour K, Hsu A, Walters A (2006), Katz A and Mumford M (2006) and Walters A and Frisby S (2011)

⁵¹ Frisby S (2006), p44

increasingly recognise the importance investing in collaborative and inclusive approaches to workouts that identify and support economically viable firms. English insolvency law is Orderly and Effective because it has been sensitive to these actual, practical developments in business and finance. It is crucial that insolvency theory follow suit.

Statement of Affairs

Statement as to affairs of

ASK P E T E Ltd

on the 13 March 2008 the date of the resolution for winding up

AFFIDAVIT

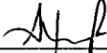
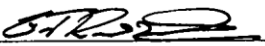
This affidavit must be sworn or affirmed before a Solicitor or Commissioner of Oaths when you have completed the rest of this form.


I, Alexander James Humphries,
of 13 Chester Road, Rugeley, WS15 1GD

Make oath and say that the several pages exhibited hereto and marked A, A1 & B are to the best of my knowledge and belief a full, true and complete statement as to the affairs of the above named company as at 13 March 2008 the date of the resolution for winding up and that the said company carried on business as supply electrical testing equipment

Sworn/affirmed at FOX SOLICITORS, 6-10 GEORGE STREET, WOLVERHAMPTON, WV2 4DN.

Date 13th MARCH 2008

Signatures  

Before Me GARETH JOHN RUBDOCK 

A Solicitor or ~~Commissioner of Oaths or duly authorised officer~~

Before swearing the affidavit the Solicitor or Commissioner is particularly requested to make sure that the full name, address and description of the Deponent are stated, and to initial any crossings-out or other alterations in the printed form. A deficiency in the affidavit in any of the above respects will mean that it is refused by the court, and will necessitate its being re-sworn

THIS IS THE EXHIBIT MARKED **A** REFERRED TO IN THE AFFIDAVIT OF ALEXANDER
 ASK P E T E L L O JAMES HUMPHRIES SWORN BEFORE ME THIS 13 March 2008
 Statement Of Affairs as at 13 March 2008

A - Summary of Assets

Assets	Book Value £	Estimated to Realise £
Assets subject to fixed charge:		
Factored Book Debts	76,199 54	68,579 59
RBS Invoice Finance		<u>(65,988 08)</u>
		2,591 51
Smart Car	4,417 00	3,700 00
Hire Purchase		<u>(4,193 64)</u>
Deficiency c/d		<u>(493 64)</u>
Assets subject to floating charge:		
Uncharged assets:		
Furniture & Equipment	2,000 00	150 00
Stock of Electrical Test Equip	6,249 61	600 00
Non Factored Debtors	2,717.86	2,310 00
Cash at Bank	12,612 56	12,612 56
Estimated total assets available for preferential creditors		<u>18,264 07</u>

Signature _____ Date _____

SECURITY HELD BY Royal Bank of Scotland Commercial Services Ltd

Fixed and Floating charge dated 26 August 2005

THIS IS THE EXHIBIT MARKED A1 REFERRED TO IN THE AFFIDAVIT OF ALEXANDER
 ASK P E T E L D JAMES HUMPHRIES SWORN BEFORE ME THIS 13 MARCH 2008
 Statement Of Affairs as at 13 March 2008

GRB-2
AH

A1 - Summary of Liabilities

	Estimated to Realise £
Estimated total assets available for preferential creditors (Carried from Page A)	18,264 07
Liabilities	
Preferential Creditors -	
Wages & Holiday Pay	2,291 45
	<u>2,291 45</u>
Estimated deficiency/surplus as regards preferential creditors	15,972 62
Estimated prescribed part of net property where applicable (to carry forward)	6,194 52
Estimated total assets available for floating charge holders	9,778 10
Debts secured by floating charges	
	<u>NIL</u>
Estimated deficiency/surplus of assets after floating charges	9,778 10
Estimated prescribed part of net property where applicable (brought down)	6,194 52
Total assets available to unsecured creditors	15,972 62
Unsecured non-preferential claims (excluding any shortfall to floating charge holders)	
Deficiency b/d	493 64
Shortfall to preferential creditors (brought down)	NIL
Trade & Expense Creditors	98,290 50
Employee Claims	2,602 47
Loan Account A Humphries	12,918 71
Loan Account - J E Collins	11,118 00
PAYE	1,427 82
Revenue & Customs VAT	4,395 85
	<u>131,246 99</u>
Estimated deficiency/surplus as regards non-preferential creditors (excluding any shortfall to floating charge holders)	(115,274 37)
Estimated deficiency/surplus as regards creditors	(115,274 37)
Issued and called up capital	
Ordinary Shareholders	100 00
	<u>100 00</u>
Estimated total deficiency/surplus as regards members	<u>(115,374 37)</u>

Signature _____ Date _____

13/03/2008

Muras Baker Jones

Page 1



Key	Name	Address	£
CA00	Alphatek Instruments Ltd	Unit 1, Hopton House, Ripley Drive, Normanton Ind Est, Normanton, WF6 1QT	13 151 62
CB00	British Telecom		54 40
CC00	City Electrical Factors Ltd	B'ham & North Wales Division Hawkes House, Hawkes Drive, Heathcote Ind Est, Warwick, CV34 6UZ	611 12
CC01	City Link Ltd	PO Box 920, Cambridge, Surrey, GU15 3HA	1 041 19
CC02	Mr J Collins	91 Beech Tree Lane, Cammock, Staffs, WS11 1AY	11, 118 00
CC03	H M Revenue & Customs	The Legal Recovery Unit, 3rd Floor, NW, Queens Dock, LIVERPOOL, L74 4AA	4,395 85
CC04	Inland Revenue Claims Handling Unit	Benlon Park View, Longbenton, Newcastle NE88 1ZZ	1,427 82
CC05	TIDO (GES)	Ty Glas Road, Llanishan, Cardiff, CF4 5ZG	0 00
CC06	The Calibration Centre	Unit 5 Greyfriars Way, Greyfriars, Stafford, ST16 2RF	351 33
CD00	D_Leg Test Equipment Ltd	Unit 26, Wheel Forge Way, Ashburton Road West, Trafford Park, Manchester M17 1EH	2,514 50
CE00	Edmundson Electric Ltd	London Credit Office, 1st Floor, Regent House, 1 Hubert Road, Brentwood, CM14 4JE	5 031 49
CF00	Fliuke (UK) Ltd	52 Humcane Way, Norwich, NR6 6JB	5 978 12
CG00	Gilbert & Co	Suite 2, Hilton Hall, Hilton Lane, Essington, WV11 2BQ	822 50
CH00	Hampville Magazines Ltd	Regal House, Regal Way, Watford, WD2 4YJ	352 50
CH01	Mr A Humphries	13 Chester Road, Rugeley, WS15 1GD	12 818 71
CK00	Kewtech Corporation Ltd	Midias House, 2b Stones Courtyard, High Street, Chesham,	1 416 77
CL00	Lockwell Lectrics Ltd	PO Box 83, 44-46 Corporation Street, Coventry, CV1 1PX	1 277 11
CL02	Lycro	38 Cadman Drive, Phenixlee, Telford, TF2 8SD	199 75
CN00	Martindale Electric Ltd	Deer Park Court, Dornington Wood, Telford, TF2 7NB	40 30
CN01	Meggere Ltd	Melrothm House, Porfold Trading Est, Imperial Way, Watford., WD24 4YY	1,830 90
CN00	NatWest	Archcliffe Road, DOVER CT17 9EN	19, 133 57
CO00	O2 (UK) Ltd	31 market Square, Rugeley, Staffs, WS15 2FA	0 00
CR00	RBS Invoice Finance	260 Bath Road Stough Berks, SL1 4DX	296 78
CR01	Redundancy Payments	3rd Floor, 2 St Philips Place, Birmingham, B3 2RB	65,989 08
CS00	Streamline	Cobalt Square, 83-85 Hagley Road, Birmingham, B16 8CG	4,693 92
CS01	Seaward Electronic Ltd	Galeshead Card Centre PO Box 27 Victory House, Fifth Avenue, Galeshead, NH8 1HU	0 00
CS02	Stipples	Bracklen Hill South West Ind Est Peterlee, County Durham, SR8 2SW	39,822 89
CS03	Seat Finance	PO Box 720, Cambridge, Surrey, GU15 3WT	33 61
CT00	Transille Ltd	Unit 4, Select Business Centre, Lodge Road, Staplehurst, Kent, TN12 0DW	4,193 64
CT01	Tesco	Friepost MID 20751, Walsall Road, Cannock, WS11 1BR	636 61
CV00	VW Financial Services (UK) Ltd	Brunswick Court, Yeomans Drive, Blakelands Milton Keynes MK14 5LR	129 05
CW00	Why Not Services Ltd	Unit 27, The Parker Centre, Mansfield Road, Derby, DE21 4SZ	1,664 04
			1,654 75
			203,290 92
			33 Entries Totalling

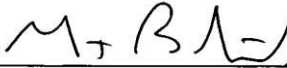



THIS IS THE EXHIBIT MARKED £ REFERRED TO IN THE AFFIDAVIT OF ALEXANDER
 JAMES HUMPHRIES SWORN BEFORE ME THIS 13 March 2008

[Handwritten Signature]

Signature *[Handwritten Signature]* Date _____

Version 2.00

APPENDIX 2: ASK PETE LTD - RETURN OF FINAL MEETING (S106)

Section 106	The Insolvency Act 1986	Form 4.72				
Return of Final Meeting in a Creditors' Voluntary Winding Up Pursuant to Section 106 of the Insolvency Act 1986		S106				
To the Registrar of Companies		For Official Use <table border="1" style="width: 100px; height: 15px;"><tr><td> </td><td> </td><td> </td></tr></table>				
Name of Company		Company Number <table border="1" style="width: 100px; height: 15px;"><tr><td style="text-align: center;">05484115</td></tr></table>	05484115			
05484115						
<table border="1" style="width: 100%;"><tr><td style="text-align: center;">ASK P E T E Ltd</td></tr></table>			ASK P E T E Ltd			
ASK P E T E Ltd						
I / We Mark Jonathan Botwood Regent House Bath Avenue Wolverhampton WV1 4EG						
give notice						
1 that a general meeting of the company was held on /summoned for 04 March 2011 pursuant to section 106 of the Insolvency Act 1986, for the purpose of having an account (of which a copy is attached) laid before it showing how the winding up of the company has been conducted, and the property of the company has been disposed of and that the same was done accordingly / no quorum was present at the meeting						
2 that a meeting of the creditors of the company was duly held on / summoned for 04 March 2011 pursuant to section 106 of the Insolvency Act 1986 for the purpose of having the said account laid before it showing how the winding up of the company has been conducted and the property of the company disposed of and that the same was done accordingly / no quorum was present at the meeting						
Signed		Date 04 March 2011				
Muras Baker Jones Regent House Bath Avenue Wolverhampton WV1 4EG		<table border="1" style="width: 100%;"><tr><td style="text-align: center;">Insolvenc</td><td style="text-align: center;"></td></tr><tr><td style="text-align: center;">TUESDAY</td><td style="text-align: center;">*A0BUCS9S* A44 08/03/2011 90 COMPANIES HOUSE</td></tr></table>	Insolvenc		TUESDAY	*A0BUCS9S* A44 08/03/2011 90 COMPANIES HOUSE
Insolvenc						
TUESDAY	*A0BUCS9S* A44 08/03/2011 90 COMPANIES HOUSE					
Ref A1581/MJB/AJE						
Software Supplied by Turnkey Computer Technology Limited Glasgow						

Liquidator's statement of account Creditors' voluntary winding up

ASK P E T E Ltd

From 13 March 2008 To 4 March 2011

S of A

SECURED ASSETS			
68,579 59	Factored Book Debts	<u>NIL</u>	NIL
SECURED CREDITORS			
65,988 08	RBS Invoice Finance	<u>NIL</u>	NIL
HIRE PURCHASE			
3,700 00	Smart Car	NIL	
(4,193 64)	Hire Purchase	<u>NIL</u>	NIL
ASSET REALISATIONS			
150 00	Furniture & Equipment	NIL	
600 00	Stock of Electrical Test Equip	1,000 00	
2,310 00	Non Factored Debtors	NIL	
	Reclaim of VAT of Factoring Charges	1,371 39	
12,612 56	Cash at Bank	12,363 29	
	Bank Interest Gross	<u>417 02</u>	15,151 70
COST OF REALISATIONS			
	DTI Cheque Fees	1 00	
	Insolvency Bond	58 00	
	Sundry Disbursements	3 00	
	Preparation of S of A	1,500 00	
	Liquidators Remuneration	8,426 18	
	Agents Fees/Commission	500 00	
	Corporation Tax	35 83	
	Postage	89 89	
	Photocopying	49 73	
	Travel Costs	17 49	
	Statutory Advertising	599 15	
	Bank Charges	106 00	
	Tax at source	<u>71 69</u>	(11,457 96)
PREFERENTIAL CREDITORS			
2,291 45	Wages & Holiday Pay	498 36	
	PAYE on Employee Dividend	<u>9 09</u>	(507 45)
UNSECURED CREDITORS			
98,290 50	Trade & Expense Creditors	2,998 06	
2,602 47	Employee Claims	NIL	
12,918 71	Loan Account A Humphries	NIL	
11,118 00	Loan Account - J E Collins	NIL	
1,427 82	PAYE	62 27	
4,395 85	Revenue & Customs VAT	<u>125 96</u>	(3,186 29)
DISTRIBUTIONS			
100 00	Ordinary Shareholders	NIL	

Section 106

Form 4 72 contd

Liquidator's statement of account Creditors' voluntary winding up

ASK P E T E Ltd

From 13 March 2008 To 4 March 2011

(115,374 37)

NIL
0 00

Dividend information

Preferential debts creditors p in £ on £
Unsecured debts creditors p in £ on £
Returns to contributories p per share

Fee information

Fees fixed by
% on £ realised and % on £ distributed

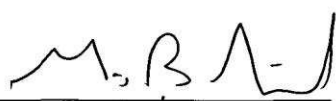
(1) Assets, including None shown in the statement of assets and liabilities and estimated to be of the value of None have proved unrealisable

(2) Amount paid into the Insolvency Services account in respect of

- (a) Unclaimed dividends payable to creditors in the winding up N/A
- (b) Other unclaimed dividends None
- (c) moneys held by the company in trust in respect of dividends or other sums due before the commencement of the winding up to any person as a member of the company None

(3) Other comment

Dated



Signed by the liquidator

4/3/11

Name & Address

Mark Jonathan Botwood
Muras Baker Jones
Regent House
Bath Avenue
Wolverhampton
WV1 4EG

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