Discussion Report: Restructuring Insolvent Companies in the UK and in the US

by

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Under the chair of Professor Dr. Dr. Dr. h.c. mult. Klaus J. Hopt, Dr. Dirk Zetzsche opened the vivid discussion about the two papers presented by Professor Adrian Walters and Professor Edward R. Morrison. As their presentations highlighted the significant differences of insolvency costs in the United Kingdom and in the United States, Dr. Zetzsche explained the higher costs in the UK as follows: contrary to the US system, which generally acknowledges a debtor in possession in Chapter 11 cases, the management does not stay in power in the UK. Accordingly, insolvency proceedings are initiated only at a later point in time. In addition, Dr. Zetzsche addressed the issue of the legitimation of insolvency law. From a secured creditor's point of view, there is no real need for insolvency law, and unsecured creditors normally receive only small fractions of their claims and are, consequently, not too interested in the outcome of insolvency proceedings either. Thus, the key question that any insolvency law system has to deal with is what happens to the management. As management and ownership are only aligned in small businesses, a theory focussing on the incentives of management also explains the different statistical figures for small and big firms that were also mentioned in the presentations.

Professor Morrison answered that contrary to a common understanding of US insolvency law, there is no empirical evidence that Chapter 11 of the US Bankruptcy Code really provides for a "soft landing" of managers. Recent studies have shown that in fact creditors dominate insolvency proceedings in the US: 80 percent of the CEOs lose their jobs in the two years before insolvency proceedings are initiated, and approximately 99 percent of the CEOs are fired during a Chapter 11 reorganisation. While it is true that Chapter 11 was enacted with the intention of keeping management in office in order to preserve value for the firm, the reality shows that the statutory provisions are very flexible. Due to this fact, US insolvency law can quite

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easily be used by hedge funds and banks as an instrument to remove managers from office. Consequently, management-focussed theories cannot convincingly explain the differing choices made by big firms on the one hand and small firms on the other hand.

Professor Walters added that one of the reasons why insolvency proceedings are initiated in the UK later than, e.g., in Germany, is that British insolvency law does not recognise a duty to file for insolvency. As there is, accordingly, no corresponding direct liability for late filing and as management has more latitude to continue trading, directors thus have few incentives to initiate insolvency proceedings. The liability rules for wrongful trading notwithstanding, British courts generally accept that it is a kind of business judgment to file or not to file for insolvency. In addition to his prior statement, Professor Morrison illustrated that in the UK the management tends to file for insolvency quite late in order to avoid the "hard landing" CEOs usually are exposed to in the US.

Ms. Estelle Guyon-Abinal mentioned that corporate insolvency law in France focuses on mechanisms to reorganise companies, while the presented studies from the UK seem to deal primarily with payments made to creditors in liquidations. Professor Walters then explained the British administration scheme in some detail. According to him, certain provisions of the new regime do not fully reflect what is happening in reality. For example, Section 3(1) of Schedule B1 of the Insolvency Act 1986 (as amended by the Enterprise Act 2002) provides that the primary objective of administration should be to rescue the company as a going concern. Only if the administrator thinks that this is not a viable possibility, the second objective for administration comes into play, namely to pursue a strategy that would lead to a better result for the company's creditors as a whole. Traditionally, in the UK, under the old administrative receivership procedure as well as under the new administration regime, the rescue for small and medium-sized enterprises in reality was an auction sale not governed by statutory provisions. The idea was and still is to preserve the going concern value of the struggling business. Accordingly, the reality is contrary to the new law's approach of first-ranking and second-ranking goals and does not favour capital restructurings. Empirical evidence proves two things for the UK: first, the goal of maximising the amount creditors receive is best achieved through an auction sale to a third party (and sometimes to the incumbent management) prior to any distribution to creditors, and secondly, any corporate restructuring is better achieved outside of formal insolvency proceedings.

With regard to the latest amendments of the Insolvency Act 1986, Dr. Carsten Jungmann questioned the validity of the British legislator's view on the

advantages and disadvantages of administrative receivership. In the political discussion leading to the enactment of the Enterprise Act 2002, one could notice the assumption that holders of floating charges which were over-secured had no real incentives to participate in reorganisation attempts. However, according to Dr. Jungmann, one should take into account that banks as the predominant holders of first-ranking floating charges in practice very well have an interest in rescuing the company, because a successful re-organisation enables them to continue their relationship with the company and thus to make further profits in the future. In addition, banks that are misusing the power granted by floating charges run the risk of losing their reputation and their status as a reliable partner of enterprises.

Professor Walters expressed his personal sympathy for this point of view but also replied that such an opinion about administrative receivership was simply not shared in the UK Ministry of Finance and also appears to be a minority opinion among academics in the UK. Although there was the political intention of limiting the rights of banks in insolvency proceedings, it can be observed that, in practice, the banks took the legislative innovations on the chin. The reason is that holders of floating charges have the possibility to nominate the administrator. In an administration procedure, they thus have a degree of influence which is at least partly comparable to the influence they used to have under the old administrative receivership scheme. Accordingly, banks can live with the amendments of the Insolvency Act 1986 by the Enterprise Act 2002.

This observation notwithstanding, it might be true that banks did not really focus on rescuing struggling enterprises in the late 1980s or the early 1990s. However, what banks were in effect doing in the more recent past and what they are still trying to do is conserving going concern value as often as possible. One should keep in mind that administrative receivers as well as administrators are insolvency practitioners. They thus have to meet professional standards and cannot purely act in the interest of floating charge holders.

The discussion then focused on auction sales. Dr. Harald Gesell stated that auction sales are one of the rare means that can be used for debt-equity swaps in Germany. Banks can enforce pledges over the shares of the subsidiary and can subsequently use their original loan claims to pay the auction price. Dr. Gesell asked the panellists how debt-equity swaps are used in their jurisdiction and what influence they have in corporate restructurings. He was particularly interested in strategies which enable banks to get an equity stake in the company and then sell the company after the completion of reorganisation proceedings in cases, in which the price in a prior auction sale would be too low.

In his answer, Professor Morrison explained the technical procedures with a particular focus on foreclosure and other techniques of reorganisations such as an "ABC" (an assignment for the benefit of creditors), which is a business liquidation mechanism under many state codes in the US. In addition and with regard to auction sales, he referred to the doctrine of successive liability in US law. The bank and the owner might bid together and the bank is in effect protected when making a bid, whereas the owner might get back the firm. Of course, there is some risk in this strategy as the courts do not want to be fooled and would not accept a situation where the firm in the end is simply not liable any more for its unsecured debt since the assets have been "washed". However, in a friendly foreclosure both the owner and the bank will have equity interests to the extent that the assets were sold for a price above the bank's claim. Dr. Gesell asserted that the situation is quite similar to Germany. Professor Walters emphasised again that in the UK, debt-equity swaps do not take place under formal proceedings regulated by the Insolvency Act 1986. While it might be possible to use a special scheme under the Companies Act 2006, debt-equity swaps are normally informal workouts. In addition, they might be seen in context with the "London Approach" which is a non-statutory set of market norms for corporate workouts.