CONTROL AND CORPORATE RESCUE—AN ANGLO-AMERICAN EVALUATION

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Abstract This article compares and contrasts Chapter 11 of the US Bankruptcy Code with the UK administration procedure under the Insolvency and Enterprise Acts. It focuses in particular on who runs a company during the restructuring process—debtor-in-possession or management displacement in favour of an outside administrator. Various reasons have been given to explain the US/UK divergence in this respect including differences in entrepreneurial culture and differences in the lending markets in the two countries. The article suggests that the divergence cannot be reduced to a single factor but instead implicates a complex web of circumstances.

I. INTRODUCTION

There are fundamental differences in US and UK insolvency law. These differences are often encapsulated in the maxim that while the US law is pro-creditor the equivalent UK law is pro-debtor.[1] It is suggested that this statement is, at best, a potentially misleading over-simplification. Both countries have legislatively declared reorganization alternatives for ailing companies as well as liquidation provisions. The countries differ, however, in some important respects on the mechanics of how the reorganization process should work. US law is based on debtor in possession—presumptively the existing management remains in control of the ailing company during the reorganization period but is legally invested with a new status, that of 'debtor in possession' (DIP). UK law, on the other hand, is manager-displacing. Although the board of directors remains in office it loses its management functions to an external administrator—an insolvency practitioner normally appointed by a secured creditor with security over the whole of the

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[1] For a comparative evaluation of the 'pro-creditor' nature of the US insolvency regime see the joint HM Treasury/DTI report, 'A Review of Company Rescue and Business Reconstruction Mechanisms' (May 2000) 38–41. The Review Group, however, concluded at p 33 of its report that 'it would be wholly inappropriate to attempt to replicate Chapter 11 in the UK, where the business culture and economic environment are quite different'.

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assets of the company.[2] Britain, however, resembles the United States when it comes to the tendency towards widely dispersed shareholdings in public companies. Given the nature of the capital markets, US theorists have suggested that UK corporate reorganization law should not be manager-displacing. The UK is something of a problem child when it comes to the view of corporate governance theorists who have suggested that there is a certain mismatch or incompatibility between dispersed corporate ownership structures and manager-displacing insolvency laws.[3]

This article will try to analyse how and why the US and UK are different in this respect. It will examine oft-stated reasons for the differences and whether these justifications can withstand critical scrutiny. Certain evolutionary theorists would have us believe that the British system will eventually come to resemble the American.[4] This article casts doubt on this prognostication and suggests that, if convergence occurs, it is more likely to occur halfway or even to be tilted in a British direction. This process may already be taking place with increased creditor influence in Chapter 11 of the Bankruptcy Code, by means of provisions in DIP financing agreements.

The article begins by describing the main features of reorganization laws in both Britain and the US, with particular reference to the party in control of the reorganization process.[5] It then examines the differences in the two systems when it comes to manager displacement and control of the recovery process and focuses on the reasons proffered to explain and justify these differences. The article suggests that individual explanations alone do not hold sufficient justificatory power and suggests that a more convincing explanation implicates a complex web of circumstance that is partly rooted in the different historical and economic experiences in the two countries. The article then suggests that the differences are not as profound as certain theorists would have us believe and that there is increasing evidence of functional conver-

[2] What is now schedule B1 Insolvency Act 1986, para 64, provides that a company in administration or an officer of a company in administration may not exercise management power without the consent of the administrator. Management power is defined as meaning a power which could be exercised so as to interfere with the exercise of the administrator's powers.

[3] On the relative merit of debtor-in-possession versus management-displacement insolvency regimes see D Hahn, 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 JCLS 117. See also V Finch, 'Control and co-ordination in corporate rescue' (2005) 25 Legal Studies 374; O Brupbacher, 'Functional Analysis of Corporate Rescue Procedures: A Proposal from an Anglo-Swiss Perspective' (2005) 5 JCLS 105.

[4] See generally on similarities and differences between the two systems J Armour, BR Cheffins, and DA Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 Vand L Rev 1699.

[5] It has been suggested that whether a firm should be kept together as a going concern is answered by estimating the income stream that the assets would generate if they were kept together, taking into account the risk of reorganization failure, discounting that stream to present value, and comparing it to the amount that the assets would realize if they were sold off in separate pieces—see DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment of adequate protection of secured creditors in bankruptcy' (1984) 51 U Chi Law Review 97, 109.

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gence in practice. The article concludes by reiterating the central themes of the discussion and makes the point that there is no end of history for corporate bankruptcy law.[6]

II. MAIN FEATURES OF THE LAW

In the US, corporate reorganization proceedings are governed by Chapter 11 of the Bankruptcy Code 1978.[7] They are almost always begun by a voluntary petition filed by the corporate debtor. The filing brings about a moratorium on enforcement proceedings against the debtor company or its property. Secured creditors, and others with property rights, may bring proceedings, however, to have the stay lifted and will succeed unless the debtor has provided them with adequate protection against a decline in the value of their property interests (collateral). There is no requirement of insolvency before a company can enter the Chapter 11 process but a case can be dismissed early if it has been filed in bad faith or without reasonable hope of success. Chapter 11 is founded on certain key assumptions including the idea of a 'going concern surplus'. In other words, there is a premise that companies in financial distress are worth more as going concerns than they are if liquidated piecemeal and that, to preserve this surplus, the financial distress must be resolved through adjustment of contractual relations with creditors, shareholders etc. It is also assumed that the necessary adjustments cannot be brought about without court supervision and that, with few exceptions, the decision to initiate formal reorganization proceedings should be made by the management of the company.[8]Another fundamental assumption is that the incumbent manage-

[6] See generally H Hansmann and R Kraakman, 'The end of history for corporate law' in J Gordon and M Roe (eds), *Convergence and Persistence in Corporate Governance* (CUP, Cambridge, 2004) 33.

[7] For a full frontal assault on Chapter 11 see M Bradley and M Rosenweig, 'The Untenable Case for Chapter 11' (1992) 101 Yale LJ 1043; and for a defence see E Warren, 'The Untenable Case for the Repeal of Chapter 11' (1992) 102 Yale LJ 437; WC Whitford, 'What's Right About Chapter 11' (1994) 72 Wash ULQ 1379. See also LM LoPucki and WC Whitford, 'Corporate Governance in the Bankruptcy Reorganisation of Large, Publicly Held Companies' (1993) 141 U Pa L Rev 669. In recent years the debate has moved on with the development of new financing techniques and new modes of Chapter 11 governance. On this see K Gross, 'Finding Some Trees but Missing the Forest' (2004) 12 American Bankruptcy Institute Law Review 203, 217–18: 'At the end of the day, the world got more complex, new markets opened, new uses of Chapter 11 were invented, new parties came to the table, lawyers and other professionals developed new strategies, and financial sophistication increased. At the end of the day, twenty-five years after the Code's passage, the secured creditor influence is but one of many influences. At the end of the day, secured creditors are one of the many players involved in a hugely complex drama. That is what twenty-five years, under the Code and in the real world, has given us.'

[8] According to Professor Stuart Gilson in deciding the merits of alternative corporate reorganization one can consider whether the various systems '(1) allow reorganization or liquidation to be accomplished at minimum cost; (2) encourage insolvent firms to reorganize when their going concern value exceeds their liquidation value, while forcing them to liquidate when their liquida-

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ment should generally remain in place although legally transformed into a quasi-trustee in bankruptcy and called the 'debtor in possession' or DIP.

A successful Chapter 11 outcome generally results in a plan of reorganization agreed by a majority of creditors. The debtor in possession can run the business in the ordinary way but will need court approval for substantial asset sales. For the first few months, only the debtor in possession can propose a reorganization plan but, thereafter, any creditor may do so. Creditors need to approve a plan and approval requires a majority in number, and two-thirds in amount, of each class of creditors. Every impaired class of creditors must approve the plan, though 'cramdown'—confirmation of a plan despite creditor objections—is possible.[9] Generally, a secured class of creditors may be crammed down if it receives the value of its collateral, plus interest, over time, while an unsecured class may insist that shareholders receive nothing if a plan is to be approved despite its objection—the absolute priority rule. Objecting creditors are protected by the 'best interests' test—each objecting creditor must receive at least as much under the plan as it would in liquidation—and also a 'feasibility test'—the company must be reasonably likely to be able to perform the promises it makes in the plan.

A dedicated corporate rescue procedure exists only in England from the 1980s, dating from the 1982 Cork Committee Report on *Insolvency Law and Practice*.[10] Cork recommended the introduction of a wholly new corporate insolvency mechanism primarily designed to facilitate the rescue and rehabilitation of the viable parts of the company in financial difficulties—the administration order procedure. The recommendation was essentially implemented in the Insolvency Act 1986.[11] The making of an administration order entailed the court handing over responsibility for the running of a company to an outside insolvency practitioner—the administrator. Existing management is displaced from its executive responsibilities. A particular type of secured creditor, namely the floating charge holder, enjoyed a veto on the making of an

tion value exceeds their going concern value; and (3) not create incentives for managers or stockholders to 'game' the system ex ante by taking actions that generate private benefits at the expense of firm value': SC Gilson, 'Methodological Issues in Cross-Country Comparisons of Commercial Bankruptcy Law: Comment on Papers by Eisenberg-Tagashira and Rajak' in JS Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford, 1994) 262, 263.

[9] See generally on cram down J Friedman, 'What Courts do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 Cardozo Law Review 1496, who suggests at p 1499 that 'the traditional mystique concerning cram down which instills fear among secured creditors is exaggerated. Cram down is applied in a remarkably homogenous and predictable manner regarding secured claims'.

[10] *Report of the Review Committee on Insolvency Law & Practice* (the Cork Report) (Cmnd 8558, 1982).

[11] D Prentice, F Oditah, and N Segal, 'Administration: The Insolvency Act 1986, Part 11' [1994] LMCLQ 487, considers the reasons for the introduction of the administration procedure, its evolution and effect. See more generally B Carruthers and T Halliday, *Rescuing Businesses: The Making of Corporate Bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998); Alice Belcher *Corporate Rescue* (Sweet & Maxwell, London, 1997).

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appointment. Administration in its original guise has therefore been described as a 'hybrid procedure combining the exceptional powers of floating charge receivership with an altered set of objectives, based on collectivity of approach and a rescue-oriented mission'.[12]

Following the White Paper *Insolvency—A Second Chance* (July 2001),[13] the procedure was changed significantly by the Enterprise Act 2002, with floating charge holders losing their veto. An administrator can still be appointed by the court though out-of-court appointments by the holder of a general floating charge or by the company or its directors are now possible.[14] It is provided that where the company proposes to appoint an administrator out of court, prior notice of the intention to do so must be given to any floating charge holder.[15] Moreover, as a general proposition, where there is a difference of view between the company and the floating charge holder regarding the identity of the proposed administrator, the floating charge holder's wishes will prevail, unless the court thinks it right to order differently in the particular circumstances of the case.[16]

Whatever the method of appointment, an administration has the overriding objective of rescuing the company as a going concern. Where, however, this is not reasonably practical and/or it is not in the interests of the creditors (as a whole) for the company to be rescued as a going concern, the objective is to achieve a better result for the company's creditors (as a whole) that would be likely if the company were wound up. If neither of the above is reasonably practical, then the final objective is to make a distribution to one or more secured or preferential creditors. An administrator is subject to an overarching duty to exercise his functions in the interests of creditors as a whole and, in realizing the property secured, not unnecessarily to harm the interests of creditors as a whole.[17]

An administrator may do all things necessary for the management of the company and it is also the administrator's task to formulate proposals to achieve the purposes of administration. During an administration, creditors, and others with property rights against the company, are barred from enforc-

[12] See IF Fletcher, 'UK Corporate Rescue' (2004) 5 European Business Organization Law Review 119, 125.

[13] *Productivity and Enterprise: Insolvency—A Second Chance* (Cm 5234, 2001).

[14] Schedule B1 Insolvency Act 1986, paras 14 and 22. It appears that most appointments are made by the company rather than by a bank holding a floating charge. Banks appear reluctant to make the appointment themselves, as distinct from influencing the company's choice of appointee, because of reputation concerns. On this see generally the empirical study by Dr Sandra Frisby on the Insolvency Service website: <http://www.insolvency.gov.uk> (11 Apr 2007).

[15] Schedule B1 Insolvency Act 1986, paras 22 and 26.

[16] ibid para 36(2).

[17] In the *Productivity and Enterprise* White Paper it was suggested that the result would be a procedure that would be as flexible and cost-effective as administrative receivership, but one in which the administrator will owe a duty of care to all creditors, unsecured creditors will have the opportunity for input and participation and the process will be subject to the oversight and direction of the court in a public and transparent way.

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ing their claims. A 'successful' administration may involve the company entering into an agreement with its creditors, a company voluntary arrangement (CVA), under which they agree to accept a certain proportion of the debts due to them or else agree that their debt will be converted into equity (shares) in the company.[18] The company will then come out of administration. Not all creditors have to agree to the proposals before they become binding on the remainder.[19] Under the old regime, administration operated as a breathing space and as a gateway to another insolvency process, be it winding up or a CVA. The new procedure, however, offers the possibility that administrations may function on a stand-alone basis, since companies can now pass directly from administration to dissolution or to a very short formal liquidation followed by dissolution. The administrator is given power to make distributions to secured, preferential and, with the leave of the court, also unsecured creditors.[20] It seems that the threshold for the exercise of such power is essentially what the administrator thinks is likely to assist in achieving the purposes of administration.[21] This implies that the administrator must use commercial judgment but early strategic planning is needed about the way in which the administration is intended to end; this should be included in the administrator's proposals.

We have seen that in the insolvency laws of both Britain and the US there is reorganization as well as a liquidation alternative. Both countries are committed to the 'rescue culture', as it were.[22] The US Supreme Court has described the objectives of Chapter 11 in the following terms:[23]

[18] An empirical study by Dr Sandra Frisby on the Insolvency Service website—<http://www.insolvency.gov.uk> (11 Apr 2007)—reveals that in only a small minority of cases will administration lead to a genuine rescue outcome. Corporate rescue, as distinct from business, remains very much a minority pursuit.

[19] A proposal for a CVA, whether made outside or within administration, cannot, however, affect the right of a secured creditor to enforce his security or affect the priority of a preferential creditor except with the consent of the relevant creditor—Schedule B1 Insolvency Act 1986, para 73.

[20] Schedule B1 Insolvency Act 1986, para 65.

[21] *Re GHE Realisations Ltd* [2006] 1 WLR 287.

[22] For a somewhat sceptical perspective on the merits of reorganization versus liquidation see DG Baird and RK Rasmussen, 'The End of Bankruptcy' (2002) 55 Stan L Rev 751, 758: 'We have a going-concern surplus (the thing the law of corporate reorganizations exists to preserve) only to the extent that there are assets that are worth more if located within an existing firm. If all the assets can be used as well elsewhere, the firm has no value as a going concern'. Richard V Butler and Scott M Gilpatric see 'going-concern surplus' more broadly in 'A Re-Examination of the Purposes and Goals of Bankruptcy' (1994) 2 American Bankruptcy Institute Law Review 269, 281: 'part of the going concern surplus represents the value to the firm of the relationships which it has established with factor owners. The rest reflects the value to it of its relationships with customers, regulators, and other interested parties'.

[23] *US v Whiting Pools Inc* (1983) 462 US 198, 203. See also HR Rep No 595, 95th Congress, Ist Session 220 (1977). It is worth pointing out that insolvency law (or bankruptcy law as it is termed in the US) is federal law, not law, under Art 1, s 8, clause 4 of the US constitution. On the other hand, property law (including secured property law) falls within the domain of the individual states.

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> In proceedings under the reorganization provisions of the Bankruptcy Code, a troubled enterprise may be restructured to enable it to operate successfully in the future. . . . By permitting reorganisation, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners . . . Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap'.[24]

There are similar judicial and legislative statements in the UK.[25] In *Powdrill v Watson*,[26] Lord Browne Wilkinson in the House of Lords talked about administration as being part of a rescue culture which seeks to preserve viable businesses.

Given the apparent similarity in objective, why the difference in approach towards manager displacement in the two countries? I shall attempt to explore the reasons for the differences under the following headings: attitudes towards entrepreneurship, debt and risk-taking; carrots and sticks and the encouragement of early filing; nature of the task to be performed during the reorganization process—professionalism and expertise; path dependency; and finally the nature of the lending markets.[27]

III. ATTITUDES TOWARDS ENTREPRENEURSHIP, DEBT AND RISK-TAKING

Professor Sir Roy Goode has commented that insolvency law in the UK is

[24] Professor Elisabeth Warren sees the law as being designed to save jobs and companies for the benefit of numerous impacted communities and not just creditors in 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 Mich L Rev 336, 354–5: 'Bankruptcy policy also takes into account the distributional impact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business. Business closings affect employees who will lose jobs, taxing authorities that will lose rateable property, suppliers that will lose customers, nearby property owners who will lose beneficial neighbours, and current customers who must go elsewhere. Congress was acutely aware of the wider effects of a business failure on the surrounding community and it adopted the 1978 Bankruptcy Code specifically to ameliorate those harmful effects . . .' Contractarian theorists would respond broadly by saying that only legally enforceable interests of particular members of these constituencies under non-bankruptcy law should be taken into account. For other inclusive perspectives see RJ Mokal, 'The Authentic Consent Model: Contractarianism, Creditors' Bargain and Corporate Liquidation' (2001) 21 Legal Studies 400, 440–3; and see also DR Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 Columbia Law Review 717.

[25] See the statement of the government minister, Lord McIntosh, when piloting the legislation through the House of Lords (*Hansard* HL Deb vol 638 col 766 (29 July 2002)):

'Company rescue is at the heart of the revised administration procedure. We want to make sure that viable companies do not go the wall unnecessarily. That is why we are restricting administrative receivership and revising administration to focus on rescue and to make it more accessible to companies as well as their creditors. That is not just for the companies themselves; it is also good for their suppliers, customers and employees. The emphasis on company rescue will create more incentive for company management to take action promptly and use the administration procedure before the situation becomes terminal. That is why the purpose directs the administrator to perform his or her functions with "objective of rescuing the company".'

[26] [1995] 2 AC 394, 442. See also A Belcher, *Corporate Rescue* (Sweet & Maxwell, London, 1997).

[27] See generally on this V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, Cambridge, 2002) 194–206.

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predicated on the assumption that where a company becomes insolvent this is usually due to a failure of management and the last people to leave in control are those who were responsible for the company's plight in the first place.[28] These arguments have been developed to a certain extent by a leading QC, Gabriel Moss who suggests that having a debtor-in-possession regime could be equated with leaving an alcoholic in control of a pub.[29] He takes the view that in England, insolvency, including corporate insolvency, is regarded as a disgrace. While the stigma may have worn off to a degree, it was nevertheless still there as a reality.[30] He speaks of a general English judicial bias towards creditors which reflects a general social attitude that is inclined to punish risk-takers when the risks go wrong and side with creditors who lose out. Creditors tend to feel very strongly that once disaster strikes, the management of the company's business should be taken out of the hands of the management and given to a professional person chosen by the creditors.[31]

Similar sentiments have been articulated by American commentators.[32] Professor Nathalie Martin in a study of common law bankruptcy systems remarks that while the UK certainly has more bankruptcies than the rest of the EU, these are still considered major embarrassments, even if they result from the failure of a business.[33] She suggests, though without adducing much in the way of empirical evidence, that executives in a company that fails can have a difficult time finding another job and often are shunned socially.

> Thus, despite all the new credit available, the British marketplace comes down hard on those who have gotten into financial difficulty. The attitude is once a bankrupt, always a bankrupt. The English government currently is attempting to change these attitudes in order to encourage people who have failed to go back into business and help fuel Britain's flagging economy. Yet it is unclear that one can change attitudes by changing laws. The government is likely to be unable to tell people how to think or whom to invite to parties, even through drastic legal change.[34]

[28] See R Goode, *Principles of Corporate Insolvency Law* (3rd edn, Sweet & Maxwell, London, 2005) 328.

[29] G Moss, 'Chapter 11: An English Lawyer's Critique' (1998) 11 Insolvency Intelligence 17, 18–19.

[30] See also B Carruthers and T Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998) 246.

[31] See generally G Moss, 'Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law—England' (1997) 23 Brooklyn Journal of International Law 115.

[32] See the comment by JL Westbrook, 'A comparison of bankruptcy reorganisation in the US with administration procedure in the UK' (1990) Insolvency Law and Practice 86, 88: 'In the U.S. a variety of factors, including a deep emotional commitment to the entrepreneurial ethic, make the owners of the corporation central to a salvage proceeding. In the U.K, the prevailing view seems to be that the prior owners were the ones whose venality or incompetence created the problem and their interests disappear from moral or legal consideration once a formal proceeding has begun. Americans are much more willing to believe that financial difficulty is the result of external forces and that preservation of the company, not just the business, is a crucial social concern.'

[33] Nathalie Martin, 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 American Bankruptcy Institute Law Review 367, 374.

[34] ibid 374–5.

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In the European context Britain is not alone in having a manager-displacing insolvency regime. In Germany, for example, under a comparatively new process, all proceeding begin as a liquidation but can then be converted into reorganization proceedings.[35] Whatever the nature of the proceedings, however, management loses their power to dispose of corporate assets once the insolvency proceedings commence. The company is then administered by an administrator, appointed by the court or elected by the creditors. The administrator has the exclusive right to dispose of the company assets. On application by the debtor however, and subject to the creditor's consent where the insolvency proceedings have been initiated by a creditor, the court may order that the company should instead be administered by existing management under the supervision of an insolvency practitioner. The court, moreover, may only authorize this course of action if this does not unduly prejudice the creditors, and a creditors' committee may at any time apply to the court to appoint an administrator instead of the DIP. In addition, the DIP must obtain the supervisor's consent to incur liabilities outside the ordinary course of business. On the whole, a German debtor in possession is subject to much tighter control than its US counterpart and, even then, the stripped-down debtor-in-possession procedure is hardly utilized.

In the process of formulating and refining the new insolvency process, Germany insolvency experts were particularly hostile towards the DIP concept, asking whether it was really sensible to let the management that was responsible for the insolvency administer the formal workout. It was feared that use of the DIP concept could lead to companies seeking insolvency protection with a view to making creditors wait for years for payment. This was a perceived defect of Chapter 11. There was also a feeling that the supervisor appointed in a DIP situation could be viewed as a second-class administrator with limited powers, especially because such supervisors were entitled to only half of the fees allowed administrators. The Insolvency Commission, whose report led to the legislation, doubted the value of the management's skills and expertise in the new insolvency context. It also doubted whether the creditors could place reliance on the old management.[36] Having an administrator run the company provided a greater guarantee of independence and also meant increased integration and harmonization of procedure if liquidation of the company was the eventual outcome.

Germany shares the same suspicion of the DIP as a concept but what is perhaps more surprising is that other 'Anglo-Saxon' economies tend to follow

[35] See generally on the German Insolvency Law M Balz, 'Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law' (1997) Brooklyn Journal of International Law 167; K Kamlah, 'The New German Insolvency Act' (1996) 70 American Bankruptcy Law Journal 417; M Schiessl, 'On the Road to a New German Reorganization Law' (1988) 62 American Bankruptcy Law Journal 233.

[36] M Schiessl, 'On the Road to a New German Reorganization Law' (1988) 62 American Bankruptcy Law Journal 233, 247–8.

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the UK rather than the US approach.[37] Despite very similar economies, reorganizing a business is not the same process in the UK, Australia, or Canada as it is in the US. Other common law countries are far more sceptical of the DIP concept than the Americans.[38] In Australia, leaving management in control of an ailing company has been likened to leaving the fox in charge of the henhouse. It has been suggested that Australian laws on corporate reorganization are even more stringent towards existing management than those of the English mother country. The Australian attitude appears to be that if a business fails, it should be pushed aside so that others can fill the gap.[39] The notion of the debtor in possession has been said to encourage wasteful, strategic behaviour by the company directors. In other words, the management personnel who originally precipitated the company's financial difficulties have not only an incentive but also the power and authority to initiate high-risk strategies. They have nothing to lose and possibly a lot to gain by speculative investment of the company's resources.[40] There are said to be moral hazards bound up with the DIP procedure analogous to those commonly associated with limited liability. Moreover, since shareholders do not bear the burden of the company's risky behaviour, an incentive is created for them to direct a company to behave in such a fashion.[41]

In the United States it is widely believed that there is a different attitude towards risk and risk-takers. One might cite in this connection the observations of former Secretary of State for Trade and Industry, and current EC Commissioner, Peter Mandelson:

> We need to examine all our regulatory systems to ensure that they do not needlessly deter entrepreneurs, such as our bankruptcy laws. Are we sure that they create confidence in enterprise and commerce? I don't think that we are confident. I think we need fundamentally to re-assess our attitude in Britain to business failure. Rather than condemning it, and discouraging anyone from risking failure, we need to encourage entrepreneurs to take further risks in the future. Here in the US, I am told that some investors actually prefer to back businessmen and women with one or more failures under their belt, because they appreciate the spirit of enterprise shown, and recognise the experience that has been gained. Can you imagine that in Britain?[42]

[37] The merits of the Australian approach has been commended by the Banking Law Sub-Committee of the City of London Law Society—see G Yeowart, 'Administrative Receivership: Abolition or Reform?' [2002] Butterworths Journal of International Banking and Financial Law 6, 9.

[38] See generally PB Lewis, 'Trouble Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide' [2001] Utah Law Review 189, 223–5.

[39] Martin (n 33) 404.

[40] Concerning perverse incentives there is a famous American story involving Federal Express: 'Federal Express was near financial collapse within a few years of its inception. The founder, Frederick Smith, took $20,000 of corporate funds to Las Vegas in despair. He won at the gaming tables, providing enough capital to allow the firm to survive'—see Stephen Ross et al, *Corporate Finance* (7th edn, McGraw-Hill/Irwin, New York, 2002) 428.

[41] See generally PB Lewis (n 38) 223–5.

[42] Addressing the British–American Chamber of Commerce—see *The Times* (London, 14 Oct

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One American commentator has remarked:

> Americans may have a different relationship with money than most other people. The American emphasis on economic conditions, consumerism and material things makes money one of the strongest forces in society. Money is power in American society. It defines Americans' worth and status in a way unmatched elsewhere. If Americans lost money, they fear that they will lose themselves. Material things appear to play a smaller role in most other societies. . . Americans are encouraged by society to buy things, also need material things in order to be valued in society. They also need a safety net if they are ultimately unable to pay for all these necessities. Given these differences in societal views and economic goals, as well as those quirks of history and culture, the differences among the common law bankruptcy systems should not be surprising. In fact, perhaps the many similarities among these systems should surprise us instead.[43]

A leading empirical study by two prominent American bankruptcy lawyers and a sociologist, *The Fragile Middle Class*,[44] concluded that bankruptcy debtors are not outliers in society but 'people we know'; in other words, students, neighbours, and associates who are victims of America's 'market-driven, highly competitive, compulsively consuming and anti-welfarist environment'.[45]

Two prominent English QCs have articulated much the same sentiments. Gabriel Moss suggests that in the US, business failure is very often thought of as the result of misfortune rather than wrongdoing. In his view, the US is still a pioneering country where the taking of risks is thought to be a good thing and creditors are perceived as being greedy. The secured creditor is often seen as the oppressor of the enterprising debtor and does not have the general sympathy of the public or the courts. By way of contrast, judges in England tend to favour the financiers; bankers appear to have acquired respectability over the centuries whereas those who take risks in business have not.[46] In addition, the English judiciary are inclined to be sympathetic towards insolvency practitioners as opposed to debtors, since insolvency practitioners are professionals generally known to the court, whereas the debtor's descent into insolvency tends to be treated as a ground for suspicion. Furthermore, insolvency practitioners act either in the interests of a secured financier or at the direction of the court. Muir Hunter QC has praised US judicial efforts which he sees as being pragmatic and compassionate, facilitating enterprise and initiative and contributing to the creation of the most successful economy in the world.[47]

1998); and see the discussion in M Hunter, 'The Nature and Functions of a Rescue Culture' [1999] JBL 491, 519–20.

[43] Martin (n 33) 409–10.

[44] T Sullivan, E Warren, and JL Westbrook, *The Fragile Middle Class: Americans in Debt* (Yale University Press, New Haven, 2000).

[45] See the review by Jacob Ziegel in (2001) 79 Texas L Rev 1241, 1244.

[46] See generally Moss (n 31).

[47] Hunter (n 42) 519.

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IV. CARROTS AND STICKS OR ENCOURAGING EARLY FILING

It might be argued that having a policy of debtor in possession goes hand in glove with encouraging a company to invoke the reorganization procedures when there are signs of financial distress rather than waiting until the disease becomes terminal.[48] This proposition was advanced during the legislative debates on the US Bankruptcy Code: 'Proposed Chapter 11 recognises the need for the debtor to remain in control to some degree or else debtors will avoid the reorganization provisions in the bill until it would be too late for them to be an effective remedy.'[49]

In short, the directors of companies in the US know that filing for Chapter 11 protection will safeguard their position as well as providing them with the exclusive right to propose a reorganization plan or the sale of corporate assets. It may be critical to the outcome that a company seeks the Chapter 11 relief stage when there is a realistic prospect of a sensible reorganization, rather than later when the potential for reorganization is exhausted. If managers believe that their jobs will be preserved in a Chapter 11 context then they will be more likely to put their company into Chapter 11 at an early stage while the company may still be viable. As a bonus, those most familiar with the company will continue managing it. To put it another way, the presumption in favour of a debtor-in-possession regime advances reorganization objectives in that management is not penalized for seeking Chapter 11 protection. In the US, early filing is encouraged by the carrot of retaining control of the company and acquiring debtor-in-possession status. However, there is a general lack of sticks in the US if directors fail to put the interests of creditors first by filing early for reorganization. There are no statutory equivalents to the English law on wrongful trading and company director disqualification. There is, however, the general law on directors' duties and in a growing number of US cases the courts have held that managerial allegiance must shift from the shareholders to the creditors when a company approaches insolvency.[50] Upon insolvency, the residual claims of the shareholders become economically worthless and creditors, who will go unpaid in the event of complete financial

[48] Hahn (n 3) 127, suggests that three primary factors affect the efficiency and fairness of corporate reorganization regimes: '(a) the ownership structure of corporate debtors and its effect on the extent of independent judgment the debtor's management is capable of exercising, (b) the effect of the respective regimes on the firm's decision-making concerning the commencement of bankruptcy, and (c) the professional qualification of the person controlling the reorganisation case'.

[49] HR Rep No 595 95th Cong, 1st Session 231 (1977).

[50] See *Federal Deposit Insurance Corp v Sea Pines Co* (1982) 692 F2d 973, 976–7: 'when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors'; and see generally RT Nimmer and RB Feinberg, 'Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity' (1989) 6 Bankruptcy Developments Journal 1.

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failure, now occupy the position of residual owners.[51] Therefore, it is not surprising that managerial allegiance should depend upon the fortunes of the business but while a number of courts have held that fiduciary duties extend to creditors upon insolvency, duties are still owed to the shareholders as well.[52] Influential judicial statements in the US emphasize that, in the vicinity of insolvency, the board of directors has an 'obligation to the community of interests that sustained the corporation to exercise judgment in an informed good faith effort so as to maximize the corporation's long term wealth creating capacity'.[53]

In England, it is also incumbent upon directors to take heed of creditor interests in the vicinity of insolvency. The proprietary rights of creditors against the assets of the company, in the event of formal insolvency proceedings, entitle them to be regarded as the company in situations approaching formal insolvency.[54] But additionally there are strong statutory sticks to encourage directors to put an ailing company into administration. Under the so-called 'wrongful trading' provision contained in section 214 of the Insolvency Act 1986, once a director or shadow director knows or ought to have concluded that there is no reasonable prospect that a company would avoid going into insolvent liquidation he/she must take every step with a view to avoiding potential loss to company creditors.[55] If a director fails to take such steps he/she runs the risk of being declared personally liable for the debts of the company. Further, causing a company to trade while insolvent may occasion disqualification proceedings against a director on grounds of unfitness.[56] In extreme cases, a director may be disqualified from taking part in company management for up to 15 years on the basis of unfitness.[57]

On the other hand, there is no particular prize or carrot in England if the directors invoke the reorganization processes promptly. There is nothing, however, to stop an administrator from retaining the services of some part of the existing management and, in many businesses, this will be essential to preserving value or to ensuring a successful rescue or sale of the business. Apart from that, and the voluntary moratorium for smaller companies introduced by the

[51] *Geyer v Ingersoll Publications Co* (1992) 621 A2d 784, 787: 'when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors'; and see generally B Adler, 'A Re-Examination of Near-Bankruptcy Investment Incentives' (1995) 62 U Chi Law Review 575, 590–8.

[52] *Commodity Futures Trading Commission v Weintraub* (1985) 471 US 343, 355–6.

[53] *Credit Lyonnais Bank Nederland NV v Pathe Communications* No CIV.A. 12130, 1991 Del Ch LEXIS 215, 108–9.

[54] See generally *Lonrho v Shell Petroleum Ltd* [1980] 1 WLR 627, 634 per Lord Diplock; and *West Mercia Safetyware Ltd v Dodd* [1988] BCLC 250, 252–3.

[55] See generally A Keay, 'Wrongful trading and the liability of company directors: a theoretical perspective' (2005) 25 Legal Studies 431.

[56] Sections 6 and 8 of the Company Directors Disqualification Act 1986. Liquidators and others are required to report suspected cases of unfitness to the Department of Trade and Industry disqualification unit.

[57] 'Unfitness' is considered by reference to the factors listed in Schedule 1 to the 1986 Act.

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Insolvency Act 2000, there is a superficially harsh manager-displacing insolvency regime. The merits of this approach have been questioned,[58] for it is arguable that in such a regime the commencement of reorganization is liable to be so late that creditors will lose the going-concern value premium that is otherwise available for capture. The argument is that only the existing management, and not the creditors, can be expected to initiate a timely reorganization. In the interim period, during which management struggles to avoid bankruptcy, the going-concern premium is at risk of being lost to the detriment of the creditors.[59]

> Risk averse management may become less motivated to work hard under a strictly enforcing regime which not only removes them from office upon business distress but also severely penalized them as a bonus if they are later found to have effectively resigned too late.

It is also argued that for several reasons creditors can not be relied on to initiate a timely reorganization effort.[60] In particular, banks have their own ways and means of addressing a company's financial distress once this is revealed, perhaps by taking additional collateral. Alternatively, a bank may be put to sleep by management's adherence to the payments schedule on the particular bank debt. That is not possible in all instances, however, especially where the company's financial plight is particularly pressing. More generally, the Enterprise Act 2002 has bolstered the collective nature of the administration process, inter alia, by removing the power of veto, which a floating charge-holder once enjoyed on the appointment of an administrator. It also stresses that an administrator must not unnecessarily harm the interests of company creditors as a whole.[61] More positively, the first statutory objective of administration is to try to rescue the company as a going concern.

V. NATURE OF THE TASK TO BE PERFORMED DURING THE REORGANIZATION PROCESS — PROFESSIONALISM AND EXPERTISE

It seems to be stating the obvious to suggest that there is a need for professional management in keeping the ongoing operations of the debtor intact notwithstanding the commencement of the reorganization process. This begs the question whether the services of an accountant/insolvency practitioner are appropriate to this end. Specialized professionals whose main role is financial analysis of corporate performance or even legal counselling and litigation hardly seem the most worthy candidates for these managerial tasks.[62] The

[58] See Hahn (n 3) 139.
[59] ibid 141.
[60] See ibid 142–3.
[61] Schedule B1 Insolvency Act 1986, para 3.
[62] See Hahn (n 3) 146.

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doyen of law and economics scholarship, Richard Posner, has stated: 'The reason for giving [the right to continue the operation of the firm] to management is that only management, and not a committee of creditors or a trustee, auctioneer, or venture capitalist or other acquirer has the knowledge to continue the firm in operation, as distinct from reviving it (maybe) after an interruption for a change in control'. [63]

Under Chapter 11, it is the norm for all companies to operate as debtors in possession. With the DIP in control, managers are far more likely to keep their jobs during reorganization whereas in England the automatic consequence of administration is that the board of directors is displaced from any management functions in relation to the company or its affairs.[64] It may be that administration is viewed very differently from Chapter 11 in the US and this accounts for the contrast. On a close reading of the relevant legislation in the UK, overall creditor wealth maximization, possibly accomplished by a sale of assets, may be at the top of the tree when it comes to the objectives of administration. Its elevated status is considerably obscured, however, by the prominence placed on corporate rescue in the statement of statutory objectives.[65] The legislation states that an administrator must perform his/her functions with the objective of (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), or (c) realizing property in order to make a distribution to one or more secured or preferential creditors.[66] An administrator can only descend the statutory hierarchy of objectives if he/she thinks that it is not reasonably practicable to achieve any of the preceding objectives; though an administrator has to move from (a) to (b) if he/she thinks that (b) would achieve a better result for the company's creditors as a whole.

While rescuing the company as a going concern comes top of the statutory list of objectives, it cannot be pursued if the administrator thinks that it is not reasonably practicable to do so, or where it would not achieve the best result for the company's creditors as a whole. There is an overarching general requirement that an administrator should not unnecessarily harm the interests

[63] See R Posner, 'Foreword' in J Bhandari and L Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (CUP, Cambridge, 1996).

[64] See Schedule B1 Insolvency Act 1986, para 64: 'A company in administration or an officer of a company in administration may not exercise a management power without the consent of the administrator.'

[65] See S Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 MLR 247, 262; and more tentatively Finch (n 3) 395–6: 'The terms of EA 2002 mean that it is arguable that an administrator is obliged to pursue a going concern sale where he thinks this will serve creditors better than efforts made to rescue the company—even where it might be possible to rescue the company. Primacy is accordingly given to maximising overall returns to creditors, rather than to rescue per se.'

[66] Insolvency Act 1986 Schedule B1, para 3(1). An administrator must also perform his/her functions in the interests of the company's creditors as a whole.

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of the creditors of the company as a whole.[67] While the administrator cannot act solely in the interests of a creditor who may have made the appointment, producing better returns for company creditors appears, at the end of the day, to be essentially what administration is about. The emphasis is on preservation of the business of the company rather than preservation of the company as an empty corporate shell. Moreover, during the parliamentary debates, the Government stressed: 'We would not want the administrator to rescue the company if it is to the detriment of creditor value.'[68]

If an administrator concludes that a sale of assets may achieve a better result for company creditors than preserving the business there seems little scope for challenging his judgment. Schedule B1 of the Insolvency Act 1986, paragraph 74, gives a creditor or member standing to apply to the court if the administrator is acting so as unfairly to harm the interests of the applicant and/or others and ammunition to support a legal challenge may come from the administrator's duty to explain why the 'rescue objective cannot be achieved'.[69] The relevant test, however, is what the administrator 'thinks' and not what he/she 'reasonably believes'; and this test leaves little scope for judicial review.[70] The courts normally will not second-guess commercial judgments, as was explained during the parliamentary debates:

> The administrator is the person on the ground who is best placed to judge whether or not a particular objective is reasonably practicable, in the light of his experience and professional judgment. . . [I]t will be for the administrator to reach a conclusion as to whether or not the objectives are reasonably practicable, taking into account all the circumstances of the particular case of which he or she is aware at the time.[71]

The administrator's opinion, formed in good faith,[72] may be very difficult to challenge though it is possible to conceive of an example where a company has two assets, one of which is essential to the carrying on of a company's business; the other is not essential. The administrator sells the key asset, because of its saleable nature, although the sale has a crippling effect on the further viability of the company's business. It would seem that the administrator has unfairly and unnecessarily harmed the interests of members (and perhaps creditors) of the company. This action may be amenable to redress

[67] Schedule B1, para 3(4).

[68] See the comments by the relevant Minister, Lord McIntosh of Haringey (n 25).

[69] Schedule B1, para 49(2)(b).

[70] For somewhat different perspectives see J Armour and R Mokal, 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' [2005] LMCLQ 28; R Mokal and J Armour, 'The New UK Rescue Procedure—The Administrator's Duty to Act Rationally' (2004) I International Corporate Rescue 136; M Simmons QC, 'Enterprise Act and Plain English' [2004] Insolvency Intelligence 76.

[71] *Hansard*, HL Deb, vol 638, col 768 (29 July 2002).

[72] See *Re GHE Realisations Ltd* [2006] 1 WLR 287; and see also V Finch, 'Re-invigorating Corporate Rescue' [2003] JBL 527, 546; L Linklater, 'The Enterprise Act: Fulfilling Great Expectations' (2003) 24 Company Lawyer 225.

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under paragraph 74, whereas similar action by an administrative receiver would be immune from challenge.[73]

Be that as it may, it seems that in England there is much more emphasis on asset sales and preserving jobs and wealth through that route rather than through the preservation of existing corporate structures.[74] A speedy sale of company assets to a purchaser who will put them to better use and, in the process, maintain employment is often seen as the better result than the tedious process of restructuring the existing corporate vehicle and getting the reorganization plan approved. The point has been made that to American eyes, even the revamped administration procedure still looks to have a different mission than Chapter 11. In Chapter 11 the business of the company tends to remain in the hands of the existing corporate set-up. While one can liquidate a company in Chapter 11 pursuant to a going concern sale, US lawyers see this as liquidation.[75]

> English rehabilitation law recently has been overhauled to promote reorganization and fuel a failing economy. Even in its new form however, this law is very different from American rehabilitation law. Existing management cannot stay in place, there is an insolvency requirement, and the process is entirely creditor controlled. This form of rescue culture may achieve its goals of saving some businesses from piece-meal liquidation by allowing them to be purchased while still operational. It also may save jobs and avoid harm to suppliers who deal with the troubled company. It is not, however, a reorganisation in the traditional American sense of the word.

If administration is really very different from Chapter 11 then this could explain the differences as to who runs the respective procedures. Having an accountant at the helm makes sense if the process is really about valuation and asset sales rather than running the business with a view to bringing about the return of profitable trading. On the other hand, administration and Chapter 11, at least in its present guise, are not poles apart. In 1978 on the promulgation of the US Bankruptcy Code, great attention was paid to corporate rehabilitation but now the emphasis seems to have shifted. In the legislative debates on

[73] An administrative receiver can choose to exercise or not to exercise the power of sale over a particular asset. According to the Privy Council decision in *Downsview Nominess v First City Corp* [1993] AC 295, the only constraint on the administrative receiver's choices is the criterion of good faith. In the words of Professor Sir Roy Goode ((n 28) 284–5) *Downsview* suggests that: 'The receiver . . . is entitled, if he so chooses, to decide not to continue the company's business, and to sell a part of the business which would be better kept. It would also seem that he can select a particular asset to realise for the benefit of his debenture holder even though the removal of that asset would damage the company's business and there are other assets to which he could resort and on which the business is less dependent.'

[74] See the comment at para 193 of the 1982 Cork Report (n 10): 'In the case of an insolvent company, society has no interest in the preservation or rehabilitation of the company as such, though it may have a legitimate concern in the preservation of the commercial enterprise'. See also the empirical study by Dr Sandra Frisby on the Insolvency Service website: <http://www.insolvency.gov.uk> (11 Apr 2007).

[75] See the comment by Martin (n 33) 397.

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the Bankruptcy Code there were discussions of community concerns; the public interest; and of how best to protect investors, protect jobs and help save troubled businesses.[76] One commentator acidly remarks:[77]

> Few free market law and economics scholars were around to make the cruel argument that society would prosper if the free market were allowed to kill off weak and inefficient companies. That the dismissed workers of a dead company might be better off in the long run as a result of that death (or that a competitor's workers would be) was hardly considered. The incantation, 'reorganization, yes, liquidation, no' echoed through the Commission's meetings and in the Halls of Congress. Firms should be given every chance to save their goodwill; no one seems to have thought much of the firms with badwill that could be liquidated for a greater sum than they would command as going concerns, nor did anyone seem to believe that a large percentage of firms that would use chapter 11 might possess badwill, not good. So even in 1978 . . . the Right was a pale and moderate version of its later self, and many of the arguments one might hear from the law and economics crowd today were but whispers then.[78]

In more recent times the melodies have played out differently, with a higher priority assigned to the maximization of creditor recoveries and asset sales coming to the fore rather than reorganizations in the traditional sense. 'Whereas the debtor and its manager seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast. Chapter 11 no longer functions like an anti-takeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with asset sales and faster cases'.[79]

There may have been something of a functional convergence between procedures on either side of the Atlantic with the common ground being more on British lines rather than on traditional Chapter 11 territory.

[76] See also the comments of the US Supreme Court in *NLRB v Bildisco* (1983) 465 US 513, 528: 'The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources' citing views expressed in the US House of Representatives HR Rep No 95–595, p 220 (1977): 'The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets'.

[77] See the comments in JJ White, 'Death and Resurrection of Secured Credit' (2004) 12 American Bankruptcy Institute Law Review 139, 139–40.

[78] For criticism of the White perspective see BA Markell, 'White's Wheel' (2004) 12 American Bankruptcy Institute Law Review 193, who comments at 201: 'I have categorized White's philosophy as that of the wheel; that interests once compromised will find ways to claw back, only to be compromised again. … I have said little about the competing metaphor of history as a ladder; that is, that there is or can be a direction to what we do. Most often, the metaphor of the ladder assumes a rise upward, an improvement for all over time. If White is correct that power and cleverness can undo the Code, we then have a reminder that movement on a ladder is not always up.'

[79] See DA Skeel Jr, 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 U Pa L Rev 917, 918.

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VI. PATH DEPENDENCY

One factor or theory that may go partly towards explaining the difference between the debtor in possession regime in the US and the manager displacing reorganization regime in the UK is that of path dependency. In other words, because procedures have historically developed in different ways these differences will remain even though the reasons for the differences no longer exist. Path dependency theory has been used in the corporate governance context to explain the persistence of different conceptions of corporate ownership and accountability. Some commentators consider the Anglo-American shareholder-oriented model under which directors and corporate managers owe their duties primarily to the holders of equity in the company to be normatively superior to other models where the constituencies that benefit from such duties are more diffuse.[80] Nevertheless, other models of corporate governance survive in many parts of the world partly because of inertia and partly because the historical circumstances that produced them exert a continued gravitational pull.[81]

The corporate insolvency and reorganization regimes in both Britain and the US are each the product of a different conjunction of circumstances. Administration grew out of receivership which was essentially a creditor-oriented procedure, though often viewed through rose-tinted corporate rescue spectacles. The Cork committee, which reported in 1982 on insolvency law and practice, highlighted the power to appoint a receiver and manager of the whole property and undertaking of a company. The committee went on to say:

> Such receivers and managers are normally given extensive powers to manage and carry on the business of the company. In some cases, they have been able to restore an ailing enterprise to profitability, and return it to the former owners. In others, they have been able to dispose of the whole or part of the business as a going concern. In either case, the preservation of the profitable parts of the enterprise has been of advantage to the employees, the commercial community, and the general public.[82]

It is arguable that the committee's view represented a rather idealized concep-

[80] See generally Hansmann and Kraakman (n 6) 33. See generally on this area J Parkinson, 'Inclusive Company law' in John De Lacy (ed), *The Reform of UK Company Law* (Cavendish, London, 2002) 43, who suggests that the priority afforded to shareholders 'reflects not so much a belief that their interests are inherently more deserving of protection than those of other groups, as acceptance of the traditional economic analysis that argues that the greatest contribution to "wealth and welfare for all" is likely to be made by companies with a primary shareholder focus'.

[81] On 'path dependency' see generally RJ Gilson, 'Corporate Governance and Economic Efficiency: When Do Institutions Matters?' (1996) 74 Washington University Law Quarterly 327; MJ Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 Harv Law Rev 641; LA Bebchuk and MJ Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127.

[82] Cmnd, para 495.

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tion of receivership,[83] since receivership specifically served the purpose of the appointing charge-holder who could make an appointment out of court and without giving prior notice to the debtor. All that was needed was the occurrence of one of the events specified in the debenture, which entitled an appointment to be made.[84] Additionally, the receiver owed no general duties to the debtor in relation to the conduct of the debtor's business prior to the realization of assets. The committee, however, pointed out that a receivership appointment and the benefits attainable were only possible where a company had created a floating charge.[85] Where there was no security, there was a gap and a receiver-type person could not be appointed. Administration was brought into being to fill this gap. It was envisaged that administration would be used primarily in cases where the company had not granted a debenture secured by a floating charge but the committee did not wish that the procedure should be confined to such cases.

When statutorily created by Part II of the Insolvency Act 1986, the administration procedure was marred by a number of features which curtailed its effectiveness. First, the procedure was very heavily court-centred. Only the court could appoint an administrator on application to it by the company or creditors. Secondly, the holder of a general floating charge over company assets had an effective veto on the making of an appointment. Largely this was because administration was seen as an alternative to receivership. Thirdly, there were no overarching statutory objectives. Section 8(3) of the Insolvency Act 1986 set out various purposes for whose achievement an administration order might be made, namely:

(a) the survival of the company, and the whole or any part of its undertaking, as a going concern;
(b) the approval of a voluntary arrangement;
(c) the sanctioning of a compromise or arrangement between the company and its creditors; and

[83] For somewhat more critical voices see J Zeigel, 'The Privately Appointed Receiver and the Enforcement of Security Interests: Anomaly or Superior Solution' in J Zeigel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford, 1994) 451, 461; and D Milman, 'A new deal for companies and unsecured creditors' (2000) 21 Company Lawyer 59–60.

[84] Receivership was essentially a creditor-centred rather than a public-interest-centred remedy. The high-water mark of this analysis came with the Privy Council decision in *Downsview Nominees Ltd v First City Corp Ltd* [1993] AC 295; [1993] 3 All ER 626. In this case it was held that provided that a receiver and manager appointed under a debenture acted in good faith for the purpose of enabling the assets comprised in the debenture holder's security to be preserved and realised for the benefit of the debenture holder, his decisions could not be impeached even if they were disadvantageous to the company or other charge-holders, and he was subject to no further or greater liability.

[85] For a defence of receivership see J Armour and S Frisby 'Rethinking receivership' (2001) 21 OJLS 73.

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(d) a more advantageous realization of the company's assets than would be effected on a winding up.

An administration order could specify more than one purpose but the legislation did not specify whether one purpose could take priority over another.

The political and business dynamics had changed in the late 1990s with the receivership model now seen as too creditor-centred and being insufficiently responsive to the concerns of other stakeholders.[86] In the recession of the early 1990s the feeling was that banks had pushed companies unnecessarily into insolvency by being unduly precipitate in the appointment of receivers.[87] The Enterprise Act 2002 was designed to strengthen the foundations of the economy with even the title of the legislation suggesting a new social order. In the majority of cases, the legislation abolished the right on the part of a charge-holder to appoint an administrative receiver. The legislation also removed the charge-holder's veto on the appointment of an administrator but substituted for this a de facto veto on the identity of the proposed administrator. Under the new regime, one route into administration is through out-of-court appointment by a qualified floating charge, though the company itself can make its own out-of-court appointment on giving prior notice to a qualified floating charge-holder.[88] The prior notification requirement affords the floating charge-holder the opportunity to make its own appointment. There is still the option of going to court but given the facility for out-of-court appointments either by a floating charge-holder or by the company itself, this option is rarely exercised. A scenario where this route may be invoked is when a company has no substantial secured borrowings but unsecured creditors are dissatisfied with the existing management and wish to see corporate restructuring proceed under the helm of an outsider. There is provision in the legislation, however, that where an administration application is made by somebody other than the qualified floating charge-holder the latter may intervene in the proceedings and suggest the appointment of a specified person as administrator. The court is mandated to accede to this application unless it thinks it right to refuse the application 'because of the particular circumstances of the case'.[89]

While an administrator has a different set of functions to perform than the old-style administrative receiver, one of the main functions of administration is still making distributions to secured and preferential creditors. If this func-

[86] The White Paper *Productivity and Enterprise: Insolvency a Second Chance* (2001) para 2.5, talked about 'making changes which will tip the balance 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 company's assets'.

[87] See the statement by the government minister in *Hansard*, Standing Committee B, Enterprise Bill, 15th Sitting (9 May 2002) col 602.

[88] Schedule B1 Insolvency Act 1986, paras 22 and 26.

[89] ibid, para 36(2).

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tion is performed and the person appointing the administrator is the floating charge-holder, then the similarities between administration and old-style administrative receivership seem very strong. This has led some observers to suggest that administration is best understood as 'receivership-plus'; in other words, receivership with a few add-ons such as somewhat wider duties. Another analysis approaches administration with the concept of transmutation in mind. On this view, the new legislative dispensation is best described as a 'transmutation' or 'merger' of the administrative receivership and administration procedures rather than as being the end of administrative receivership.[90] Whatever analysis is adopted, the similarities between administration and administrative receivership can hardly be denied. The former was born out of the latter and still shows the marks of its parentage.

In the United States the antecedents of Chapter 11 of the 1978 Bankruptcy Code can be traced back to the railroad receiverships of the 19th century.[91] History shows that the idea of leaving the old management at the steering wheel and allowing it to navigate the corporate debtor through the reorganization process can be traced back to these 19th-century cases. In these authorities, the judiciary formulated principles entirely outside the framework of the federal bankruptcy laws. It was not until the 1930s that Congress added an effective manager-driven reorganization provision to the Bankruptcy Act. Perhaps the most celebrated of all the railroad receiverships is that of the Wabash railway in 1884. This case is notorious because the railroad's managers dispensed with the pretence of creditor action and simply requested the receivership themselves. The judge in the case, the aptly-named Judge Treat, said that in the absence of judicial intervention you would have nothing but a 'streak of iron-rust on the prairie'.[92] The Wabash railway receivership is widely regarded as a turning point in the development of corporate insolvency law by creating a new-fashioned procedure which enables debtors to initiate, and, to a great extent, control receiverships, as well as facilitating reorganizations of the insolvent firm at the expense of creditors' rights. One study of the history of railroad receiverships reveals, however, that for decades before 1884 judges allowed managers to initiate receiverships, appointed managers as receivers and forced creditors to accept changes in their contractual rights.[93] Judges nevertheless refused to extend reorganization procedures to companies outside the railroad industry and justified their special treatment of railroads on the grounds that the foremost obligation of railroads was to serve the public. Consequently, the Wabash receivership was consistent with the princi-

[90] See generally S Davies (ed), *Insolvency and the Enterprise Act 2002* (Jordans, Bristol, 2003) 40–1.

[91] See generally D Skeel Jr, 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51 Vand L Rev 1325; D Skeel Jr, *Debt's Dominion* (Princeton University Press, Princeton, 2001); Armour, Cheffins and Skeel Jr (n 4).

[92] *Central Trust Co v Wabash* (1886) 29 Fed 618, 626.

[93] B Hansen, 'The people's welfare and the origins of corporate reorganization: The Wabash receivership reconsidered' (2000) 74 Business History Review 377.

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ple that had governed railroad law since the 1840s; namely, that the primary obligation of a railroad was not to its creditors or shareholders but to the public.[94]

The railroads form part of the American frontier mentality and their continued operation was essential to 'taming the frontier' which forms a large part of American mythology. There was a wide and deep ideological consensus that railroads should not be permitted to fail.[95] Legislative and executive solutions to the problems of ailing railroad companies were largely foreclosed, however, for a number of reasons. In the federal jurisdiction that is the United States there were doubts about the legislative competence of Congress[96] and, clearly, individual states had no jurisdiction to pass laws governing the overall affairs of railways that passed through more than one state. Moreover, it is possible that some interest groups might prefer that a particular railroad should be allowed to fail and it is possible that these interest groups lobbied against specific legislative intervention. A solution whereby the railroads' lawyers and bankers used the judicial system to bring about a negotiated workout carried certain tangible benefits. Not least, because in the courtroom setting only the parties directly interested in the fate of a particular railroad would have standing to support or oppose the receivership process. The choice of institutions significantly affects the interest group dynamic and, for this reason, railroad managers through their lawyers and investment bankers, turned to the judicial system. Judicially appointed receivers, who generally included members of the railroad's management, worked out the terms of a reorganization.[97] For non-railroad companies, however, conditions were different, interest group dynamics were different and creditors often controlled the receivership process. The perception that railroads were public in nature and could not be allowed to fail simply did not apply. Moreover, railroads were vastly more valuable as going concerns than in liquidation but this was not so self-evidently true with other corporations. Consequently, there was much less of an obvious consensus in favour of manager-driven reorganization.

[94] See ibid, text accompanying footnote 63: 'Later decisions, including those by the Supreme Court, continued to emphasize that creditors did not have the same rights in quasi-public corporations that they did in other enterprises. These judges also made clear that the remedies available to railroads were not available to corporations in general but were restricted to enterprises that were regarded as quasi-public, such as railroads or drawbridges. It would be left to Congress to make reorganization available to all corporations' and see generally *Canada Southern v Gebhard* (1883) 109 US 527.

[95] See generally for a discussion of these issues Skeel Jr, 1998 (n 91) 1353–8; Skeel Jr, 2001, (n 91) ch 2.

[96] See generally B Hansen, 'Commercial Associations and the Creation of a National Economy: The Demand for Federal Bankruptcy Law' (1998) 72 Business History Review 86.

[97] One contemporary study of 150 receiverships between 1870 and 1898 found that in over 90 per cent of these cases insiders were appointed as receivers—see H Swaine (1898) 3 Economic Studies of the American Economic Association 71, 77, where he refers to Bradley Hansen (n 93) text accompanying footnotes 48–51.

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In general, investment bankers exerted particular influence in the receivership process arising from their role as underwriters of securities that had previously been issued by the ailing company.[98] JP Morgan & Co played an important role in several reorganizations and while there were various efforts to neutralize the role of large financial intermediaries in corporate governance generally, Morgan and other banks continued to retain enormous influence until the sweeping reforms of the New Deal under President Roosevelt in the 1930s. The New Deal led to a sea change for New Deal reformers like William O Douglas (later President of the Securities and Exchange Commission (SEC) and Supreme Court Justice), characterizing underwriters and the reorganization bar as being more concerned with fees and keeping managers happy than with the investors they ostensibly represented.[99] The Chandler Act 1938 was part of a SEC campaign to reform bankruptcy law and to introduce to such cases outside trustees and governmental outsight in the form of the SEC. The Act in Chapter X ended the perceived hegemony of a company's managers and underwriters over corporate reorganization. These insiders were excluded from the process altogether for, in every substantial case, Chapter X required that the current managers should be displaced in favour of a bankruptcy trustee. Underwriters of securities issued by the company and lawyers formerly engaged by the company were prohibited from becoming the trustee. In consequence, their ability to manage the reorganization process and to shape its outcome was also eliminated. Under Chapter X only a trustee was permitted to propose a reorganization plan. In many respects, the Chandler Act changed the face of US corporate bankruptcy law since, by effectively cutting Wall St bankers out of corporate reorganization, the Chandler Act also eliminated Wall St lawyers whose position and status was closely linked to that of their clients. Removing the investment banks from the reorganization process opened up and eventually transformed bankruptcy practice.[100]

In time, however, the position of the SEC in reorganization cases was weakened and the mandatory trustee requirement bypassed. As well as Chapter X, the Chandler Act included a second reorganization chapter in Chapter XI. By way of contrast to Chapter X's trustee requirement and pervasive government oversight, Chapter XI left a company's managers in control and did not provide for SEC intervention. It seemed clear from the framework of the legislation that Chapter X was designed for publicly held corporations and Chapter XI for smaller companies, yet nothing in the statute precluded the managers of a large firm from steering the firm towards the more hospitable waters of Chapter XI. This defect in the eyes of the SEC was noticed immedi-

[98] See generally Skeel Jr, 1998 (n 91) 1368–70.

[99] See generally *Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel and functions of Protective and Reorganization Committees volumes 1–8* (1937–40) and see generally the discussion in Skeel Jr, 1998 (n 91) 1369–70.

[100] See generally Skeel Jr, 2001 (n 91) ch 4, 'William Douglas and the Rise of the Securities and Exchange Commission'.

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ately but left unrepaired.[101] In *General Stores Corp v Shlensky*[102] the Supreme Court ruled that the choice of chapter depended on the 'needs to be served' and that even a publicly held corporation could invoke Chapter 11 in an appropriate case. The SEC won on the facts of *Shlensky*, but the decision helped to ensure that it would become marginalized in large-scale corporate reorganizations. Bankruptcy practice circumvented the effective operation of Chapter X in that companies increasingly filed for reorganizations under Chapter X. Middle-sized companies with publicly held securities, rather than large companies, first opened the doors to Chapter XI, which became increasingly ajar.[103] In 1973 the National Bankruptcy Commission Report concluded that 'it is readily apparent that Chapter XI has evolved into the dominant reorganization vehicle and very substantial debtors are able to reorganize in Chapter XI.'[104] Chapter XI became the popular choice On the other hand, the SEC still retained a role when companies reorganized in Chapter XI for it could negotiate benefits for public investors in return for an agreement not to challenge the company's use of Chapter XI.

Professor Skeel has pointed out that two, sometimes clashing, ideological threads tend to come together in bankruptcy. First, there is a general antipathy towards large businesses and secondly, the desire to give failed businesses a second chance.[105] By the 1970s, however, investment banks and Wall St firms were but a distant memory in bankruptcy practice. The US Congress was less troubled by the elimination of SEC oversight than it might otherwise have been and the general background sentiment of favouring corporate reorganizations prevailed. Chapter X of the Chandler Act was laid to rest and the new Chapter 11 took over where the old Chapter XI left off, minus any role for the SEC. Under Section 1107 of the Bankruptcy Code the debtor in possession has all the powers of a bankruptcy trustee. Outside trustees can only be appointed for cause—1104(a)(1), and their appointment in Chapter 11 is exceptional.[106]

The trajectory of corporate insolvency law is clearly different in the US than it is in England. The interest group dynamics are different and have played out differently. There are important issues in the American context which do not merit a mention on this side of the Atlantic, such as the whole issue of federalism versus localism and the competence of Congress under the

[101] In *SEC v United States Realty & Improvement Co* (1940) 310 US 434 the Supreme Court, however, leaned against publicly held companies using Chapter X1.

[102] (1940) 350 US 462, 466.

[103] See B Weintraub and H Levin, 'A Sequel to Chapter X or Chapter X1: Coexistence for the Middle-Sized Corporation' (1957) 26 Fordham Law Review 292.

[104] *Report of the Commission on the Bankruptcy Laws of the United States*, HR Doc No 93, p 137.

[105] See generally Skeel Jr, 1998 (n 91) 1375.

[106] There is a legislative statement that a trustee can be appointed only for cause such as fraud, dishonesty or gross mismanagement and that sheer size or large numbers of bondholders or shareholders are not enough—s 1104. This provision has cautioned the courts against appointing trustees. It has been held that simple mismanagement is not a sufficient reason for an appointment—*Re Anchorage Boat Sales* (1980) 4 Bankr 635.

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Bankruptcy Clause of the US Constitution. These factors explain some of the legislative choices in the US. General hostility towards Wall St, ie big banks, has also played a role in the United States. The banking and lending markets are much more concentrated in England and this fact alone has been used to develop an explanation as to why US law is based on debtor in possession whereas English law is manager-displacing.

VII. NATURE OF THE LENDING MARKETS

The UK is seen as a bit of a problem child as far as certain US-oriented corporate governance theorists are concerned.[107] Patterns of share ownership are widely dispersed and broadly similar in Britain and the US. Moreover, there is an active market for corporate control in both countries via the stock exchanges and takeover bids, contested or otherwise. In the strong version of the theory, dispersed ownership is compatible with, and compatible only with, a debtor-in-possession corporate reorganization regime.[108] By way of contrast, concentrated-ownership corporate structures are compatible only with a manager-displacing regime. The US conforms to this theory—a dispersed pattern of share ownership coupled with debtor-in-possession reorganization law whereas, broadly speaking, the UK does not. Dispersed share ownership sits alongside manager-displacing bankruptcy. The evolutionary theory favoured by American commentators suggests that such a regime, mixing 'ex post' corporate governance[109] with 'ex ante' bankruptcy, is unstable over time. Subsequent developments would either push corporate governance in an ex ante direction through concentrated shareholdings or managers would somehow re-establish a manager-driven bankruptcy process. It is suggested that this is just what happened in the United States, whereby by the early 1960s market-driven governance through the takeover mechanism rather than concentrated shareholding had become the norm. The upsurge in market-driven corporate governance was accompanied by a shift in the insolvency law component towards a more flexible, manager-driven regime with Chapter X of the Chandler Act sidelined in favour of Chapter XI, and its ultimate replacement in 1978.

Of course one could look at the matter through different ends of the telescope. One might emphasize the effect of a particular corporate insolvency regime on the shaping of a country's corporate governance structure, more or less a 'law first' analysis.[110] In other words, the prospect of being supplanted

[107] See MJ Roe, 'Political Foundations for Separating Ownership from Control' in JA McCahery (ed), *Corporate Governance Regimes: Convergence and Diversity* (OUP, New York, 2002) 113, 129.

[108] See generally Armour, Cheffins and Skeel Jr (n 4); and see also Hahn (n 3).

[109] This is referred to as 'ex post' because of the after-the-fact nature of the correctives—see Skeel Jr, 1998 (n 91) 1328.

[110] See Hahn (n 3) 128–30.

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in a reorganization context would cause management to avoid saddling a company with large debts. Moreover, management would likely seek out large, stable shareholders who would implicitly promise not to sell their shares to outside bidders and therefore the corporate governance of a country would gravitate towards concentrated shareholdings. Alternatively, one could look at matters the other way around and explain, for example, the concept of debtor in possession in the US as deriving from the principal characteristic of US publicly traded corporations; namely, the separation of ownership and control.

Normatively, it has been argued that in jurisdictions where there is a separation of ownership and control, management can be relied upon to continue controlling the company though the restructuring process and to cooperate with the creditors. On the other hand, where there are concentrated shareholdings, allowing management to keep control of the company jeopardizes the creditors and leaves then vulnerable to manipulation by shareholders. In concentrated ownership systems the management of a company is closely associated with the dominant shareholders and leaving the incumbent management in control plays into the hands of the dominant shareholders and exacerbates the risk of loss to the creditors. To neutralize this risk and better represent the creditors' interest during the reorganization process, management should be removed from control of the company.[111]

In the so-called Berle-Means company, typified by a separation of ownership and control, the relative independence of management vis-à-vis shareholders may serve the interests of creditors. Management is not so clearly and generally identified with shareholders' interests and the normative shift of management's fiduciary duties from shareholders to creditors in insolvency can comport easily with the factual realities. To put the matter another way, because management aligns itself with shareholders by virtue of legal norms, any change in the nature of these norms can reasonably be implemented by management. Management is likely to abandon the focus on shareholders' interests in a reorganization situation and cooperate with creditors in devising a reasonable restructuring plan.

The United States fits neatly into the state of affairs postulated by this analysis—not surprisingly since the theory was framed with reference to US conditions. The position of the UK with regard to the model is, however, somewhat awkward.[112] The UK possesses a corporate governance system which is close to that of the US,[113] yet a manager-displacing insolvency regime. One explanation for the divergence is that aggregate holding of shares by UK institutional investors is considerably higher than that of their US counterparts and UK institutions are closely knit with the result that collective

[111] ibid 120.
[112] ibid 134.
[113] See BR Cheffins, 'Law, Economics and the UK's system of Corporate Governance: Lessons from History' (2001) 1 Journal of Corporate Law Studies 71.

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action costs are significantly reduced. This would suggest that share ownership in the UK is de facto concentrated but most commentators are of the view that the explanation is far from convincing given the generally wide dispersion of shares in the UK market and the relative passivity of investors.[114] Despite the potential for exercising control by institutional shareholders, the UK is generally characterized as having an outsider or arm's length system of corporate governance.

An alternative explanation is a lack of synchronization between legislation and conditions in the marketplace with legislation always being one or more cycles behind economic developments. When the Cork Committee drafted its report, which led to the creation of the administration procedure, the UK capital markets were in the final stages of transition from concentrated to dispersed ownership. Given the present configuration of the UK corporate ownership landscape, the evolutionary theory of insolvency law would predict that the corporate reorganization regime is likely to exhibit manager-driven characteristics. The legislative cycle, however, may work at a slower pace than the economic cycle and, currently, the UK is less manager-friendly than evolutionary theory would predict for a country with dispersed share ownership.

One explanation that has been proffered stems from the concentrated nature of corporate debt in the UK compared with the US where corporate debt is widely diffused through the bond markets.[115] In the UK the norm for public companies is to have dispersed equity and concentrated debt. A manager-displacing insolvency law is a valuable governance lever as far as concentrated creditors are concerned but much less so in a situation of dispersed debt. Dispersed creditors face considerable coordination difficulties in deciding whether to pull the lever and displace the directors by initiating insolvency proceedings. Certain commentators have suggested that the UK is in a state of transition. The UK debt markets will become more diffuse over time and will ultimately fall into line with the dispersed pattern of share ownership. Consequently, pressure will build for establishment of an increasingly manager-driven process and the predicted alignment between an outsider or arm's length system of ownership and control, and manager-friendly insolvency laws will occur.[116]

It is submitted that a single theory like this justifying differences in US and

[114] See generally Armour, Cheffins and Skeel Jr (n 4) 1754.

[115] ibid 1766–72.

[116] ibid 1775–6: 'If such pressure develops and ultimately yields the creation of a Chapter 11 option for larger firms, the end result would be what our refined evolutionary theory of corporate bankruptcy and corporate governance would suggest: diffuse share ownership, dispersed debt, and manager-driven bankruptcy law. The available evidence suggests that these various predictions are turning out to be true. To start, there is evidence that banks already are losing their near hegemony over debt finance for widely held UK firms. In recent years, British firms have increasingly turned to other institutional lenders, such as insurers and pension funds for debt financing. Although the market for public debt remains much smaller than in the US, it has significantly increased in recent years. . . With respect to law reform, there has been lobbying of the type the reconfigured evolutionary theory would predict.'

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UK insolvency law is much too pat. Single, unifying theories hold considerable intellectual appeal. The also have the ineluctable advantage of simplicity. Grand imperialistic visions of this nature should, however, be resisted. Complex realities almost never can be reduced to a simple proposition. The explanation that 'it's all to do with the bond markets' may be part of a comprehensive justificatory web but, standing alone, it seems much too thin an explanation. For a start, it hardly fits the facts. Yes, debt and bond markets are much more concentrated than in the UK than in the US but the UK is not alone among Anglo-Saxon economies in having a manager-displacing insolvency regime. In fact, the US is more of an outlier than the UK. For instance, analyses of the equivalent Australian legislation conclude that it manifests much harsher manager-displacing features than the UK, yet Australia has basically an outsider or arm's length system of corporate governance.[117] Canada is somewhere in between.[118]

A second reason for failing to embrace 'silly, it is the bond markets' theory in its entirety lies in the fact that UK legislation may be moving in the opposite direction than these evolutionary theorists suppose should happen. It is suggested that a manager-displacing insolvency framework aligns well with concentrated ownership companies since in these companies management is subject to manipulation by shareholders and more likely to respect shareholders interests to the detriment of creditors.[119] The Insolvency Act 2000, however, introduced in effect a stand-alone debtor-in-possession procedure for smaller companies proposing a restructuring plan; namely the Company Voluntary Arrangement (CVA) with a moratorium. The moratorium lasts for 28 days, bars creditor recovery actions during this period and is designed to facilitate shareholder and creditor approval of the plan.[120] The existing management remains in control but to obtain the moratorium they must persuade an insolvency supervisor who is going to act as supervisor of the CVA that the proposal is likely to be approved and that the company will have sufficient funds to carry on business during the period. Only smaller companies as defined in section 247 of the Companies Act 1985 may avail of the

[117] See Martin (n 33) 397: 'Aussies share the English distrust of the American debtor in possession system, finding it mired by the potential misdeeds of existing management'; and her comment at p 404: 'The attitude down under seems to be if a business fails, it should be pushed aside so others can fill the gap'. For a somewhat different perspective see BR Cheffins, 'Corporate Governance Convergence: Lessons from Australia' (2002) 16 Transnational Lawyer 13, who makes the point, inter alia, that Australia's listed companies exhibit a far higher degree of ownership concentration than do those of UK listed companies. Cheffins also discusses the implications of the Australian example for theories of Anglo-American insolvency law at pp 37–8.

[118] See generally L LoPucki and G Triantis, 'A Systems Approach to Comparing US and Canadian Reorganization of Financially Distressed Companies' in JS Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford, 1994) 109.

[119] See Armour, Cheffins and Skeel Jr (n 4) 1733.

[120] See Insolvency Act 1986, section 1A and Schedule A1 as amended by section 1 and Schedule 1 Insolvency Act 2000.

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procedure and the section uses turnover, balance sheet totals and number of employees as the qualifying conditions.[121] Of course, these smaller companies are the very ones where there is more likely to be a convergence, rather than a divergence, of ownership and control.

VIII. CONVERGENCE IN PRACTICE

There are undoubtedly significant differences between US and UK corporate bankruptcy law, not least with respect to the issue of who runs the company during the reorganization period. In the US it is the existing management in the new guise of debtor in possession whereas in the UK it is an outside administrator acceptable to, if not appointed by, a dominant creditor. Various reasons have been put forward to explain this divergence between the two systems. It is submitted that no one reason has sufficient independent explanatory power. The various factors are best looked at in conjunction and collectively they may tell the story of why there is this difference.

But the story would not be complete without a bit of blurring between the two systems and not just at the edges. The debtor-in-possession procedure for smaller companies in the UK through CVAs with a moratorium has already been highlighted. One might also mention the so-called 'London Approach' or private consensual workout procedure for larger companies in the UK; replacement of existing management during Chapter 11 in the US; and, in addition, creditor control over the US Chapter 11 process through onerous provisions in debtor in possession financing agreements.

IX. THE LONDON APPROACH

In the 1980s, the Bank of England developed a set of principles for multi-lender corporate workouts. The Bank of England's interest in corporate workouts is linked directly to its core responsibilities relating to the maintenance of financial stability and the promotion of an effective and efficient financial system. These principles came to be known as the London approach.[122] The key features of the London approach are a willingness by the main creditors to consider a non-statutory resolution of a company's financial difficulties, the

[121] Basically a company is a small company if it meets two of the following three criteria: (1) annual turnover not greater than £5.6m, (2) balance sheet total not more than £2.8m and (3) not more than 50 employees.

[122] On the 'London Approach' see generally P Brierley and G Vlieghe, 'Corporate workouts, the London Approach and financial stability' [1999] Financial Stability Review 168; P Kent, 'Corporate Workouts—A UK Perspective' (1997) 6 International Insolvency Review 165; J Armour and S Deakin, 'Norms in Private Bankruptcy: the "London Approach" to the Resolution of Financial Distress' [2001] Journal of Corporate Law Studies 21.

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commissioning of an independent review of the company's long-term viability and the operation of an informal moratorium on creditor enforcement procedures during the review period.

The main creditors work together to reach a joint view as to whether, and on what terms, a company is worth supporting in the longer term; and to facilitate these discussions, a coordinating or lead bank may be designated. Generally, this is the bank with the largest exposure to the company and it is usually also the bank with which the company has its main banking relationship. A steering committee of creditors is formed and this provides a forum to which some decisions by lenders can be delegated. Lenders will agree to maintain the existing credit facilities in place and may agree to supplement this with additional lending if there is a need for liquidity support. The new finance may come from one or more existing lenders and usually takes priority over existing exposures. If the financial review concludes that the company is viable on a long-term basis and there is support for this among creditors, then the creditors will move on to consider longer-term arrangements such as stretching out loan repayment periods, providing additional financial support, or converting debt into equity. Continued creditor support for the operations of the company is normally conditional on the implementation of an agreed business plan, which may involve management changes, sales of assets or divisions, or even the take-over of the company.

The London Approach is an example of a debtor-in-possession restructuring process but it would be unwise to exaggerate the similarities between it and Chapter 11. A company in Chapter 11 enjoys a great deal of autonomy whereas a company undergoing a London Approach restructuring is subject to the dictates and actions of its lender banks. The lenders determine whether the company shall enter the restructuring and at any stage during the course of the workout negotiations they may decide to withdraw from them and initiate formal manager-displacing administration or liquidation proceedings. The existence of the London Approach, however, may have acted as something of a safety valve and muted to some degree any momentum in favour of the introduction of formal Chapter 11-type procedures in the UK.[123] The concentrated nature of UK corporate debt has also helped to create the right conditions for London Approach rescues to flourish.[124]

[123] See Armour, Cheffins and Skeel Jr (n 4) 1774.

[124] An important empirical study suggests the existence, even in the case of small and medium-sized companies, of an elaborate rescue process outside formal procedures. Banks, it appears, use their position as secured creditors to encourage or force financially distressed firms to undergo restructuring that would include downsizing and management replacement—see J Franks and O Sussman, 'The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies' (2000). This study was sponsored by the DTI/Treasury Working Group on Company Rescue and Business Reconstruction Mechanisms. See also G Cook, N Pandit, and D Milman, 'Formal Rehabilitation Procedures and Insolvent Firms: Empirical Evidence on the British Company Voluntary Arrangement Procedure' (2001) 17 Small Business Economics.

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X. REPLACEMENT OF EXISTING MANAGEMENT DURING CHAPTER 11

While Chapter 11 is based on debtor in possession, that does not mean that the same individuals will be in control of the company before, during and after the restructuring. In fact, key management personnel are often replaced during the Chapter 11 process in cases involving large, publicly traded companies. These changes are often instigated by the creditors who along with the shareholders form the managers' constituents in an insolvency context. One empirical study has found that over half of Chief Executive Officers (CEOs) and directors of companies lost their jobs during the restructuring period.[125] Another examination revealed that in over 90 per cent of the sample cases the CEO was replaced at least once in the period dating from 18 months before filing to six months after confirmation.[126] Where the financial distress of a company was due to endogenous events, management replacement was even more of a probability as creditors were likely to condition their continued cooperation on these changes taking place.[127]

XI. THE INFLUENCE OF CREDITORS AND THE NEW CHAPTER 11 GOVERNANCE

Changes in personnel were always a de facto part of Chapter 11 but what appears to have accelerated in recent years is creditor influence over, or control of, the Chapter 11 process by way of onerous clauses in debtor-in-possession financing agreements. This has been accompanied by an apparent change in the nature of corporate reorganization as traditionally understood in the United States going hand-in-hand with the rise of the New Economy. For example, Professors Baird and Rasmussen[128] have argued that to the extent that corporate reorganization law is conceived of as creating a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, that era has come to

[125] S Gilson, 'Management Turnover and Financial Distress' (1989) 25 Journal of Financial Economics 241, 261, finding that 'in any given year, 52% of sampled firms experience a senior management change if they are either in default on their debt, bankrupt, or privately restructuring their debt to avoid bankruptcy'; and see also S Gilson, 'Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default' (1990) 27 Journal of Financial Economics 355, 386, stating that 'on average, only 46% of incumbent directors and 43% of CEO's remain with their firms at the conclusion of the bankruptcy or debt restructuring'.

[126] LoPucki and Whitford, (n 7).

[127] According to B Carruthers and T Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998) 265, the Chapter 11 process 'is not a safe haven for management'. See generally R Broude, 'How the Rescue Culture Came to the United States and the Myths that Surround Chapter 11' (2001) 16 Insolvency Law and Practice 194.

[128] 'The End of Bankruptcy' (2002) 55 Stan L Rev 751.

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an end. In *US v Whiting Pools Inc*,[129] the US Supreme Court said that a troubled enterprise may be restructured in Chapter 11 so as to enable it to operate successfully in the future. Chapter 11 is premised on the assumption that the assets of a debtor company are more valuable when used in a rehabilitated business than if sold for scrap. Maintaining a business in operation and restructuring it is seen as more desirable than liquidating it since liquidation of a business's assets can be very costly to the persons directly involved in the business and also to society as a whole.

Baird and Rasmussen, however, suggest that firms today that cannot meet their obligations are not like the 19th-century railroads. Nowadays, firms in financial distress are unlikely to have a substantial going concern surplus and even when an economic enterprise depends on dedicated assets, rarely do the assets themselves need to remain in a particular firm. Many assets work equally well in one firm as in another and other assets that are tailored to a specific firm may not represent a source of value but rather the source of failure.[130] Moreover, human capital today is increasingly industry-specific, rather than firm-specific. Chapter 11 is capable of playing its traditional role only in environments where specialized assets exist; where those assets must remain in a particular firm; where control rights are badly allocated and where going-concern sales are not possible. Generally speaking, large companies no longer fit this paradigm although the necessary ingredients may be present in small enterprises where firm-specific assets can exist often in the form of the human capital of the owner-manager:[131]

> Small firms are more likely to have haphazard capital structures. Their size makes them more vulnerable to exogenous shocks. . . The principal value of preserving such small firms is that it allows their owners to continue to enjoy the psychic benefit of running their own business. The costs fall disproportionately on non-adjusting creditors. One can make the case for a law that facilitates the survival of such firms, but the case is not an easy or compelling one. The days when reorganization law promised substantial benefits are gone.

Baird and Rasmussen also make the point that by virtue of revolving credit facilities and DIP financing mechanisms, lenders have gained greater practical control over the Chapter 11 process and the control that managers of the debtor company once enjoyed has been greatly reduced. As far as companies likely to survive as going concerns are concerned, bank lenders and other professional investors ensure that they are in the driving seat.

In the new Chapter 11 dynamic there is much more stress on asset sales and

[129] *US v Whiting Pools Inc* (1983) 462 US 198, 203.

[130] See also Charles W Adams, 'An Economic Justification for Corporate Reorganizations' (1991) 20 Hofstra L Rev 117, 133: '[M]ost assets are probably not firm-specific, and so, most insolvent corporations will not have substantially greater going concern than liquidation values and, consequently, will not be good candidates for an effective reorganization.'

[131] 'The End of Bankruptcy' (2002) 55 Stan L Rev 751, 788.

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faster procedures rather than propping up troubled businesses.[132] The instrument of this change and of creditor influence more generally has been DIP financing agreements.[133] Through DIP financing, new lenders may emerge. Indeed old lenders may make fresh loans that will take priority over existing debt. These financing agreements inevitably have features that facilitate the lender in exercising control over the company during the restructuring operations. The credit facility is invariably set up before the company files for Chapter 11 protection, and the prospective lender may require a chief restructuring officer be brought in to explore ways of restructuring the company.[134] By way of loan covenants, DIP lenders can force changes in the management structure with further finance being conditional on management turnaround. The control by lenders over the cash lifeline can force the company to bow to the lenders' wishes.[135] The covenants in the loan agreement may include a time schedule, setting out a date by which the company must confirm a reorganization plan or else corporate assets will be auctioned off to the highest bidder.[136] An alternative approach is to keep the company on a tight leash

[132] In *United Timbers Association of Texas v Timbers of Inwood Forest Associates Ltd* (1988) 484 US 365, the US Supreme Court gave a very firm push in the direction of speedier reorganizations. It said that once the creditor establishes that the debtor has no equity in the collateral, the debtor has the burden of establishing that the collateral is necessary to an effective reorganization. What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it, but that the property is essential for an effective reorganization that is in prospect. This means that there must be a reasonable possibility of a successful reorganization within a reasonable time. For criticism of the pre-*Inwoods* state of affairs see DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi L Rev 97, 126–7: 'A Chapter 11 proceeding typically buys time for the managers, the shareholders, and other junior owners at the expense of the more senior ones. . . . Bankruptcy judges sometimes seem inclined to do little to remedy this state of affairs. A few seem to show either an inability or unwillingness to comprehend the possibility that secured credit may be something more than a perverse and unfair creature of state law that should be thwarted at every possible turn. Even more remarkable is their wonderful capacity for hope, their unshakeable faith that given time, the firm's ship will come in. Often, bankruptcy judges seem to think that markets systematically undervalue firms that have filed petitions in bankruptcy. A bankruptcy judge may insist that he, not the market, is the best one positioned to set a value on a firm in distress, even though year after year in case after case his valuations prove wildly inflated.'

[133] See E Warren and JL Westbrook, 'Secured Party in Possession' (2003) 22 American Bankruptcy Institute Journal 12: 'We have a new form of chapter 11 emerging in the courts. Having invented the DIP (debtor-in-possession), American lawyers are now creating the SPIP (secured-party-in-possession). More and more chapter 11 chases seem to be no more than vehicles through which secured parties may enjoy their Article 9 rights under the umbrella, and the protective shield, of the bankruptcy laws.'

[134] See DG Baird and RK Rasmussen, 'Four (or Five) Easy Lessons From Enron' (2002) 55 Vand L Rev 1787, 1807: 'In the case of a large firm in bankruptcy, we find that, at the moment Chapter 11 is filed, a revolving credit facility is already in place that entrusts decision making authority to a single entity. This entity will often step in and replace management. It will make the necessary operational decisions before Chapter 11 begins.'

[135] See generally D Skeel Jr (n 78); D Skeel Jr, 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) Cardozo Law Review 101; DG Baird, 'The New Face of Chapter 11' (2004) 12 American Bankruptcy Institute Law Review 69.

[136] For an argument that market failure could induce too much liquidation in the new world of

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rather than setting out a specific date for the company's emergence from Chapter 11. DIP financing arrangements act both as a governance mechanism as well as a mechanism for providing continuing finance:

> Unlike the 'new' bankruptcy governance ushered in by Congress in 1978, the 'new' new Chapter 11 governance is contractual in nature. Creditors have converted two existing contractual tools into important governance levers. The first is debtor-in-possession (DIP) financing. Before they even file for bankruptcy, corporate debtors must arrange an infusion of cash to finance their operations in Chapter 11. To an increasing extent, lenders are using these loan contracts to influence corporate governance in bankruptcy. . . The second is that key executives are increasingly given performance-based compensation packages in Chapter 11. The most common strategy is to promise the executives a large bonus if they complete the reorganization quickly; likewise, executives face ever-smaller bonuses if the case takes longer.[137]

The increased and varied role of DIP financing has provoked mixed views. On one analysis, a company is able to obtain new financing despite substantial debt overhang and the control exercised by the DIP lender may help to resolve the company's financial difficulties.[138] A different viewpoint sees the new developments turning Chapter 11 into a quasi-liquidation process[139] and even enthusiasts for the Chapter 11 metamorphosis have warned of several possible downsides.[140]As a result of the new Chapter 11 governance there may be a greater externalization of risk and costs leading to the extraction of value from the company and the enrichment of lenders and corporate insiders at the expense of vulnerable employees.[141] An example is where corporate

Chapter 11 see BE Adler, 'Bankruptcy Primitives' (2004) 12 American Bankruptcy Institute Law Review 219, 222.

[137] See DA Skeel Jr (n 78) 918–19.

[138] See Douglas G Baird and Robert K Rasmussen (n 22) 751–2: 'Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds . . . Even when a large firm uses Chapter 11 as something other than a convenient auction block its principal lenders are usually already in control and Chapter 11 merely puts in place a preexisting deal. Rarely is Chapter 11 a forum where the various stakeholders in a publicly held firm negotiate among each other over the firm's destiny.'

[139] But for a different perspective see LM LoPucki 'The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy' (2003) 56 Stanford Law Review, who concludes by saying 'Big-case bankruptcy reorganizations have not ended. They are booming . . . Baird and Rasmussen's view of the bankrupt firm as merely an asset-owning entity misses the firm's essence. Coase's view of the bankrupt firm as a relationship among people captures it. Baird and Rasmussen's firm has no going concern value and so it makes no sense to reorganise it. Coase's firm may have going concern value, and so it makes sense to reorganize it if the relationships are working or can easily be fixed. Baird and Rasmussen's firm does not fit the data; Coase's firm does.'

[140] See, eg, D Skeel Jr (n 135) 117–25 who refers to DIP lenders bootstrapping earlier unsecured debt through cross-collateralization provisions in new financing agreements.

[141] For an early perspective see TH Jackson and RE Scott, 'An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 Va L Rev 155, 159: 'The problem of transferring decision-making power from the equity owners . . . is compounded by the associated problem that no other

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executives negotiate a 'sweetheart' deal with a DIP lender under which the executives receive substantial financial inducements if the company cuts its costs, perhaps by shedding much of its workforce or forcing wage levels downwards. [142] There is the additional fear that as a result of DIP lending agreements, the screws on hard-pressed companies will be tightened too much. This would have the effect of discouraging even appropriate risk-taking and pressurising companies to liquidate assets rather than to reorganize.[143]

However one views the phenomenon and the possible downsides, the control exercised by lenders over the Chapter 11 reorganization process demonstrates an increasing functional convergence in practice between it and the administration process in the UK.[144] The DIP lending lever may be trying to achieve through the backdoor an element of 'creditor-in-possession' though without the checks and balances that are a feature of the UK regime.[145]

XII. CONCLUSION

Substantial differences do undoubtedly exist between corporate reorganizations under Chapter 11 of the US Bankruptcy Code and the UK administration procedure for ailing companies. Chapter 11 is based on debtor in possession while in administration the board of directors loses its management powers and functions to an administrator—an insolvency practitioner normally appointed by the principal creditor. This paper explores some of the reasons given to explain this variation in insolvency legislation between Britain and the US. These reasons relate to different attitudes towards entrepreneurship and risk-taking in the two countries; a different jurisdictional mix of carrots and sticks in encouraging early invocation of corporate rescue procedures; different conceptions of the nature of the two processes as well as their aims and objectives; path dependency and the continued gravitational pull of historical circumstances and, finally, differences in the nature of the lending markets, and in particular the bond markets in the two countries.

class may sufficiently reflect the interests of the claimants taken as a whole. Thus, the objective of the collective is never entirely congruent with the objective of any of the constituent parts.'

[142] See Skeel Jr (n 135) 118.

[143] If too many firms liquidate rather than reorganize, industry may become concentrated in the hands of a few major players.

[144] See, however, the comment by K Gross (n 7) 217–18: 'Yes, secured creditors did make some gains, some of which were not originally contemplated. Yes, they may control some cases through DIP financing packages. But, there are a host of other things that have been operating since 1978 that explain how large Chapter 11 cases are working and why secured creditors have done that which they have done and why, in some instances, they are not the star of the show . . . At the end of the day, the world got more complex, more markets opened, new uses of Chapter 11 were invented, new parties came to the table, lawyers and other professionals developed new strategies, and financial sophistication increased.'

[145] See Warren and Westbrook (n 133).

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All of these factors have been examined and it is submitted that no one factor adequately explains the divergence. There is no single knockout or standout reason that adequately captures the phenomenon of transatlantic dissonance. The reasons given in combination, however, may contain the explanatory force that when viewed individually they lack. To American observers, the UK compared with the United States is often seen as unforgiving in its treatment of companies in financial distress and indeed a bankers' Valhalla where creditors exercise control over the corporate restructuring process.[146] It has been submitted that this characterization is more a caricature and that the UK, far from being an outlier in terms of corporate governance/corporate insolvency structures among Anglo-Saxon economies, is more in the mainstream than the US. Nor are creditors bereft of influence in US corporate restructurings. Creditors in the US have acquired increased control through the terms of debtor in possession financing agreements.

[146] See the comment in Westbrook (n 32) 87: 'if an American banker is very, very good, when he dies he will go to the United Kingdom. British banks have far more control than an American secured lender could ever hope to have. Receiverships on the British model are unknown and almost unthinkable in the US. A US banker could barely imagine a banker's Valhalla in which a bank could veto a reorganization as a UK bank may effectively veto an administration by appointing an administrative receiver'. This comment must now, of course, be seen in the light of the changes to the administration procedure introduced by the Enterprise Act 2002.

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