RETHINKING CORPORATE RESCUE IN THE UK IN LIGHT OF THE GROWING DISTRESSED DEBT MARKET

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DECLARATION

I, Abderahim Mokhtar Alwallani, confirm that the work presented in this thesis is my own. Where information has been derived from other sources, I confirm that this has been indicated in the thesis.

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Thesis Abstract

Over the past several years, the structure of the finance industry has experienced significant changes. There has been a noticeable shift from hold-to-maturity debt investment strategies toward more active trading strategies. A new and diverse range of private investment funds have emerged, driven by the opportunities to generate returns through these trading strategies. Their presence is becoming increasingly visible in insolvency situations. In fact, it is argued that these investors are gradually displacing traditional lenders as the primary source of financing for distressed companies. This rise in involvement has coincided with a growing focus on the control and administration of the insolvency process, as well as the efficiency and adequacy of the insolvency system in achieving its intended objectives.

This thesis begins by examining the concerns that the UK's corporate insolvency system was originally designed to address. It then proceeds to trace the development of the system to address the issues prevailed in a finance market dominated by a small group of homogeneous banks.

The thesis examines originally collected quantitative and qualitative data to provide evidence for the emergence of concerns related to the role of distressed debt investors in situations of distress. This thesis argues that the existing insolvency framework lags behind current trends evident within corporate finance and insolvency practice. In response, the thesis concludes by recommending reforms to improve the functioning of the system.

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Chapter One: Framework of the Study

1.Introduction

In the UK, the resolution of insolvency depends primarily on dominant security interests.[1] The lending market in UK was dominated by a few large banks.[2] By virtue of their security interests[3], these banks have been placed with the responsibility to evaluate the financial viability of their customer businesses in distress scenarios. Depending on the extent of distress, the bank will decide the fate of the distressed company and the appropriate vehicle through which to implement a rescue or a liquidation plan.[4] Concerns had arisen that the great control and wide decision rights could lead to to the underutilisation or suboptimal use of a debtor's assets.[5]Based on this theoretical concern,[6] the control rights of secured banks were slightly weakened as the administrator is now under a mandatory duty to perform his functions in the interests of the company's creditors as a whole, rather than solely in the interests of the creditors who appointed them.[7] However, the banks still have the power to dictate the identity of the administrator, which allow them to exercise significant influence over the management of the insolvency proceedings.[8] Banks still also retain the judgement regarding the viability of the company. This is largely because the distressed company's

[1] Jay Lawrence Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82 Texas Law Review, 795,815.
[2] John Armour, Brian R. Cheffins, and David A. Skeel Jr, 'Corporate ownership structure and the evolution of bankruptcy Law: Lessons from the United Kingdom'(2002)55 Vanderbilt Law Review 1699,1705.
[3] Security interests fall into two main categories: A floating charge taken over all the assets owned by a company or a fixed charge attached to a specific identifiable asset. In practice, Banks often combine both to create a hybrid charge. Eilís Ferran, 'Floating Charges. The Nature of the Security'[1988] 47 The Cambridge Law Journal,213,215.
[4] Sarah Paterson, 'Rethinking Corporate Bankruptcy Theory In The Twenty-First Century' (2015) 36 Oxford Journal of Legal Studies, 697,702.
[5] Michael Grylls, 'Insolvency Reform: Does the UK Need to Retain the Floating Charge?' (1994) 9 Journal of International Banking Law 399, 402.
[6] It was a 'perception' that banks, were too ready to place distressed companies into receivership, a mechanism considered as hostile to the preservation of viable enterprises and to the interests of unsecured creditors. However, the abolition of this option, it is hoped, would provide the needed remedy. John Armour, and Riz Mokal, 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' (2005)1 Lloyds' Maritime and Commercial Law Quarterly,28,30.
[7] Insolvency Act 1986, Sch. B1
[8] Insolvency Act 1986, Sch B1, Para 36

ability to continue operations—and the feasibility of any proposed recovery plan, proposed in an attempt to save the company, largely depends upon the lines of credit provided by the bank. In an oligopolistic finance market, the withdrawal of this critical funding source typically signals the end of a company's existence and the failure of any rescue efforts.[9] It is fair to say that banks, therefore, still have substantial power to control the insolvency process. A series of empirical studies were undertaken to analyse how the UK's insolvency system works and how these banks exercise their control rights in practice.[10] These studies demonstrated that banks generally use their control rights to pursue value-maximising actions. Banks are not over-zealous to liquidate their customer companies in distress scenarios. Instead, they provide advice and guidance through sophisticated support units built within their branches.[11] Banks may also coordinate actions with other banks through the use of the so called 'London Approach' in an attempt to relieve financial pressures faced by their customer companies.[12] Therefore, the emphasis has always been on market-led solutions and insolvency proceedings are only commenced as a last resort and when market-led solutions are exhausted. This behaviour was attributed to the banks' desire to maintain customer relationships and preserve reputation, particularly by avoiding the reputational risk associated with being seen as the cause of corporate failures.[13] Procedural inclusiveness,

[9] John Flood, Robert Abbey, Eleni Skordaki, and Paul Aber, 'The professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach' (1995) ACCA Research Report 45 (Certified Accountants Educational Trust, London)

[10] See for example, Julian Franks and Oren Sussman, 'Financial Distress and Bank Restructuring of Small to Medium Size UK Companies' (2005) 9 Review of Finance, European Finance Association,65; Sandra Frisby, Report on Insolvency Outcomes: Presented to the Insolvency Service (26 June 2006), available at https://webarchive.nationalarchives.gov.uk/ukgwa/+/http:/www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/InsolvencyOutcomes.pdf.

[11] Franks and Sussman (n10)67.

[12] John Armour and Simon Deakin, 'Norms in Private Insolvency: The "London Approach" to the Resolution of Financial Distress' (2001) 1Journal of Corporate Law Studies 21,29.

[13] John Armour, Adrian Walters and Audrey Hsu, 'The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings' (2006)5 European Company and Financial Law Review 148,152.

uncertainties, and complexity arising from regulatory reforms also encouraged banks to help preventing troubles from developing into disasters.[14]

In insolvency, banks have also been trusted to steer the company's business into a value-maximising sale. This aligns with their own interests, as they aim to recover as much of their lending as possible—otherwise, they risk receiving significantly less than the full value of their claims.[15] They may facilitate or support the sale of the debtor's assets through a pre-packaged administration. However, they have a strong incentive to ensure the sale is successfully completed while also minimising potential harm and guarding against abuse of the process.[16]

By its nature, power imbalance between secured and unsecured creditors is so inherent in this system. Several arguments have been put forward to justify the relatively weak position of unsecured creditors. Unlike secured creditors, they are typically dispersed and heterogeneous, with varying commercial interests and preferences regarding how to address a financially distressed company. Moreover, unsecured creditors often lack the financial resources, expertise, and understanding of insolvency procedures needed to effectively protect their interests. This heterogeneous creditor base, combined with the relatively small and widely dispersed nature of their claims, acts as a significant disincentive for unsecured creditors to actively engage in the insolvency process.[17] In this sense, the fact remains that because of their often-dispersed nature, unsecured creditors will always lack the ability to exert control over distressed companies or to monitor recovery plans in distress scenarios.

[14] Vanessa Finch, 'The Recasting of Insolvency Law' (2005) 68 The Modern Law Review,713,715.
[15] Douglas Baird and Thomas Jackson, 'Bargaining After the Fall and the Contours of the Absolute Priority Rule' (1998) 55 U Chi L Rev 738,742.
[16] Vanessa Finch, "Corporate Rescue: who is interested?" [2012]3 JBL 190,199.
[17] These are more commonly referred to as the agency problems and information-asymmetry problems occurring between shareholders during a company's solvency and between creditors during a company's insolvency. For more see Michael C. Jensen and William Meckling, H., 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) Journal of Financial Economics 305

However, they would benefit from recovery plans devised with assistance and monitored by secured banks.[18]

The system also reduces lengthy disputes and litigation and eliminates the need to form a costly coalition around a consensual arrangement between the debtor and creditors.[19] In this way, it reduces the risk of opportunistic hold-up and hold-out behaviour by some creditors who may do so to obtain additional private benefits.[20] Finally, since the company is not disrupted by claims pursued by a single creditor (i.e. racing to the court for the debtor's asset), the company can dedicate its attention and time to value maximising projects.[21]

The deference to the rights of banks is crucial for fostering growth and improving enterprises. Indeed, equipped with a great deal of power and certainty, banks will be more inclined to provide credit at lower interest rates.[22] On these arguments, scholars and policy makers have considered transplanting the UK's system into their jurisdictions.[23]

However, banks under regulatory pressure[24] or when 'they feel their reputation is not at risk'[25] may decide to dispose their customers' loans on the distressed debt market.

[18] John Armour and Sandra Frisby, 'Rethinking Receivership' (2001) 21 OJLS, 73.
[19] The low uptake rate of the Company Voluntary Arrangements (CVA) was attributed to the cost and delay involved in the process of obtaining the consent of the majority of all creditors to become effective. Sandra Frisby and Adrian Walters, "Preliminary Report to the UK Insolvency Service into Outcomes in Company Voluntary Arrangements" (March 2011)https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1792402
[20] For more on the risk of opportunistic hold-up behaviour see Horst Eidenmüller, 'Trading in times of crisis: formal insolvency proceedings, workouts and the incentives for shareholders/managers' (2006) 7 European Business Organization Law Review 239.
[21] Armour and Frisby (n18) 75
[22] Kee-hong Bae and Vidhan Goyal, 'Creditor Rights, Enforcement, and Bank Loans' (2009) 64 Journal of Finance 823,825
[23] See for example, Jodie A. Kirshner, 'Design Flaws in the Bankruptcy Regime: Lessons from the U.K. for Preventing a resurgent creditors' race in the U.S.' (2015) 17 University of Pennsylvania Journal of Business Law 527
[24] Such as bank liquidity regulations and the minimum capital standards for all banks introduced under Basel III. See The Basel Committee on Banking Supervision (BCBS), BASEL III: A global regulatory framework for more resilient banks and banking systems. (2010 https://www.bis.org/publ/bcbs189_dec2010.pdf (accessed October 10, 2017)
[25] Frisby (n10) http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/InsolvencyOutcomes.pdf

Companies may also turn to the distressed debt market to finance their operations.[26] The transfer of debt to the participants of the distressed market known as distressed debt investors involves the transfer of debt's accompanied governance rights.

Distressed debt investors usually lend to companies on secured basis. Despite this, there is remarkably little discussion in the academic literature regarding how these investors exercise the control rights conferred by their security interests over the insolvency process.[27] The nature of these investors, along with their investment strategies and use of the insolvency system, often differs from that of banks. They seek to make a profit on their investment primarily through recoveries on the debt in a sale of the debtor's assets to a third party or by converting the debt into an equity position in a sale to a company owned by them. In some cases, they their claim as currency for the company in a quick auction and before any other bidder can become involved.[28] This reintroduces the problem of underuse or sub-optimal use of a debtor's assets or the perverse incentives and to a large extent makes it more acute. It undermines the UK's approach to raising the profile of the rescue culture and raises concerns of wealth transfer and abuse. This is the core of this thesis. It tests both the validity of these concerns in practice and the adaptability of the existing safeguards built in the system to provide adequate remedies. Having proved the existence of these concerns in practice, this thesis offers a systematic based solution to the problems found.

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[26] Jennifer Payne, *'Schemes of Arrangement: Theory Structure and Operation'* (Cambridge University Press 2014) 193' The author argues that the debt market has experienced changes in such a way that companies these days finance their operation via loans provided by a ''new breed of sophisticated financiers' including hedge funds, private equity funds, investment banks etc. Compared to the previous situation about a decade ago where bank lending was the typical source of funding and the main creditor of a company would usually be a single bank.

[27] In general, John Tribe argues that there is so little research on the law of bankruptcy. John Tribe, 'Why the theory of English and Welsh bankruptcy law is not yet written' (2019) 9 International Company and Commercial Law Review,473. Moreover, the rise of distressed debt investing has been noticed by a few scholars. In a recent article Sarah Paterson discussed the role which debt investors may play in the insolvency process. Paterson (n4). However, this article is brief and lacking in detail. This thesis provides a detailed and in-depth analysis of the relevant issues to further and enhance that discussion.

[28] Michelle M. Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing (2008) 77 Fordham L. Rev, 703.

2. Motivation for This Study

The involvement of distressed debt investors in global financing market is becoming more pronounced and has generated considerable debate over the past several years.[29] As a company slides into distress, distressed debt investors —typically hedge funds and private equity firms—begin employing various distressed investing strategies. These strategies include buying and selling the company's equity or debt securities, such as bank debt, loan notes, shareholder loans, or credit claims. Additionally, they may take on the role of the debtor's post-petition lender, providing necessary financing during the insolvency process to secure a position of influence in the restructuring efforts. The latter role has given rise to a practice known as 'loan to own' where the investor provides new financing to the distressed company in order to influence control and ultimately acquire ownership, through a debt for-equity exchange, sale transaction or otherwise.[30]

However, scholars[31] and policymakers[32] continue to vigorously debate the role of distressed debt investors who hold or acquire positions of influence in a distressed company's capital structure and the future implications of their investment strategies on the nature and outcome of the insolvency process. Some commentators have been highly critical of various aspects of the role distressed debt investors play in the distressed company space. Their main concern is that these investors' focus on quick, short-term returns may destroy corporate value and often lead to the unnecessary liquidation of otherwise viable entities. The activities of these investors can also be disruptive to the company's operations and

[29] Adam J. Levitin, 'Bankruptcy Markets: Making Sense of Claims Trading'(2010) 4 Brooklyn J. of Corporate, Financial & Commercial Law, 74,77.
[30] Michelle M Harner, 'Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives' (2008) 16 Am Bankr Inst L Rev 69,74.
[31] A brief overview of current debate has been provided by Levitin (n29)
[32] Final Report and Recommendations, Commission to Study the Reform of Chapter 11 (American Bankruptcy Institute, 2014) 2 ["ABI Report"]. Online: <https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h

rescue attempts. Such activities can also produce significant profits for the investors at the expense of the other stakeholders (the value destruction problem and the wealth transfer problem).[33]

There have been a number of empirical studies exploring the potential benefits of the distressed debt investors' involvement in restructuring process of US companies.[34] In fact, the empirical evidence suggests that their involvement is positively associated with value enhancing effects. These effects include, among other things, improved management discipline, reducing the debt overhang problem, higher probability of a successful and faster reorganisation, positive power balance between the debtor and secured creditors, positive stock market response at the time of an insolvency filing, higher probabilities of emergence and payoffs to junior claims (unsecured debt and equity). It is important to note that these results have emerged within the context of the US debtor-friendly regime, in which several robust procedural safeguards are built to protect vulnerable creditors and deter value-destructive behaviour.[35] As its contribution to the knowledge, this thesis examines the way in which distressed debt investors involvement affects the insolvency process and the outcome of such process in light of the UK's secured creditor-friendly insolvency system.[36]

This research and the approach adopted is timely for three key reasons. First, the past decade has witnessed intense debate over the influence of distressed debt investors, particularly as

[33] Richard Thomas, 'Tipping the Scales in Chapter 11: How Distressed Debt Investors Decrease Debtor Leverage and the Efficacy of Business Reorganization' (2010) 27Emory Bankruptcy Developments Journal 213; Douglas G Baird and Robert K Rasmussen, "Antibankruptcy" (2010) 119 Yale LJ, 648.
[34] Jongha Lim, 'The Role of Activist Hedge Funds in Financially Distressed Firms' (2013) 50 Journal of Financial and Quantitative Analysis 1321; Wei Jiang, Kai Li and Wei Wang, Hedge Funds and Chapter 11 (2012)67; The Journal of Finance 175; Edith S. Hotchkiss and Robert M. Mooradian, 'Vulture Investors and the Market for Control of Distressed Firms'(1997)43 Journal of Financial Economics 401.
[35] Delay tactics, the pursuit of fire sale of viable business to quickly make profit, chilling the bidding process, value extraction from other claims are all examples of value destructive behaviour.
[36] The United Kingdom has always been perceived as a 'bank-friendly' jurisdiction because of the traditional deference to the rights of banks, Armour, Walters and Hsu (n13)

they have been linked to a series of high-profile insolvencies. From Monarch Airline[37] and Four Seasons health care[38], to Bathstore[39] and Interserve,[40] the blame was laid on distressed debt investors for the insolvency of these companies. Beyond the social outrage caused by their collapses, the short-term strategies they pursued reflect concerns about adapting insolvency remedies—originally designed for the orderly collection, realization, and fair distribution of the debtor's assets to designated beneficiaries—toward achieving quick and manipulative debt restructuring, often without regard for other important factors such as the survival of the debtor and the interests of other stakeholders.[41] This thesis endeavours to provide a comprehensive analysis of the implications of the rise of the distressed debt investors' strategies in light of secured-creditor oriented system of the UK.

Secondly, in recent years, the UK government has implemented significant insolvency reforms aimed at stimulating the growth of private enterprise by preserving viable companies. These reforms also seek to ensure greater inclusivity and participation among stakeholders.[42] However, the trend in current times is suggestive of a return of the secured creditor control. Corporate Insolvency and Governance Act 2020 empowers secured creditors to impose a restructuring plan on dissenting creditors.[43] One of the central contributions of this thesis is to analyse how the renewed secured creditor control plays into the hand of distressed debt investors.

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[37] Ford Jonathan,'Greybull eyes profit from Monarch collapse' (The Financial Times, London Oct 11, 2017) https://www.ft.com/content/a2ee882c-adb9-11e7-beba-5521c713abf4

[38] Daniel Dunkley, 'Four Seasons in intensive care as the vultures wait' Sunday Times (London, Oct. 29, 2017) https://www.thetimes.co.uk/article/four-seasons-in-intensive-care-as-the-vultures-wait-dlnxf86gv

[39] Mark Kleinman, 'Vulture fund Hilco plots swoop on ailing Bathstore' Skynews (London 21/6/2019) https://news.sky.com/story/vulture-fund-hilco-plots-swoop-on-ailing-bathstore-11746147 0

[40] Gill Plimmer, 'Interserve taken over by its creditors' Financial Times (London 15/3/2019) https://www.ft.com/content/8f209dac-471f-11e9-b168-96a37d002cd3 accessed 12/06/2020

[41] Anousha Sakoui, 'Vulture fund takeover of Countrywide was more than picking at the bones' Financial Times (London, 19/Feb/ 2010) https://www.ft.com/content/d9963e4e-14a9-11df-9ea1-00144feab49a

[42] For example, see the Small Business, Enterprise and Employment Act 2015 (SBEEA 2015) Enacting the recommendations of the Graham Report, and also Corporate Insolvency and Governance Act 2020.

[43] The powerful cross-class cram down facility was added to the Companies Act 2006 by Corporate Insolvency and Governance Act 2020.

Thirdly, considerable discussion has been mounted on the effects of the secured creditor control in the resolution of distress in traditional lending and insolvency situations under the assumption that the capital structure in a company were shareholders own shares; creditors provide credit[44], with banks holding secured debt. The widespread belief was that banks prefer consensual rescue-based outcomes negotiated against the benchmarks provided by insolvency law. If informal rescues cannot be achieved, the bank will have no choice other than to seek the appointment of an administrator or liquidator. The cost savings yielded by the informal workouts, the desire to preserve and prolong existing and future customer relationships, and the reputational constraints increase the incentives for banks to keep the company out of insolvency. However, inside insolvency—as residual claimants—are expected to make objective, value-maximising decisions that benefit all stakeholders. In short, banks' economic goal of receiving the principal and interest rate and governance rights are 'bundled' together, and therefore, they tend to act in an economically rational manner when exercising their insolvency governance rights.

However, distressed debt investors tend to solidify their positions and buttress their priority. They can strategically invest in distressed companies to position themselves in the event the company restructures or files for insolvency. To this end, most of their investment strategies are pursued on a secured basis. However, the practice has given rise to the emergence of the 'empty crediting theory'.[45] The theory asserts that distressed debt investors, due to their extraneous interests, may be indifferent to resolving distress scenarios through informal workouts or to the company's long-term survival. In fact, they might even be incentivised to push the company into an inefficient insolvency process, where they

[44] The term ''credit' is broad and covers money including a loan of cash or the arrangement for deferred payable payment, supply goods or services.
[45] Henry T. C. Hu and Bernard S. Black, 'Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications' (2008)14 European Financial Management Journal 663.

could potentially extract greater value through control over assets or restructuring, rather than pursuing more cooperative or value-preserving strategies. Inside insolvency, they may also have little incentives to take value maximisation decisions. In this sense, their economic exposure to the company and their governance rights are mismatched.[46] However, practitioners and scholars have become increasingly interested in disputing the existence of the problem, arguing that it is more theoretical than real.[47] This thesis will test the validity and soundness of the 'empty crediting theory'.

Finally, over the last years, the focus has been on creating incentives for lenders to provide finance to distressed companies. A number of statutory mechanisms were proposed and then shelved.[48] The underlying reasoning resides on the premise that the decision whether or not to lend to a distressed business and on what terms, is a business judgment that may be best left to the market.[49] However, the weaknesses of the market-based approach are very diverse. Distressed companies in desperate need of finance have grown dependent on distressed debt investors.[50] Without further bargaining power, the companies agree to high interest rates and grant them rights that facilitate 'loan to own strategies' to the detriment of unsecured creditors.[51] The new financing may in fact delay a debtor's inventible failure, complicate matters, or accelerate its decline. This thesis aims to undertake a critical

[46] Kevin J. Coco, 'Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases' (2008) 2008 Colum Bus L Rev 610; Edward J. Janger and Adam J. Levitin, "One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy' (2019) 104 Iowa L. Rev 1857

[47] Vincent S.J. Buccola, Jameson K. Mah, and Tai Zhang, 'The Myth of Creditor Sabotage' (2020) 87 The University of Chicago Law Review, 2029

[48] Insolvency Service, A Review of the Corporate Insolvency Framework: a consultation on options for reform, May 2016

[49] Jennifer Payne, 'The Role of the Court in Debt Restructuring' (2018) 77 Cambridge Law Journal 120, 142.

[50] Harvey R Miller, 'Chapter 11 in Transition - From Boom to Bust and Into the Future'(2007) The American Bankruptcy Law Journal 375, 393. The author emphasised the important role of hedge funds, a leading player in the distressed debt market, in replacing traditional lenders as providers of financing to troubled companies. This trend is evident across the Atlantic. Alan McNee, 'NPL trading takes off in Germany'(2005) The Banker Database available at https://www.thebanker.com/NPL-trading-takes-off-in-Germany-1120431600 accessed 22/12/2021

[51] Rolef de Weijs and Meren Baltjes, 'Opening the Door for the Opportunistic Use of Interim Financing: A Critical Assessment of the EU Draft Directive on Preventive Restructuring Frameworks' (2018) 27 International Insolvency review 223,224

assessment of the market-based approach and whether the light-touch[52] and de-regulatory system[53] of the UK could assimilate the contentious issues that arise from the distressed debt investors' agenda and strategies.

3. Research Questions

The objective of this thesis is to provide a well-focused analysis into the actual strategies and practices of distressed debt investors for the purpose of seeking answers to the following questions:

1- What are the concerns raised by the recent growth in distressed debt investing and are they substantiated in practice?

2- If so, have the mechanics of the UK's corporate rescue model, namely: the decision-making structure and the incentive structure become obsolete so far as their capability to enable value-maximising course of actions for companies in distress?

3- Have the checks and safeguards built in the insolvency system become redundant so far as their ability to minimise harm and abuse?

4. Summary of Research Methodology Of this Study

To examine the research questions, this thesis aims to adopt a mix of empirical and doctrinal research methods. The research is to a large extent concerned with empirically evaluating the effect of distressed debt investors activism on company value. The issues surrounding the role of distressed debt investors have been the subject of many heated debates among

[52] The choices of the stakeholders involved in the process. For example, the timing of the sale, marketing process, the selection of the buyer, the way in which insolvency practitioner conduct their duties are influenced by means of codes on best practice and "comply or explain" approach.

[53] Unlike court-supervised regimes of other countries. The insolvency process in UK is administrative in nature. Insolvency Practitioners are vested with the responsibility to administer the process as well as management powers to determine the fate of the insolvent debtor company for a fee. The employment of a private sector solution to the corporate insolvency matters was a part of a trend prevailed in the 1980s. This trend refers to the enactment of deregulation policies and privatisations.

insolvency lawyers and scholars. However, the debate has operated with a high level of generality and scant evidentiary basis.[54] Particularly in the UK, the debate has raged without any empirical foundation, raising the risk that assumptions will remain rooted in anecdote and hypothesis. As a result, any claims about whether distressed debt investors create or destroy corporate value remain open to criticism.[55]

It is worth noting that scholars begin their analyses of insolvency policy issues by framing the theoretical debate and frequently highlight the need for empirical evidence to support their assertions.[56]Similarly, a number of insightful academic articles have provided a theoretical framework for understanding the role of distressed debt investors in the restructuring of financially distressed companies with an emphasis for more empirical work to tie the theoretical work more closely to real-world practice.[57] However, this thesis will venture off the conventional path and provide further empirical evidence in order to provide a more robust understanding for the issues at stake.

The approach is consistent with the need for more empirical legal studies as the basis for the formation or amendment of an insolvency policy.[58] Data compiled carefully and analysed systematically will raise the level of policy debate and improve its conclusions.[59]

Skeptics may disagree to the use of empirical methods in insolvency policymaking, blaming its problematic application and lack of practical use.[60] This argument fails in its premise for

[54] Levitin (n29)77
[55] For a somewhat similar criticism, the EA 2002 was criticised for eradicating receivership on account of criticisms, theoretical analysis and without much empirical support. For more, see Sandra Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 The Modern Law Review 247,255.
[56] Elizabeth Warren and Jay Westbrook, 'The Dialogue between Theoretical and Empirical Scholarship' (2006) Harvard Public Law Working Paper No 137, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=945155.
[57] See for example, Paterson (n4)
[58] Tracey E. George, 'An Empirical Study of Empirical Legal Scholarship: The Top Law Schools. Indiana Law Journal, The Next Generation of Law School Rankings Symposium' (2005) 81 Indiana Law Journal 141
[59] Teresa A. Sullivan, Elizabeth Warren, and Jay Westbrook, 'The Use of Empirical Data in Formulating Bankruptcy Policy'(1987)50 Law and Contemporary Problems,195.
[60] Robert Rasmussen, 'Empirically Bankrupt' Vanderbilt Law and Economics Research Paper No. 06-7, Vanderbilt Public Law Research Paper No. 06-06, Available at SSRN: https://ssrn.com/abstract=895547

many reasons. The approach advances the debate to a new phase that better reflected reality.[61] In fact, it tends to gain momentum very quickly in field of insolvency law. As a result, recent studies[62] and reform efforts[63] were based on empirical research. In this sense, the creation of a database for information on the use of control rights by distressed debt investors would enrich the analysis and represents an important contribution to knowledge of the actual functioning of the UK's corporate insolvency regime in light of the distressed debt market development.

The empirical study examines originally collected quantitative data on administration cases with distressed debt investors involvement. The variables analysed in this research tracked those in similar studies.[64] A combination of factors—including the point at which distressed debt investors enter the capital structure of their targets, the incidence of pre-insolvency workouts, the outcomes of the insolvency process, and the returns to different classes of stakeholders—illustrates how these investors exercise control over the fate of the company. However, as the data was recorded emerging, patterns were noted particularly in high-profile cases. Whilst it was always envisaged that the database would be statistically analysed. It was recognised that particular findings would require further investigations. Therefore, as a matter of necessity, the thesis uses qualitative research because such a method is considered as exploratory and therefore can expose the emergence of certain theoretical and legal issues.[65] To that end, a series of five case studies will be explored to provide detailed insights into changing patterns of the governance of corporate insolvency.

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[61] Warren and Westbrook (n59)
[62] For example, Alan Katz and Michael Mumford, 'Study of Administration Cases – report to the Insolvency Service' (Oct 2006); Walters and Frisby(n19)
[63] For example, the quantitative study commissioned in connection with the Graham Report and Sandra Frisby, Report on Insolvency Outcomes (2006)
[64] Lim (n34); Jiang, Li and Wang(n34)
[65] DJ Bluhm, 'Qualitative Research in Management: A Decade of Progress' (2011) 48 Journal of Management Studies 1866, 1870.

A doctrinal analysis is employed to critically examine and assess the effectiveness of the existing protections and safeguards built in the system to handle the concerns raised by distressed debt investors activism. Doctrinal analysis is extensively used to develop a deeper understanding about the operation of the law in real life and its effectiveness to achieve its stated goals.[66] To achieve this end, the analysis involves a review of primary sources (e.g. legislation, case-law, government reports, white papers, consultations, and committee reports) and secondary sources (e.g. books, legal journal articles and relevant electronic sources).[67]

This method not only serves to logically and systematically examine the current legislative framework and judicial practice,[68] but it also enables us to provide regulatory suggestions to deal with the problem found. Indeed, to provide thoughtful suggestions for reform, one has to robustly understand and familiarise himself with the meaning of the legal rules, principles, doctrines, and judicial pronouncements relating to the issue under examination.

5. Structure of the Thesis

The thesis is divided into eight chapters including the introduction and conclusion. The first chapter presents an introduction to the research, and deals with the following aspects: the scope of the research, the significance of the research, the research problems that the thesis seeks to answer, the research methodology used and the contributions made. This chapter also outlines the structure of the thesis.

[66] Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) Deakin L. Rev. 83

[67] For more on the richness of the doctrinal method in providing an understanding of the laws and regulations see the Michael Salter, *'Writing Law Dissertations: An Introduction and Guide to the Conduct of Legal Research'*(Pearson Education 2008) 132.

[68] Terry Hutchinson, 'Valé Bunny Watson? Law Librarians, Law Libraries and Legal Research in the Post Internet Era' (2014) Law Library Journal 579, 580.

Chapter two provides a literature review of the study. It reviews the literature on distressed debt investors, their investing strategies, and the role they play in the governance and reorganisation of distressed companies. Existing studies have explored their role in the context the debtor-orientated system evident in the United States and have found more positive evidence pointing to their salutary impact on insolvency outcomes. This is attributable to various reasons, chief amongst which are the broad and long-established market for distressed debt and rescue finance (i.e. highly competitive and supplied with plentiful of investors),[69] as well as the great scope and extent of the judicial scrutiny and inquiry of the insolvency process. In essence, transactions involving obstructive tactics and hold-up techniques to extract additional value from others are subject of extensive investigation by the courts.[70] Also, the US has a well-developed framework to address shareholder loans under the rules of equitable subordination[71] and recharacterisation[72] and rescue finance under the rules of debtor-in-possession, or DIP.[73] However, it is questionable whether such investors can have the same impact in the UK in which a 'private sector solution' supplemented with voluntary guidance notes,[74] is applied to insolvency matters. Rules are also lacking on shareholder loans and rescue finance. Notwithstanding that

[69] Jennifer Payne and Janis Sarra, 'Tripping the Light Fantastic: A comparative analysis of the European Commission's proposals for new and interim financing of insolvent businesses' (2018) 27 international insolvency review, 178

[70] For example, procedures and the price of sales to connected parties attract great judicial scrutiny In *re W.A. Mallory Co*., 214 B.R. 834, 836 (Bankr. E.D. Va. 1997); Jessica Uziel, '§ 363(B) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law' (2010) 159(4) University of Pennsylvania Law Review 1189, 1197.

[71] First developed in in the landmark cases of *Benjamin v. Diamond (In re Mobile Steel Co*., 563 F.2d 692 (5th Cir. 1977) and *Pepper v. Litton*, 308 U.S. 295 (1939) and then codified in the bankruptcy code 1978 under § 510.

[72] The doctrine of recharacterization is closely related but a separate development from the equitable subordination. This doctrine emerged from case law in cases of In *re Autostyle Plastics, Inc*., 269 F.3d 726 (6th Cir. 2001) and In *re Outboard Marine Corp*., 2003 WL 21697357 1, 5 (N.D. Ill. 2003)

[73] 11 USC, s 541 (a); 11 USC, s1101 (1).

[74] For example, SIP 16, or Statement of Insolvency Practice 16 only provides guidance to IPs and its information requirements have no binding force. R3 (Association of Business Recovery Professionals), Statement of Insolvency Practice 16: Pre-packaged Sales in Administrations (London: R3, 2009)

distressed debt investing and claim trading remains a poorly understood and little studied area of insolvency. This thesis aims to fill this gap.

Chapter Three examines the main scholarly debates surrounding the control of the insolvency process. When a debtor company defaults on payment of its debts, the creditors become, in a meaningful sense, the owners of the company's assets. The creditors tend to be dispersed and heterogeneous, making creditor coordination on how the value of the company is maximised and allocated difficult, impossible or very costly.[75] Creditor heterogeneity is also presented as a justification for the existence of state-supplied corporate insolvency systems.[76] The structure of insolvency systems — particularly the key elements of control and priority—has been the focus of various competing theories. This chapter examines the existing theories on the control of the insolvency process theories insolvency, including the dispersed creditor model and the concentrated creditor model of governance. With the theoretical discussion complete, the chapter goes on to provide an overview of the UK's corporate insolvency regime, with particular emphasis on the reforms to the administration procedure that were introduced by the Enterprise Act 2002(EA2002)[77], and the rise of pre-packs following the EA reforms. It argues that despite the attempts to weaken the entitlement of the secured creditors to exert control over the insolvency process, English Insolvency law still gives special deference to—and avoid interfering with them. Powerful banks that have dominated the UK finance market have essentially been entrusted with the responsibility of choosing which companies should be rescued and which should be permitted to fail. However, this discretion operates under a veil of reputation and relationship constraints, banks have an incentive to exercise governance rights well to avoid

[75] Baird and Rasmussen(n33) 687
[76] Robert Gertner and David Scharferstein, 'Theory of Workouts and the Effects of Reorganization Law' (1991) 46 Journal of Finance 4; Thomas Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 Yale LJ 857.
[77] The Enterprise Act 2002

being linked with corporate collapses and maintain customer relationships. In this sense, bank's economic interests and governance rights are bundled together. That explains why the emphasis has always been on market-led solutions (The London Approach[78] and business support units[79]).

The advent of the distress debt market in the UK has been linked to the emergence of the 'empty creditor' phenomenon. Distressed debt investors are wholly unconcerned about reputational and relationship concerns, and because of other extraneous reasons, would not take objective and value maximising decisions inside the insolvency process. In short, empty crediting alters the creditors-debtor relationship and thus, implicates the core aspects of the insolvency process.[80] The chapter examines the assumptions upon which empty creditor theory is premised and its potential implications.

Chapter four sets out the methodology, analysis, and conclusions of a quantitative empirical study conducted by the author on 120 administration cases. The data gathered provides the basis for testing the validity and soundness of the empty creditor hypothesis. It also provides empirical evidence on effects of the distressed debt investors presence on the nature and outcome of the insolvency process. It identifies determinants of value creation/destruction. In particular, it tracks the key variables of points of entry in the target capital structure, investment strategies, the incidence of pre-pack sales, returns to the distressed debt investor, returns to other classes of creditors. As the data was recorded emerging patterns were noted, particularly in high-profile administration cases. The chapter culminates with fives case studies which have the function of illustrating particular issues raised by the practice of distressed investing in some administration cases.

[78] Armour and Deakin(n12)30
[79] Armour, Walters and Hsu(n13) 150; Franks and Sussman (n10) 69
[80] Hu and Black(n45)665

Chapter five examines closely the efficacy of existing checks on self-dealing, value destruction, and wealth transfer embedded within the administration process. An emphasis will be placed on the lack of regulation within the insolvency industry, the reluctance of the judiciary to interfere with an administrator's decision,[81] the limited functions of the pre-pack pool, the underdeveloped methods used in determining the value of an insolvent company's assets. It is important to mention that the administrator's decision can be skewed in the interest of the distressed debt investors, and other stakeholders are unable to voice their concerns because they are either 'out of money' or lack the ability to block harmful outcomes.

Chapter six focuses on the Corporate Insolvency and Governance Act 2020. The Act found its way into legislation to encourage company rescue and improve the position of the UK in the World Bank rankings. To achieve this end, a new mechanism under Part 26A was introduced.[82] It is closely modelled on the scheme of arrangement,[83] but it includes a cross-class cram down feature by which a restructuring plan is crammed down on the throat of whole classes of creditors.[84] This means that the guard rail against risk of abuse (e.g. the possibility of wealth transfer and minority oppression) is removed. The chapter examines the potential pitfalls of the new tool and how it plays into the hands of distressed debt investors.

Chapter seven examines the reliance on market-led contractual solutions to avoid or mitigate the risk of empty crediting and the resulting destructive behaviour. This chapter tests the validity of suggestions often put forward, proposing that market conventions

[81] *DKLL Solicitorsv HMRC* [2008]1BCLC 112*; Transbus International Ltd*, [2004] EWHC 932; *Re Hellas Telecommunications(Luxembourg)II SCA* [2009] EWHC 3199 (Ch8)
[82] Companies Act 2006, sections 901A-901L
[83] Companies Act 2006, sections 895-901
[84] Companies Act 2006, sections 901F

similar to those reflected in the famous London Approach[85] will emerge and become a normative force. The chapter also examines the ability of parties to contractually incorporate transferability restrictions in their lending agreements to exclude investors with value destructive tendencies. In short, the chapter has evidenced the shortcomings of the market-led contractual solutions.

Chapter eight provides regulatory suggestions that would make additional checks and balances within the insolvency system in order to eliminate the detrimental aspects of distress-investing while at the same time preserve the benefits that distressed debt investors contribute to the insolvency system.

6.Contribution to knowledge by this Study

6.1 Impact and implications

Distressed debt investors can deliver economy-wide benefits with the appropriate regulation. Distressed debt investors may be the only source of financing available to distressed companies. Traditional lenders might be unwilling to provide financing or remain invested in distressed companies. The reasons range from regulatory constraints,[86] risk aversion,[87] and the availability of other sources of income.[88] The existence of a distressed debt market can enhance overall liquidity in capital markets and lower the cost of credit.

[85] Mutual co-operation among banks for the restructuring of a debtor company enforced by the threat of exclusion from future business and became a normative force. For more see, Armour and Deakin(n12)
[86] Such as bank liquidity regulations and the minimum capital standards for all banks introduced under Basel III. See The Basel Committee on Banking Supervision (BCBS), BASEL III: A global regulatory framework for more resilient banks and banking systems. (2010) https://www.bis.org/publ/bcbs189_dec2010.pdf (accessed October 10, 2022).
[87] Kai Li and Wei Wang, 'Debtor-in-possession financing, loan-to-loan, and loan-to-own' (2016) 39Journal of Corporate Finance 121.
[88] Lawrence E. Mitchell, 'Financialism. A (Very) Brief History' (2010) 43 Creighton Law Review 323. Capitalist economies, initially designed for financial institutions to facilitate the funding required for the production and trade of goods and services, have undergone a transformation. In the new economic order, financial markets primarily serve their own interests. Within this system, capital is raised for the creation, sale, and trade of securities. Interestingly, these securities don not necessarily contribute to industry financing; instead, they circulate within markets that essentially operate as an independent economy.'

This is because the distressed debt investors' key strategy is purchasing non-performing loans from the banks' books. The option of avoiding the uncertainty, costs, and delays of being a creditor in the insolvency process increases the risk appetite of banks to provide financing to companies, frees up their resources to be invested in other enterprises. In this sense, a sufficiently deep market supplied by investors equipped with substantial resources can allocate capital in the economy to best use, and serve as provider of liquidity to both banks and companies.[89]

There are some hazards arising from the distressed debt investors activism. These investors are always motivated by their self-interest, hoping to profit either through recoveries on the debt in the insolvency process or by converting the debt into new equity in the reorganised company, very often at the expense of the junior creditors.[90] These concerns are borne out by the data. There are important correlations between the distressed debt investors' strategy and the choice of the procedure. Standard administration was more utilised to realise a gain on the distressed debt. Meanwhile, pre-packs were most common for the implementation of debt for equity swap strategies. In both strategies and procedures, distressed debt investors tend to fare better overall, leaving little, if anything, for unsecured creditors.

The presence of distressed debt investors changed the restructuring landscape and the application of insolvency law. Indeed, new concerns arise in this landscape, of great importance is the empty crediting problem. In a finance market dominated by banks, the emphasis has always been on market-led solutions and formal insolvency procedures have always been viewed as mechanisms of last resort.[91] This is because of the non-legal constraints (e.g. reputational and relationship concerns). If informal solutions are

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[89] Levitin (n29) 77

[90] Harner (n28) 85; Thomas(n33) 216

[91] Armour, Walters and Hsu (n13) 150; Vanessa Finch, *'Corporate Insolvency Law: Perspectives and Principles'*(2nd ed,2009) 294

exhausted, formal insolvency proceedings are commenced, banks as residual claimants favour a larger recovery (i.e. value maximisation decisions). This is no longer the case, with the advent of distressed-debt investing, insolvency procedures have become mechanisms of first resort for investors seeking either to convert their claims into cash or to ownership of the distressed business. The data collected in this study shows that informal negotiations are rarely considered or rejected in favour of formal insolvency process. In the insolvency process, distressed debt investors have a strong incentive to depress the value of the assets to end up with ownership of the company.

Numerous reforms of insolvency law, which include EA2002, have been directed to make corporate rescue a real alternative to liquidation. The motivation behind the EA 2002 reforms is to "put company rescue at the heart of insolvency procedures because the need to save companies which have a decent chance of survival so that they are not driven to the wall unnecessarily".[92] Hence, the aim of corporate rescue is to preserve the distressed company that houses the business, not just the business itself. Business rescue is a sale of the core business with the old corporate entity terminated. A liquidation procedure may also have the effect of preserving a company's business. The liquidator, during the winding-up process, may sell a company's business on either a going concern or break up basis to anyone who is willing to pay the highest price for it.

Previous empirical evidence shows that company rescue or pure rescue in administration are, in general, rare in the extreme.[93] On this basis, it has been argued that corporate rescue is an inefficient process and it is in fact better to liquidate a distressed company.[94] However, it has been suggested that the advent of distressed debt investing may promote the clearly

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[92] Rizwaan Mokal and John Armour, 'The New UK Corporate Rescue Procedure — The Administrator's Duty to Act Rationally' (2004) 1International Corporate Rescue,136,138.
[93] Frisby (n14).
[94] Michael Bradley and Michael Rosenzweig, 'The Untenable Case for Chapter 11' (1992)101 Yale LJ 1043,145.

defined goals of the EA 2002 and raise the profile of pure rescue. The argument goes that selling a claim allows a creditor who no longer willing to remain invested in the company to 'cash out' and sell its claim to a new investor who want to take the time and effort to support the company.[95] An analysis of the data gathered in this study shows that distressed debt investors view administration as a potentially lucrative instrument to realize gain on their distressed debt investments by selling a company's assets to a third party or to an entity they themselves own and control. The latter transaction is functionally a debt for equity swap.[96] In fact, out of the 120 companies, only two companies emerged from the administration process intact even though under the ownership of the distressed debt investors.[97] It is fair to say that the advent of distressed debt investing is unlikely to restrict the business rescue or promote company rescue.

One of the main advantages of distressed debt investors lies in the possibility of improving the position of unsecured claimants. Support for this stems from the premise that distressed debt investors buy the so-called 'fulcrum' security (i.e. the most junior class of claims or interests that is not entirely 'out of the money' and is therefore entitled to the debtor's residual value).[98] However, the investor may only purchase a blocking position in the 'in of the money' class (i.e., two-thirds in amount and a majority in number of the relevant claims). The argument goes that distressed debt investors will, in the course of making their own profits, challenge managers and senior creditors and expand the recovery pool for their

[95] Paterson (n4) 703

[96] A form of corporate restructuring. In its simplest form, a creditor agrees to withhold enforcement action against a debtor company at the risk of default or has already defaulted and convert its debt to an equity stake in the distressed debtor. After the swap takes place and depending on the barging reached, the interests of the existing shareholders are totally or significantly diluted and the creditor become the new shareholder. For example, In the debt-for-equity swap restructuring of the Spanish energy firm Abengoa, the majority shareholder retained a stake of 5 percent and creditor banks and bondholders converted their debt into equity stake, effectively becoming the new majority shareholders of the company; Patrick Fitzgerald, Abengoa Seeks U.S. Court Approval of Debt-for-Equity Swap' Wall Street Journal (New York,21,11,2016)

[97] Distressed debt investors acquired ownership of the targeted companies in a traditional debt for equity swap without transferring the companies' assets to a company owned by them.

[98] Jiang, Li and Wang(n34) 179.

own benefit as well as their fellow unsecured creditors. Indeed, senior claimants may prefer a lower valuation, which can result in junior claimants receiving a reduced rate of recovery. They may align their interests with those of management and initiate a pre-pack strategy to ensure a swift recovery at the expense of other junior creditors. Senior creditors, whose debt is fully secured or 'above water', may have little incentives to maximise recoveries and minimise costs.[99] Hence, they may push for a quick sale or a break-up sale strategy even if the distressed company has a viable business and better realisations could be accomplished via a longer sales process or a reorganisation. This argument fails in its premise, the data gathered in this thesis shows that secured debt is the most popular entry point in the capital structure for distressed debt investors. This preference is consistent with governance structure of the UK insolvency system and the valuation methodologies adopted. Of course, secured creditors are granted significant powers and can exercise significant influence on the way in which the administration, and especially the pre-pack version, is conducted.[100] While unsecured creditors lack an endowment of authority and their rights can be easily extinguished. More importantly, market testing valuation methods adopted by the English courts to determine the value of the insolvent companies produce low valuations as post-organisation value or profit is not taken into account. Low valuations position the holders of the secured debt to take control of the process without significant (if any) input from other creditors whose claims become 'out of the money'.

The senior lender is allocated governance rights on the basis that, as the residual claimant, it is best positioned to make value-maximising decisions. This is particularly important in the majority of cases—especially those involving under-secured loans—where the senior

[99] Philippe Aghion, Oliver Hart and John Moore, 'The Economics of Bankruptcy Reform' (1992) 8 Journal of Law, Economics, and Organization,523,526.
[100] For example, the right to appoint administrators of their choice, and the right to apply for a substitution of the debtor company's choice of administrators. IA 1986, Sch B1, Para 36 and 14

lender would otherwise recover significantly less than the full value of its debt. However, there may be inefficiencies or suboptimal outcomes (i.e. break-up sales, fire sale) if the senior lender is over-secured. The EA 2002 was introduced to address the perverse incentives of the over-secured creditors. To achieve this end, their rights to take enforcement actions against the company's assets—regardless of the business's financial viability or whether preserving the company in some form would yield better results for all creditors—has been weakened through the abolition of administrative receivership and the establishment of the more inclusive, more uncertain processes of the streamlined administration. As a result, the secured creditors became more inclined to manage the risks of insolvency *ex ante* and step in to assist in reviving or nursing the distressed company back to health before its position becomes terminal.[101]

However, the advent of distressed debt investors reintroduces the problem of perverse incentives and to a large extent makes it more acute. These investors usually purchase the debt off the books of the banks at an extremely deep discount to bar seeking to make a quick profit through recovery. In fact, they may buy at 20[102] and seek to recover at 30. The desire for quick profit may lead to suboptimal outcomes for the debtor's stakeholders as a group (i.e. pressing for quick sale on a break up basis or fire sales even though better realisations or a less terminal outcome such as a sale on an going concern basis or a reorganisation can be accomplished). Investors seeking to make a profit on their investments by converting the debt into an equity position would also prefer quick sales designed to chill bidding and avoid the consultation of the wider market, and a lower valuation, because the proportion

[101] Vanessa Finch, 'Doctoring in the shadows of insolvency'(2005) Journal of Business Law 690; 715; Vanessa Finch, 'Corporate Rescue in a World of Debt' (2008) 8 Journal of Business Law 756; Finch(n14)
[102] Harner (n28) 85

of equity that they are expected to receive will be increased and unsecured creditors will be wiped out.

Investors may pursue both traditional takeover strategies and/or debt-based takeovers. Indeed, such strategies can be either hostile or friendly.[103] Irrespective of the nature of the strategy employed, the diagnosis of the cause of the distress and the implementation of a feasible operational plan[104] are crucial for the newly organised company to return back to health under the new ownership. Of great importance is also the need for further finance for the implementation of the plan and for the company to continue in operation. While it is traditionally assumed that a company may re-enter the debt markets to raise new financing, the data gathered in this study reveals the emergence of a different practice. Distressed debt investors—characterised by substantial resources and significant cash reserves—often provide this financing themselves, typically in the form of a loan rather than an equity contribution. Distressed debt investors, therefore, will be entitled to profits in the form of a fixed interest rate, instead of dividends, regardless the viability of the recovery strategy. Given the fact that they can satisfy their secured claims first in an insolvency situation, they would lead a rescue effort without taking the risk of failure. They also have a strong incentive to gamble for the resurrection of an unviable company at the expense of the other stakeholders. The company will relapse into insolvency a second or third time because the distressed debt investor can initiate pre-packs and buy the business back many times. Distressed debt investors become effectively empty creditors, indifferent or even overzealous to push their companies into insolvency. This stands at odds with the insolvency guiding principles (absolute priority[105], collectivity and *pari passu*

[103] Michelle M. Harner, 'Activist Distressed Debtholders: The New Barbarians at the Gate? (2011) 89 Washington University Law Review,155.
[104] Usually involves measures such as cost cutting and downsizing the workforce, disposing of non-core assets or units of the business.
[105] In *re Tea Corporation Ltd* [1904] 1 Ch 12 and *In re Oceanic Steam Navigation Company Ltd* [1939] Ch 41.

distribution).[106] It also limits the ability of the system to perform its functions (liquidation of terminally ill companies and the preserving of viable companies).[107] It also runs directly counter to the successive reforms amid at addressing the problems of perverse incentives. It also increases the risk of what is often referred as the recidivism problem, where a debtor company emerging from an insolvency procedure to just relapse into another multiple times.[108] The presence of high rates of recidivism in rescue procedures has fundamental policy implications as it undermines public confidence in the integrity of the insolvency system and its insolvency practitioners.[109]

The investor may seek to make a profit by reselling the debt before the company enters administration or during the administration case.[110] This strategy can be either productive or counterproductive. The changing identity and motives of investors may make the insolvency process more uncertain and complex and thus more costly. Indeed, the creation of a strategy (e.g., restructuring, business sale) may prove impossible or very costly with a revolving cast of investors and the administrator may have to start from scratch with every new set of investors entering the case.[111]

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[106] The *pari passu* principle is a fundamental rule in corporate insolvency law. It mandates that, in liquidation and administration, the proceeds arising from the sale of the assets are distributed equally and rateably amongst all unsecured creditors ''according to the quantity of their debts' so that all the unsecured claimants benefit to the same extent from the debtor's wealth whilst at the same time bear to the same extent the brunt of the losses flowing from the debtor's insolvency. In this sense, a provision of *pari passu* distribution serves to promote equity and fairness between claimants and also eliminates the risk of an inefficient individual race to the debtor's assets. See s 107 of the Insolvency Act 1986 (applying in voluntary winding up) and r 14.12 Insolvency (England and Wales) Rules 2016 (SI 2016/1024) (applying in compulsory winding up). Also, S 372 r 2.69 of Insolvency (England and Wales) Rules 2016 (SI 2016/1024)

[107] United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Insolvency Law 18 <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> 9-14, accessed 22 April 2022.

[108] Edward I. Altman, 'Revisiting the Recidivism - Chapter 22 Phenomenon in the U.S. Bankruptcy System'(2014) 8 Brooklyn Journal of Corporate, Financial & Commercial Law,253.

[109] Bolanle Adebola, 'An Invitation to Encourage Due Consideration for the Survivability of Rescued Businesses in the Business Rescue System of England and Wales' (2017) 26 International Insolvency Review 129, 133 The author argues that "recidivism erodes trust in the rescue system."

[110] Jared A. Ellias, 'Bankruptcy Claims Trading' (2018)15 Journal of Empirical Legal Studies 772

[111] Jonathan C. Lipson, 'The Shadow Bankruptcy System (2009) 89 B. U. L. REV, 1609,1705.

However, claims trading may allow dispersed claims owed to 'claim flippers'[112] to be consolidated into the hands of a small number of specialised investors and this, in turn, would reduce the impediments and difficulties (e.g. free rider risk, creditors hold out risk, the interchangeability of creditors problem, the creditors' race to the court) of reaching an optimal outcome.[113] Understanding the UK debt financing market is essential. Generally, companies rely on three primary sources of debt to finance their operations: public bond markets, banks, and privately placed debt markets. However, the public bond market in the UK is 'underdeveloped' in comparison to the more robust markets such as the US market. Support for this stems from the premise that the number of corporate bond and privately placed debt issues in the UK is relatively low when compared to other developed capital markets. Consequently, UK companies tend to rely more heavily on banks as their primary source of borrowing.[114] The data gathered in this study shows that distressed debt investors prefer enforcement of security and sale (recovery or asset realization through insolvency process over selling loan debt to a third investor). This, however, would probably scupper the argument that distressed debt market allows an exit for those creditors who no longer willing to remain invested in the company and the entrance to the process of those equipped with the resources and want to take the time and effort to support it through the troubled times. This means also that the concerns of changing identities and intentions of distressed debt investors during the administration case are not of real importance.

However, the aforementioned concerns do arise in administration cases of large companies financed with bonds. Trading of bond debt is pervasive; some investors buy to resell, while

[112] Claim flipping is an investment strategy in which the investor purchases and sells debt quickly to make profit resulting from price movements in the market. Thomas(n33)
[113] Victoria Ivashina, Benjamin Iverson, and David C. Smith, 'The Ownership and Trading of Debt Claims in Chapter 11 Restructurings' (2011) 119Journal of Financial Economics 316,324.
[114] Jenny Corbett and Tim Jenkinson, 'How is Investment Financed? A Study of Germany, Japan, the United Kingdom and the United States'(1997) 65 Manchester School of Economic and Social Studies 69,71; Andrew Marshall, Laura McCann, and Patrick McColgan, 'The market reaction to debt announcements: UK evidence surrounding the global financial crisis' (2019) 51The British Accounting Review 92,94.

others purchase with the intention to pursue litigation to claw-back claims from the company's owners/shareholders and directors or to swap their bonds into equity. These cases highlight a growing concern among administrators, who point to the reluctance of distressed debt investors to engage in the process, despite the fact that their participation is crucial for resolving the insolvency case. The desire to continue trading in the bonds of the distressed company has been expressed as the main reasons for this lack of participation. Administrators also point out to changing identity of distressed debt investors and the subsequent long negotiations, complexity, and increasing costs.[115]

6.2 The Efficiency Level of the Safeguarding Measures to Assimilate the New Challenges

The advent of distressed debt investors warrants a reexamination of the assumption that there are sufficient mechanisms available under current law that ensure transparency, accountability, and procedural fairness.[116] There are considerable reasons to doubt that these mechanisms can fully identify and address the challenges created by the distressed debt market. Unsecured creditors lack the ability to challenge administrators' decisions that might be skewed in the interest of distressed debt investors. The functions of pre-pack pools do not extend to lender-led pre-packs, which are used to implement loan-to-own strategies, as secured creditors are not classified as 'connected persons' under the relevant definitions.[117] The valuation of the debtor is of major importance in every insolvency

[115] See for example the Phones 4U case where the administrator points out to the unwillingness of distressed debt funds to engage with him or to release the security required for the sale of debtor's assets. PHONES 4 U GROUP LIMITED, 'Statement of administrator's proposal (Companies House,13 Nov 2014) https://find-and-update.company-information.service.gov.uk/company/04943837/filing-history?page=2accessed 20 July 2022

[116] Alexandra Kastrinou and Stef Vullings, 'No evil is without good: A comparative analysis of pre-pack sales in the UK and the Netherlands' (2018) 27 International Insolvency Review,320. The authors argue that 'Major lenders have powerful incentives to pursue optimal solutions for the benefit for the creditors as a whole, and to limit abuses and maintain a level of perceived legitimacy by ensuring that the administrator acts appropriately. They conclude that the current regime is functioning well and the imposition of additional safeguards and disclosure requirements in pre-pack sales would be economically wasteful'

[117] The regulations created the pre-pack pool refer to the definition of 'connected person' as contained in the Insolvency Act 1986 Para 60(A)(3) of Schedule B1, which does not include secured creditors.

procedure. It serves to discern whether the creditors or members in question have a genuine economic interest in a debtor and therefore, being able to exercise participation rights.[118]

There appears to be a heavy reliance on traditional valuation methodologies, such as market tests and liquidation values, where the business's value is determined solely by the highest bid received, without considering its future earning capacity. [119] This approach is likely to result in a low valuation, leaving unsecured creditors out of the money. As a result, if a creditor is out of the money, they will neither be able to participate in recoveries nor have any influence over the insolvency process.

At Common Law, the court may examine the purpose for which a winding up order petition is brought. It may restrain or dismiss a winding-up petition in order to prevent coercive behavior or the abusive use of insolvency laws (i.e. to pursue individual rather than collective goals).[120] However, the remedy is still in its infancy and is scarcely used. The cases where courts focused on examining the petitioning distressed debt investor's purpose and motive are few and far between. Moreover, the challenges so far have come either from the company or other sophisticated investors. It has been shown that a company's directors may support the actions of the petitioning distressed debt investor so they can retain their jobs or benefit from compensation packages in the newly organized company, even if the shareholders still have residual value in the company or/and despite the coercive tendencies of the distressed debt investors.[121]

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[118] These include monitoring and scrutinising of how administrators conduct their duties, scrutinising, challenging, raising objections, providing suggestions and casting their vote on the actions proposed to determine the fate of the company.

[119] Eugenio Vaccari, 'Broken Companies or Broken System? Charting the English Insolvency Valuation Framework in Search for Fairness' (2020) 35 Journal of International Banking Law and Regulation 135,145.

[120] *Crigglestone Coal Company Limited* [1906] 2 Ch 327

[121] See for example, the Interserve case where the shareholders urged directors to stop advocating rival proposals put forward by the company's lenders. Rob Davies, 'Interserve's largest shareholder issues rescue deal demand'' The Gurdian, (London, 4 Mar 2019) https://www.theguardian.com/business/2019/mar/04/interserve-shareholder-rescue-deal

Rules on shareholder loans are lacking, despite the distortions caused by such loans to the basis of insolvency law. However, it is important to mention that pursuant to the doctrine of shadow directors,[122] directors' liability for wrongful trading or fraudulent trading can also be extended to shadow or *de facto* directors (e.g. shareholders, creditors[123]acting in a managing capacity even though they have not been formally appointed as a director). A distressed debt investor in such a capacity can be held liable for acting in detriment of other creditors' rights. However, to prove shadow directorship, it has to be shown that the company did not exercise its discretion and judgment but acted in accordance with the instructions of the creditor/shareholder.[124] This is indicative of the limitations of this remedy. Determining the point when a creditor/shareholder started acting as a shadow director can be quite challenging. The distressed debt investor might be commercially linked to its company (e.g. receiving the interest rate) but they might be formally and managerially independent. The remedy only applies where wrongful trading is established. The difficult onus of proof in establishing wrongful trading makes it hard to obtain positive judgments.[125] Given the fact that only liquidators (and since October 2015 admittedly also the administrators)[126] have the power to pursue a claim for wrongful trading. Therefore, they may deliberately choose not to given the difficulties of proof mentioned above, leaving creditors with no mechanisms to safeguard their rights for wrongful trading.

There is also the question of to what extent market forces alone can effectively address and correct the issues created by the practice of distressed debt investing. The argument goes that market conventions similar to the London approach would be developed and companies may be left to negotiate bespoke transfer restrictions in their lending contracts to limit the

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[122] Insolvency Act 1986 ss. 214, 217(7)
[123] *Re a Company, ex parte Copp* [1989] B.C.L.C. 13)
[124] *Secretary of State for Trade and Industry v. Deverell* [2000] 2 WLR 907, [2000] BCC 1057
[125] *The Liquidator of Marini Ltd v Dickensen* [2003] EWHC 334 (Ch), [2004] BCC 172 and *Re Continental Assurance Co of London plc* [2001] BPIR 733.
[126] Small Business, Enterprise and Employment at 2015 (SBEEA 2015) s117

involvement of 'aggressive' investors.[127] This argument carries little logic, the London Approach was developed in an era of a market dominated by a few large homogeneous banks with the availability of strong state institutions, the Bank of England with threat of regulatory sanctions for non-cooperative behaviour played a significant role in stimulating the emergence and the subsequent stability and dissemination of the principles that constitute the London Approach.[128] In contrast, distressed debt investors are a wide-range of largely unregulated heterogeneous investment vehicles.[129] The lifespan of these vehicles is relatively short[130], and their motives and objectives differ significantly.[131] Distressed debt investors may even establish a separate, ambiguously-named entity for the sole purpose of buying up claims while concealing their identities. These entities are typically domiciled offshore and rarely deal or interact with other regulated institutions.[132] This, in turn, makes the formation of new market conventions practically challenging if not impossible.

Contractual restrictions seem to have shortcomings which impact their efficiency in curbing predatory and manipulative practices. The vast majority of loan trades are documented using the secondary trading documentation created and maintained by the Loan Market Association (LMA). Pursuant to the LMA terms and conditions, a bank is able to freely transfer its voting participations to 'another bank or financial institution or to a trust, fund or other entity that is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets'. These terms are quite broad and the court ruled that unregulated funds and companies newly incorporated for the

[127] Sarah Paterson, *'Looking to the Future', Corporate Reorganization Law and Forces of Change'* (1st edn, Oxford Academic 2020) 248.
[128] Armour and Deakin (n12) 24.
[129] Hotchkiss and Mooradian (n34) 402
[130] Edith S. Hotchkiss, David C Smith, and Per Strömberg, 'Private Equity and the Resolution of Financial Distress' (2021) 10 The Review of Corporate Finance Studies,694,699.
[131] Harner (n28) 90
[132] Ana Maria Fagetan, *'The Non-Regulation of Hedge Funds in Offshores Jurisdictions: Cayman Islands, British Virgin Islands, Mauritius, and Delaware' "The Regulation of Hedge Funds"* (1st edn, SpringerLink,2020) 288

purpose of buying defaulted loans with a view to turn such loans into cash or equity can fall within the definition of a 'financial institution'.[133] More importantly, transfer restrictions cease to exist upon the occurrence of an event of default. This means that restrictions fall away when they are most needed. The bank as the original lender may avoid transfer restrictions by creating, through a distinct agreement, an interest in the loan, or at least its proceeds and related risks in favour of a sub-participant. In this transaction, the bank remains the lender of the record and maintains the relationship with the borrower. However, the sub-participant (e.g. distressed debt investor) has no contractual standing against the borrower but pursues his agendas and strategies, exerts influence over the daily management and oversight of the underlying loan, and exercises control over the insolvency process through the lender of record behind the curtain. It is safe to say that in most cases, negotiating transfer restrictions in facility documentation becomes meaningless. The loosening of transferability language stems from the British banking industry's resistance to efforts aimed at tightening it, as banks seek to maintain the freedom to offload non-performing loans in the secondary loan market and clean up their balance sheets.

Unsecured creditors who lack sufficient financial resources, bargaining power, market control, interest, information and power, and therefore, are not able to achieve traction with the debtor can benefit from the great extent of the banks' powers and informational advantages. The debtor company itself can rest upon the advice and guidance provided by banks to steer itself away from the troubled water. This familiar pattern no longer applies as distressed debt investing is becoming more prominent. Distressed debt investors have little incentives to concern for the interests of another stakeholder. Even more problematic is the possibility of unfair transfers of wealth from vulnerable unsecured creditors to

[133] *Re Olympia Securities Commercial plc (in administration) and ors* v WDW 3 Investments Ltd and anor ([2017] EWCH 2807)

powerful distressed debt investors. Indeed, one needs to be more concerned about the risk of inter-creditor rent-seeking behaviours and intra-creditor strategic behaviours in this new paradigm. To combat these risks, pre-pack sales to distressed debt investors should face higher scrutiny. To this end, the powers of the pool should be first expanded significantly and then extended to pre-pack sales to distressed debt investors.

6.3 Impact and Implication of the Corporate Insolvency and Governance Act 2020 (CIGA)

The insolvency framework has recently been reviewed and significant changes were introduced. A number of drivers of reform have been identified, chief among them is the need to improve the UK's standing in the World Bank rankings and the need to modernise the existing insolvency regime so that it can continue competing with other European insolvency frameworks. To this end, certain distinct features of the US Chapter 11 were transplanted into the UK's insolvency system. Of particular interest is the inclusion of the cross-class cram-down feature in a newly introduced stand-alone restructuring mechanism.

The law of unintended consequences may go to work as a result of reforms, especially ill-thought-out ones. The intention of the EA 2002 was to make a streamlined administration a real alternative to liquidation for financially distressed companies.[134] However, administration has simply been used as a substitute for liquidation and administrative receivership returned through the back door. The number of pre-packs, which is functionally equivalent to receivership, increased sharply following the introduction of EA 2002.[135] In the same fashion, the underlying goals of the new reforms are defined to include

[134] The Insolvency Service, Productivity and Enterprise: Insolvency – A Second Chance (Cmnd 5234, 2001); Department of Trade and Industry, A Review of Company Rescue and Business Reconstruction Mechanisms (2000)
[135] Sandra Frisby, 'Report to the Association of Business Recovery Professionals: A Preliminary Analysis of Pre-packaged Administrations' (2007) http://www.r3.org.uk/media/documents/publications/press/preliminary_analysis_of_prepacked_administrations.pdf, accessed 22/09/2022

improving the UK's standing in the now defunct World Bank rankings and reigniting the rescue culture, and improving outcomes for preferential and unsecured creditors.[136] However, unintended consequences may materialise. The new Part 26A restructuring plan[137] is closely modelled on the scheme of arrangement procedure.[138] Under the scheme of arrangement, the creditors are divided into classes based on the similarity and commonality of their interests and rights.[139] Unless a statutory majority in each class consents, the court cannot sanction the scheme.[140] This requirement, combined with judicial oversight, serves as a safeguard against the abuse or oppression of minority creditors and helps prevent the risk of a 'tyranny of the majority.

For a scheme of arrangement to be legally binding, it must be approved by a majority of creditors in both number and value.[141] This requirement means that a small group of creditors holding sufficient voting power may oppose the proposed arrangement and exercise hold-up rights, potentially derailing the restructuring effort. In practice, a scheme can be imposed on dissenting classes of creditors by combining it with a pre-packaged administration. In such cases, the company's business and assets are sold to a new entity owned by the consenting creditors, in exchange for a release of their debt. Meanwhile, the dissenting classes are left behind in an empty shell company, effectively excluded from the value of the restructured business.[142] This type of transaction is functionally equivalent to a debt-for-equity swap. When used in this manner, distressed debt investors have, on

[136] Consultation Paper, May 2016(n48)
[137] Companies Act 2006, Part 26A, s 901A
[138] Companies Act 2006, s 895(1)
[139] *Hawk Insurance Co Ltd* [2001] EWCA Civ 241
[140] Companies Act 2006, s 899(1)
[141] A majority in number representing 75% in value of the creditors or class of creditors or members or class of members, Company Act Section 899.
[142] *Re MyTravel Group* [2004] EWHC 2741 (Ch); Daoning Zhang, *'Insolvency Law and Multinational Groups'*(1st edn, Routledge 2020) 151-152; Jennifer Payne, 'Debt Restructuring in the UK' (2018) 15 European Company and Financial Law Review 449

numerous occasions, circumvented the requisite majority approval rules and effectively forced swap plans upon dissenting classes of unsecured creditors.[143]

Under the new Part 26A restructuring plan procedure, the safeguard requiring approval by the requisite statutory majority of each class no longer applies.[144] The removal of such safeguard plays into the hands of distressed debt investors, as courts can now be asked to sanction a plan over the objections of dissenting classes. This enables a *de facto* cramdown of entire classes without the need to combine the plan with a pre-pack administration, as was previously required.

It is worth noting that, the process for sanctioning a Part 26A restructuring plan is now subject to more rigorous court scrutiny. Courts have shown a readiness to exercise greater oversight on matters of transparency, disclosure, and class composition.[145] However, this heightened level of scrutiny does little to alleviate the above-mentioned concerns, as the concepts of market price and current market value simply result in junior stakeholders being classified as 'out of money' or have no remaining economic interest in the company, rendering them unable to participate in the restructuring process.

Valuation disputes lie at the heart of the Chapter 11 reorganisation process. The premise of reorganisation is that the company's underlying business remains viable and thus has greater value as a going concern than liquidated. This going-concern value cannot be captured through an immediate sale of the entire company when the markets for its assets

[143] See for example the Stemcor case where a scheme of arrangement twinned with administration in which the core business transferred to a new company owned by the distressed debt investorand non-core business along with dissenting creditors were left stranded in an empty shell company. Moorgate Industries Limited, 'Statement of administrator's proposal' Company house, 04 Dec 2015) https://find-and-update.company-information.service.gov.uk/company/01038435/filing-history?page=2 accessed 12/01/2023; Maytaal Angel, 'Britain's Stemcor agrees deal with buyout firm Apollo, other creditors' Reuters (London, 06/07/2015
[144] Companies Act 2006, Part 26A, s 901A
[145] *Re DeepOcean 1 UK Ltd* [2020] EWHC 3549 (Ch); [2021] Bus LR 632

are illiquid or when the timing of sale coincides with an industry-wide recession.[146] To avoid the illiquidity problem, the law allows a 'hypothetical sale' in which new claims (new debt and new equity) on the reorganised company are distributed to old investors in return for the cancellation of their pre-bankruptcy entitlements.[147] During the process, professional valuers are appointed to value the enterprise. Each of the valuation experts puts forward his opinion on value, and the bankruptcy judge ultimately decides between the views expressed.

Valuation disputes can delay the confirmation of a restructuring plan by several months, significantly increasing the associated costs. In an effort to improve their treatment under the proposed plan, unsecured creditors may threaten to employ delay tactics. In essence, they may form a creditors' committee that can hire counsel and advisors[148]—whose fees are often reimbursed by the distressed company as an administrative expense.[149]

Unsecured creditors may employ valuation manipulation and the court may fail to spot this kind of practice. The adverse effect on the value of the assets makes the threat credible in the eyes of senior creditors and accordingly they often accept less than the full value of their claims and provide some distribution to junior classes of creditors to avert confrontation, costs and lengthy delays, even when junior classes have no real voting leverage (out of money).[150] It is safe to suggest that what is written in the law does not entirely correspond to what happens in practice. In other words, the law functions differently from how it appears on paper,

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[146] Kenneth M. Ayotte and Edward R. Morrison, 'Valuation Disputes in Corporate Bankruptcy' (2018)166 University of Pennsylvania Law Review, 1819,1820.
[147] Thomas Jackson, '*The Logic and Limits of Bankruptcy Law'* (Harvard University Press, 1986) 64
[148] 11 U.S.C. § 1102(a)(1)
[149] 11 U.S.C. § 1103(a), (c)
[150] Robert K Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Texas Law Review, 51,60.

The importation of bits and pieces, especially a powerful and unique feature such as the cramdown, out of statute books that work differently in practice may cause unintended consequences. Reports and rankings grounded on statute books may not necessarily reflect the practice in real life. Thus, even if the introduction of the cramdown feature into the corporate insolvency law toolbox improves the UK in the World Bank doing business rankings, it may not necessarily raise the profile of the rescue culture or improve outcomes for preferential and unsecured creditors, it may in fact worsen their positions. The advent of distressed debt investors marked the start of a shift in focus from market-led solutions negotiated by secured creditors and supported by unsecured ones in the shadow of insolvency law, to the more use of formal mechanisms. Unsecured creditors lack the ability to threat the use of valuation fights to extract concessions from secured creditors because the straightforward and quick[151] market price and current market valuation methods usually result in replicable, consistent, and predictable valuations.

6.4 The way forward

Crucially, the level of protection and the power unsecured creditors can exercise hinges on the valuation of the debtor. The problem of the current adopted market testing approach lies in limitations of the auction process currently used to determine the debtor's enterprise value. The 'relevant alternative scenario' approach (i.e. what unsecured creditors would receive in a liquidation of the debtor) is wrong. It deprives unsecured creditors of their fair share in debtor's profit that it would generate in the future while over-compensate distressed debt investors.

The reliance on an expert valuation approach to decide what the company is worth would be more appropriate. Courts should take the future viability and earning capacity (i.e. the

[151] The court is not obliged to delay the auction sale for the hope of getting a better price, *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch

going concern plus) into account of a company that can be saved as a going concern.[152] This in turn will put the junior unsecured creditors 'in the money' and thus, will improve their position and protection as more bargaining power will be conferred on them. The approach would also ensure a greater potential for these creditors to receive distributions. However, strengthening bargaining powers of unsecured creditors may enable them to engage in opportunistic hold-up behaviour, (i.e. opposing or withholding consent to a solution in order to obtain additional benefits or advantages even though the proposed solution would be best overall result for all parties).[153] The use or the threat of use of power by unsecured creditors to extract more value than they are entitled to is a deliberate deviation from the absolute priority rule[154] which is one of insolvency guiding principles.[155]

However, empirical studies undertaken[156] in the context of chapter 11 support the view that fears about strengthening the voting and/or bargaining power of junior claimants or widening the 'circle of cooperation', to include several participants increases the risk of an opportunistic hold-up behaviour and destabilises the already fragile situation are overstated. Contrary to the widespread belief, deviations from absolute priority in favour of junior claimants have occurred much less frequently in Chapter 11 cases.[157]

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[152] Ayotte and Morrison (n146) 1822

[153] Michael Schillig, 'Corporate Insolvency Law in the Twenty-First Century: State Imposed or Market Based?' (2014) 14 Journal of Corporate Law Studies 1,5.

[154] Absolute priority principle denies a class of lower priority creditors a stake in the rescued business, until more senior creditors have been totally satisfied.

[155] Lucian A. Bebchuk, 'A New Approach to Corporate Reorganizations'(1988) 101Harvard Law Review 775,780.

[156] Julian R. Franks and Walter N. Torous, 'An Empirical Investigation of U.S. Firms in Reorganization' (1989)44 Journal of Finance 747,751.

[157] Ibid 751 the authors point out that in the 1980s, deviations of the absolute priority (APR) were in favour of equity holders. At that time, stockholders had a significant influence at the negotiation table largely due to their managerial representatives remaining in control of the company and their exclusive albeit temporary right to formulate a restructuring plan and a classification of all claims to allow the holders of these claims to consider and vote on the plan. However, Bharath, Panchapegesan, and Werner
indicate that In the period 1991–2005 the proportion of cases with APR deviations favoring equity holders has markedly decreased, with the advent of senior secured creditor control over the reorganization process. Sreedhar T. Bharath, Venky Panchapegesan, and Ingrid Werner, 'The Changing Nature of Chapter 1'(2007) Ohio State University, Charles A. Dice Center for Research in Financial Economics, Working Paper 2008-4. While Demiroglu, Franks, and Lewis indicate that in the period 1995 -2013, deviations of the absolute

Chapter Two: Literature Review

2.1 Introduction to the Distressed Debt Market

The origin of distressed investing can be traced back in history to the first century, a time when 'money changers' arbitrage the pricing of Shekel in the Temple Mount.[158] More recently, particularly since the 1930s, investing in distressed debt refers to purchasing the debt of companies in financial distress or already in default. Distressed debt can be also of a company that undergoing informal restructuring or formal bankruptcy.[159]

A company's debt during an insolvency procedure may not seem like an attractive investment, but beneath the distress lies underutilised or overlooked value that existing creditors may have missed. For this reason, distressed debt is illiquid[160] and investing in this form of financing is inherently risky and requires specialised skills. Moreover, returns on distress investing are not tethered to a specific market or the broader economic trends. Instead, the value of distressed debt tends to fluctuate in tandem with the fate of the distressed company, especially in relation to its negotiations with investors. The success or failure of these negotiations becomes a crucial factor in determining the returns on distress investments.[161]

Over the past 20 years, distressed debt investing has become increasingly popular, the face value of distressed debt in the United States experienced a remarkable surge, escalating

priority were in favour senior creditors and other times the junior creditors. Cem Demiroglu, Julian Franks, and Ryan Lewis, 'Do Market Prices Improve the Accuracy of Court Valuations in Chapter 11?' (2022) 77 Journal of Finance 1179,1181.

[158] Jay Krasoff and John O'Neill, 'The Role of Distressed Investing and Hedge Funds in Turnarounds and Buyouts and How This Affects Middle-Market Companies' (2006) 9 The Journal of Private Equity, 17,23.

[159] Joy Flowers Conti, Raymond F Kozlowski Jr and Leonard S Ferleger, 'Claims Trafficking in Chapter 11--Has the Pendulum Swung Too Far' (1992) 9 Bankr Dev J, 281,291

[160]Levitin (n29)74

[161] Mark J. P. Anson, Frank J. Fabozzi, and Frank J. Jones, *'The Handbook of Traditional and Alternative Investment Vehicles: Investment Characteristics and Strategies*'(1st edn, John Wiley & Sons) 432; Rachel Deitch, 'An Argument for Regulating Debt Buyers under the Fair Debt Collection Practices Act' (2018) 25 Geo J on Poverty L & Pol'y 407,409.

from $70 billion in 1998 to a substantial $867 billion in 2007.[162] The number of distressed debt investors has grown correspondingly. The commitment of capital to distressed debt investment strategies witnessed a substantial increase, reaching around $300 billion in 2010. This marked a significant rise from $65 billion in 2003 and a mere $6 billion in 1991.[163] A substantial amount distressed debt is also traded in Europe and in other markets.

> We estimate that there are, today, more than 200 financial institutions investing between $400-450 billion in the distressed debt market in the U.S. and a substantial number and amount operating in Europe and in other markets.[164]

> We estimate that the number of so-called vulture investors has grown to more than 200 in the United States and 100 operating internationally in 2018. Usually, they are now called credit or event-driven strategic investors.

During cyclical downturns the likelihood of defaults and credit problems increases. The recession triggered by the subprime mortgage collapse in 2007 played a pivotal role in expanding the distressed market.[165] Another factor which contributed to this expansion is the private equity boom. There was a notable increase in leveraged buyout transactions led by private equity firms around the world over the last 30 years.[166]In a private equity leveraged buyout (LBO), the firm establishes a company or a group of companies to acquire a target company along with its group entities. The target can be either a privately owned company offered for sale by its current owners or a publicly traded company. The acquisition typically relies on substantial debt, exceeding industry averages, with multiples

[162] Edward I. Altman and Shubin Jha, 'Special Report on the Investment Performance and Market Size of Defaulted Bonds and Bank Loans: 2006 Review and 2007 Outlook' (2008) New York University Working Paper No FIN-03-008

[163] Edward I. Altman, Brooks Brady, Andrea Resti, and Andrea Sironi, 'The Link between Default and Recovery Rates: Theory, Empirical Evidence, and Implications' (2005)78 The Journal of Business 2203,2206.

[164] Edward I. Altman, 'The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations' (2014) 22 American Bankruptcy Institute Law Review 75,80.

[165] Thomas(n33) 220

[166] Paul Gompers, Steven N. Kaplan, and Vladimir Mukharlyamov, 'What do private equity firms say they do?' (2016) 121 Journal of Financial Economics,449,455.

of the target group's earnings. The private equity firm contributes a relatively small amount of equity to fund the transaction. The debt is borrowed by the newly established finance company purchaser, guaranteed, and secured by the assets of the acquired operating subsidiaries. This highly leveraged capital structure, intuitively, contributes to disproportionately high default rates, as it requires substantial cash allocation for interest payments on the significant debt amount.[167] Consequently, a highly leveraged business is more susceptible to the rapid impact of cash flow shocks compared to a business with lower debt.[168] When LBO firms experience failure, they often leave behind substantial amounts of debt. This situation presents an opportunity for distressed debt investors to step in, acquire discounted non-performing loans, remove the previous private equity investors from the equation, and establish their own private equity ownership.[169]

The tremendous growth of syndicated loans has also played a significant role in increasing the depth and liquidity of the distressed debt market.[170] Bank debt is commonly syndicated and participated. In syndication, a group of banks (the syndicate) pools their resources to jointly provide a credit facility to a borrower through a single document. This means that lenders jointly participate in the origination and the lending process. However, the bank with the biggest portion of the loan takes the lead role. Thus, it is charged with the administering the loan (e.g. obtaining the necessary information, collecting loan payments and fees, and monitoring the borrower for the benefit of the creditors as a whole).[171]

In participation, a leading bank originates the loan to a borrower. Subsequently, or concurrently with the origination of this loan, the leading bank sells ownership interests to

[167] Sarah Paterson, 'The Rise of Covenant-lite Lending and Implications for the UK's Corporate Insolvency Law Toolbox'(2019) 39 Oxford Journal of Legal Studies 654,655.
[168] Hotchkiss, Smith, and Strömberg (n130) 700.
[169] Mark J.P. Anson, 'A Primer on Distressed Debt Investing' (2002) 5 The Journal of Private Equity 6,7.
[170] Baird and Rasmussen (n33) 655.
[171] See David Billington, 'Syndicated lending' in Andrew Shutter (ed), *A practitioner's guide to syndicated lending* (Second edn, Sweet & Maxwell 2017) 86

one or more participating banks. While the lead bank retains a partial interest in the loan, it also holds all loan documentation in its name, maintains possession of the original documentation, services the loan, and directly engages with the borrower on behalf of all participating banks. Thus, the borrower may not even be aware that the other participants are involved.[172]

Loan syndications and loan participations allow lenders to expand beyond their traditional sources of revenue, maintain acceptable levels of diversification of their investments, and share development risks and credit risks with respect to particular or complex projects, borrowers or industries.[173]

Loan syndications were typically confined to banks, but pension funds also frequently joined these syndicates, attracted by the prospect of stable returns on their assets. Often, they placed trust in and followed the lead bank's recommendations, finding reassurance in the collaborative approach of syndication as a strategy to fulfil their investment objectives.

Syndications are now structured with an eye toward trading, allowing a syndicate member an exit option by selling its portion of the loan to a willing buyer. As a result, trading of these loans has increased dramatically, and a secondary market has developed in which syndicated interests (assignments or participations) change hands frequently. The composition of this market is no longer limited to banks and pension funds. Banks and pension that face liquidity and regulatory constraints, or do not wish to incur the hassle and expense of waivers and amendments negotiations can sell their portions in the syndicate to distressed debt investors.[174]

[172] Robert O Weink, 'Loan Syndications and Participations: Trends and Tactics' (1993) 9 Com Lending Rev 4,7.
[173] Bradford Anderson, 'Loan Participations and the Borrower's Bankruptcy' (1990) 64 Bankruptcy Law Journal, 39,42.
[174] Baird and Rasmussen (n33) 657

Given the fact that it is an unregulated and an over-counter market, the debt market is informationally inefficient. The market is also segmented. Segmentation occurs when certain investors refrain from investing in the market. Commercial banks, as traditional financiers are credit providing institutions and they face regulatory and liquidity constraints that limit their ability to remain invested in a financially distressed business or involve in the tedious work out process of a bankruptcy situation. Consequently, they tend to dispose their non-performing loans at discount on the secondary debt market. Similarly, mutual and pension funds have an investment mandate in their charters that prohibits them from investing in below investment grade debt. They tend to sell their portion in the syndicated loans when the borrower trips up covenants or files for bankruptcy. When a company becomes distressed, they must sell their bonds regardless their true value, often at a depressed price. The space largely remains the preserve of hedge funds and private equity funds.[175]

2.2. The Participants in the Distressed Debt Market

Similar to any other market, the distressed debt market has its own set of participants, commonly referred to as investors. These investors were originally labelled with derogatory terms like 'vulture investors' and 'locusts'. These nicknames arise from the perception that these investors target distressed companies to extract value, often by disassembling the company and selling its most valuable assets, leaving it unable to continue operations or undergo reorganisation.[176] This implies that there has been intense criticism of these investors in the press and classed as something undesirable by the general public, in a

[175] Konstantinos E. Zachariadis, and Ioan F. Olaru, 'The Impact of Security Trading on Corporate Restructurings' (2017) 21Review of Finance, 667,770.
[176] Hilary Rosenberg, '*The Vulture Investors'* (John Wiley & Sons, 2000) 299

similar way to the classification of corporate raiders in the context of hostile equity-based takeovers.[177]

However, in recent years, there has been a significant shift in attitudes towards these investors. The somewhat derogatory characterisation of these investors has nearly vanished,[178] replaced by much more reputable terms like 'distressed debt investors', 'special situation funds', and 'credit or event driven strategic investors'. [179] This shift is partly due to several studies suggesting that their involvement enhances the overall value of distressed firms, which has, in turn, improved their reputation.[180] Also, the negative effects attributable to these funds may have gone unnoticed due to the decrease of bankruptcy filings experienced in the United States between 2003 and 2007.[181]

The participants in the contemporary distressed debt market encompass a diverse spectrum, including dedicated distressed funds, various non-traditional lenders like alternative investment capital funds, states represented by their sovereign wealth funds and central banks, as well as state-affiliated 'bad banks'.[182] Despite the diversity of investors in this arena, certain entities have been more active than others. This section will concentrate on

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[177] The term refers to the acquisition of a public company against the wishes of its management and board of directors. In this strategy, as the name suggests, the acquirer or bidder approaches the target company's shareholders directly, and after purchasing a majority of the shares, the acquirer will replace the management with a new one which will approve the takeover bid. The management may employ a range of defensive tactics to thwart the unwanted acquisition. The target is often a company with a record of underperformance, and to profit from such an acquisition, the acquirer will take measures such large scale workers layoffs or wages reductions, or disposition of assets. The general public have perceived such strategy as short-term, rent-extraction strategies. Simon Deakin and Giles Slinger, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm'[1997]24 Journal of Law and Society,124,141.

[178] It should be noted that some newspapers still use the description of vulture funds. See for example Kleinman M, "Vulture Fund Hilco Plots Swoop on Ailing Bathstore" sky news (June 21, 2019)

[179] Sarah Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards'(2014) 14 Journal of Corporate Law Studies, 333,336.

[180] Hotchkiss and Mooradian (n34) 405 (finding that "vulture investors add value by disciplining managers of distressed firms")

[181] Thomas(n33) 225

[182] The list of distressed debt investors will include: investment banks, hedge funds, pension funds, private equity funds, mutual funds, specific distressed debt funds, 'bad banks' often backed by the government, central banks, as well as vehicles that issue collateralized debt obligations (CDOs), university endowments, foundations, and sophisticated individual investors.

these particularly active investors. However, a common characteristic among all these participants, albeit to varying degrees, is their primary motivation to maximise profits from their investments in financially distressed businesses. In other words, their investments are fundamentally centred around obtaining returns from the claims they have purchased, either during the restructuring process or at a later stage, such as post-restructuring. Considering the significant role played by hedge funds and private equity firms in distressed debt investing, the analysis below will primarily focus on these entities.

2.2.1. Hedge funds

Hedge fund is a 'loose' term used to describe a wide range of non-traditional investment vehicles.[183] It is notable that there is no commonly accepted definition of hedge funds[184] but what is common is their tendency to employ wide-ranging investment strategies and operate in various markets. With this in mind, experts typically find it convenient to characterise hedge funds according to their specific features. These include, for example, the legal nature which is a type of pooled asset that can be invested in a wide range of securities and derivatives. The pooled vehicle is privately accessible to a limited group of investors, with specific wealth requirements such as a net worth exceeding $1 million or an annual income over $200,000. Such wealth thresholds usually met by sovereign wealth funds, pension funds, family offices, and high net-worth individuals.[185]

The investors are entitled to redeem their investment periodically, though this practice is often restricted by certain contractual provisions. Fund managers are fundamentally skill-based whose interest is aligned with those of the investors through performance-based

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[183] INSOL INTERNATIONAL, ECONOMIC AND GEOGRAPHICAL IMPLICATIONS OF HEDGE FUNDS IN DISTRESSED DEBT 1 INSOL International Technical Series 1 (2007)
[184] Phoebus Athanassiou, '*Research Handbook on Hedge Funds, Private Equity and Alternative Investments*' (Edward Elgar 2012) at 1-12.
[185] Gregory Connor and Mason Woo, 'An Introduction to Hedge Funds' (2004) Financial Markets Group Discussion Paper No 477 https://eprints.lse.ac.uk/24675/ accessed on 08/02/2022

incentive fee (usually 20% of profit commitment of his own money in the fund. Finally, hedge funds are mostly formed as a limited partnership or offshore LLC for the purpose of tax avoidance.[186] While hedge funds have a significant role in capital markets in general, credit-oriented hedge funds have become particularly active in the distressed debt market. They acquire positions in various tranches of the debtor's capital structure and offer the much-needed financing for distressed companies.[187]

In contrast to some other investors who may shy away from troubled companies, distressed-oriented hedge funds take a different stance. Rather than avoiding challenging situations, hedge funds, as outlined by Macey, perceive them as investment opportunities.[188]

Their approach to investing in distressed businesses sets them apart from traditional commercial banks and other regulated financial entities. While traditional lenders are primarily concerned with preserving their investment in the debtor in times of distress, distress investing hedge funds strategically invest in distressed businesses with the intention of generating significant returns. Empirical evidence demonstrates that while bank lenders provide post-petition financing to companies with relatively strong operating performance and temporary liquidity issues, which in turn have a higher *ex ante* likelihood of emergence, hedge funds are more likely to provide such financing to underperforming companies.[189] This could be because poorly performing companies have greater potential for improvement compared to their less distressed counterparts, and investors in these distressed companies stand to gain more from their activism.[190]

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[186] Chi Zhang, 'Securitisation, hedge fund and private equity: the systemic risks in organisational financing'(2020) Journal of International Banking Law and Regulation,123,126.
[187] Lim (n34)1323
[188] Jonathan R. Macey, *'Corporate Governance: Promises Kept, Promises Broken*' (Princeton University Press, 2008) 247
[189] Li and Wang(n87) 124
[190] Ibid 126.

Consistently, empirical work also points to the significant prevalence of hedge funds in distressed businesses. Jiang, Li, and Wang examined a sample of 474 Chapter 11 cases from 1996 to 2007 and found close to 90% of the sample cases had publicly observable involvement of hedge funds.[191] Likewise, Lim's study, examining a sample of 469 financially distressed companies that attempted to restructure their debt between 2001 and 2011 out of court, in conventional Chapter 11, and via pre-packaged bankruptcy, found the active involvement of hedge funds along with distressed investing private equity firms in 297 of the financial distress events (63% of the sample).[192] Using survey responses from 82 distressed debt investors, Harner found that 35 (44.9%) of the respondents identified themselves as hedge funds. This suggests that distressed investing has become an important avenue for hedge fund activism.[193]

This is unsurprising for several reasons; hedge funds enjoy considerable flexibility in the complex financial instruments they can hold and the wide range of investments they can pursue. Hedge funds are subject to relatively few regulatory, public scrutiny, or reporting requirements,[194] and they are typically open to a limited range of 'accredited' investors.[195] Moreover, unlike traditional fund managers and individual investors, hedge funds are not constrained by mandates, risk limits, transaction costs, leverage restrictions or insufficient technological knowhow when choose trading strategies.[196]Therefore, given this flexibility and freedom, they may hold highly concentrated and illiquid positions that may be restricted or seem to be too costly for other types of investors.

191 Jiang, Li and Wang(n34) 178
192 Lim (n34)1327
193 Harner (n28) 88
194 Only restrictions on the marketing of hedge funds domiciled in the UK, the Financial Services and Markets Act 2000 (FSMA)
195 Marcel Kahan, and Edward B Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) University of Pennsylvania Law Review, 1021,1023.
196 On more on the discretion and the great deal of flexibility which hedge fund managers have, see Rene´ M. Stulz, 'Hedge Funds: Past, Present, and Future'(2007) 21 Journal of Economic Perspectives.175, 177

Simultaneously, they are able to strengthen their influence at the negotiation table. Hotchkiss and Mooradian argue that distress-oriented hedge funds have the ability to exert influence during reorganisation negotiations and manipulate the allocation of control rights to their advantage.[197] To achieve this end, Gietzmann, IsidroI and Raonic argue that they opportunistically exert influence over the valuation process in a way that strengthens their control rights over the target company upon its exit from bankruptcy.[198] Hedge funds may also include a series of financial covenants within the post-petition financing agreement to assert control over the insolvency process.[199]

In addition to their investment flexibility, hedge fund managers have a sufficiently strong economic incentive to generate abnormal returns. It is understood that hedge fund managers commit their own money to the fund and receive a management fee of around 1% to 2% of the fund's net asset value annually, and they also receive a performance-based fee of approximately 20% of the fund's annualized returns. High water marks are sometimes included in the calculation of incentive fees.[200] A high-water mark is an absolute minimum level of performance over the life of an investment that must be reached before incentive fees are paid.[201] The flexibility, secrecy, combined with this aggressive incentive compensatory structure provide hedge fund managers with strong monetary incentives and increase their risk appetite to pursue distressed investment strategies, as long as doing so will achieve attractive profit.

Hedge funds have emerged as the most prominent participants in the distressed debt market, and their active involvement is now evident. However, they are not the sole investors in this

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197 Hotchkiss and Mooradian (n34) 405
198 Miles Gietzmann, Helena Isidro, and Ivana Raonic, 'Vulture Funds and the Fresh Start Accounting Value of Firms Emerging from Bankruptcy' (2018) 45 Journal of Business Finance & Accounting, 410,414.
199 Li and Wang(n87) 125.
200 Mark C. Hutchinson, Quang Minh Nhi Nguyen, and Mark Mulcahy, 'Private hedge fund firms' incentives and performance: Evidence from audited filings' (2022) 28 The European Journal of Finance, 291, 292.
201 Connor and Woo(n188)

space. Other activist investors are taking on a more prominent role, actively engaging and participating in the distressed market alongside hedge funds.

2.2.2. Private Equity Firms

Private Equity (PE) refers to a form of investment in which investors and funds inject capital directly into private portfolio companies that are not listed on a stock exchange. The objective is to foster positive economic development and partake in the cash flow growth generated by their portfolio companies.[202] Active ownership is a distinct characteristic of these types of structures. This means that the acquiring PE sponsor engages in the governance, operational, and financial affairs of the portfolio companies.[203] This involvement enables the sponsor to exercise a high level of control and implement a range of incentives designed to motivate management teams to create value—ultimately for the sponsor's benefit. The involvement of owners/sponsor in this way gives the acquired portfolio companies more credibility and raises the value of the portfolio companies.[204]

The two main categories of private equity funds are buyout funds (BO) and venture capital funds (VC). The former involves acquisitions of shares in an established company either in public company takeovers or through auctions or private purchases. While the latter are those funds which co-invest with the entrepreneur in a company at an early stage or in a company seeking to expand.[205] This means that private equity funds invest across different industries and in companies covering the entire spectrum from startups to mature businesses.

[202] Joseph A. McCahery and Erik P.M. Vermeulen, *'Corporate Governance of Non-Listed Companies'*(Oxford University Press,2010)214
[203] Young Soo Jang and Simon Mayer, 'Capital Structure in Private Equity' In Douglas Cumming, Benjamin Hammer (ed) *The Palgrave Encyclopedia of Private Equity* (Palgrave Macmillan Cham,2024) 142
[204] Jonathan Blake and Ajay Pathak, 'Private Equity Fund Structuring'(2007)19 Student Bar Review,1,5.
[205] Steven N. Kaplan and Per Strömberg, 'Leveraged Buyouts and Private Equity' (2009) 23 Journal of Economic Perspectives, 121,130.

The most common organisational structure of private equity funds is the limited partnership, in which the managers of the PE company serve as general partners (GPs) and raise outside funding from a set of limited partners(LPS).[206] The LPs consist of institutional investors, families, or individuals with substantial financial resources who commit capital to the fund but do not participate in its day-to-day activities, instead relying on the GPs to generate a satisfactory return on their investment.[207]

The relationship between the GPs and the LPs may give rise to a principal-agent problem,[208] as the LPs might be either unwilling or unable to access and verify information with respect to the GPs' capabilities and behaviour. The ultimate performance of a fund only becomes clear at the end of its planned lifetime, once all investments have been exited and the cash is returned to investors. Therefore, current and prospective investors face difficulties in assessing the expected performance of a fund to decide whether or not to provide future funding. As agents, GPs may be inclined toward opportunistic behaviour in an effort to influence LPs' perceptions, exaggerate fund performance, and enhance their prospects for future fundraising.[209] LPs may employ various mechanisms to align their interests with those of the GPs, including high compensation packages, a limited life cycle for the private equity fund, restrictive covenants in the partnership agreement, and, in extreme cases, early

[206] William A. Sahlman, 'The Structure and Governance of Venture-Capital Organizations' (1990) 27 Journal of Financial Economics,473,480.
[207] Vijay Mehta, 'Principal-Agent Issues in Private Equity and Venture Capital' (2004) Wharton Research Scholars Journal,3 ,8.
[208] Managers are appointed to act for the firm in the interests of shareholders. However, managers may exercise decision-making authority delegated to them in pursuing private objectives at the expense of the shareholders. To avoid the unbeneficial consequences of the misalignment of director and shareholder interests, shareholders often put in place a system aimed at maximising the incentives of the managers towards maximising shareholder wealth. Devising a mechanism to ensure the alignment of director and shareholder interests creates what is referred to as agency costs. Jensen and Meckling (n17) 305
[209] Miguel Meuleman and others, 'When the Going Gets Tough: Private Equity Firms' Role as Agents and the Resolution of Financial Distress in Buyouts' (2020) 60 Journal of Small Business Management 513,515.

termination and liquidation of the fund. However, even with these mechanisms in place, information asymmetry can still lead to suboptimal investment outcomes.[210]

Historically, private equity firms pursued value-creation primarily through investing in the equity (or equity related securities) of non-distressed privately held companies. Their attention was not originally focused on distressed businesses.[211] The great reluctance rested on the belief that the investment in distressed businesses consumes a lot of time and resources due to the fact that there is no standard model for risky distressed debt investing as each distressed situation requires a unique approach and solution. However, private equity managers were also less confident of their expertise to pursue such high-risk business strategies.[212] With this in mind, it made sense to leave these strategies to those with the necessary expertise, risk tolerance, and appetite. Furthermore, there were investors focused on distressed funds and the sponsorship of these funds were different from those on which private equity firms relied for their own sponsorship.

The generic term of private equity now encompasses mezzanine debt financing and distressed debt investing. The new focus on distressed debt investing is not unconnected to the distressed debt opportunities that followed the explosion of the global financial crisis in 2007-08.[213] Prior to 2008, companies with substantial debt portfolios had the advantage of accessing a more cost-effective and readily available source of capital for refinancing their debts. However, as the financial crisis unfolded, the strain on the financial market disrupted its ability to accurately price assets. This shift in dynamics made it challenging for

[210] Sridhar Arcot and others, 'Fund Managers under Pressure: Rationale and Determinants of Secondary Buyouts' (2015) 115 Journal of Financial Economics, 102,110.
[211] McCahery and Vermeulen (n202) 181.
[212] Stephanie Breslow and Schwartz Phyllis, *'Private Equity Funds: Formation and Operation'* (2nd edn ,Practising Law Institute) S,1,4,6
[213] Sabrina Willmer, 'Oaktree Activates Distressed-Debt Fund Amid Market Turmoil' WSJ Pro Bankruptcy (New York City,16/Aug/2011) (https://www.proquest.com/scholarly-journals/oaktree-activates-distressed-debt-fund-amid/docview/883325643/se-2).

companies to continue relying on the previously accessible and affordable capital sources. This, in turns, creates illiquidity, and to survive the illiquidity, the businesses resorted to private capital injection. Private equity firms, which the crisis has restricted their ability to raise funding for takeovers, took advantage of the distressed sale value at which the businesses and their securities were being offered.[214] Evidently their capacity to participate in the market for distressed debt is informed by the control it gives them to effect strategies aimed at maximising profits for their investors.[215]

Howard and Hedger identify private equity funds as one of the main participants in the distressed debt market.[216] The new interest in distressed debt investing became clear in an empirical study undertaken by Harner who shows that 42.3% of distressed debt investors in his survey study identify themselves as private equity firms.[217] Lim included distressed investing private equity firms in his sample of distressed investing hedge funds, reasoning that big asset management firms often run both private equity funds and hedge funds and found their active involvement in 297 of the financial distress events (63% of the sample).[218] Li and Wang identify activist investors in the DIP financing market as hedge funds and private equity funds. Both types of funds target poorly performing companies. The weak operating performance and the pressing cash flow demands enable activist investors to exert control over the target company, the direction of the insolvency process and increase the likelihood of a smooth debt for equity conversion.[219]

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[214] Anousha Sakoui, 'Private equity funds focus on distressed debt' (2008) FT.com (Aug 12), https://www.proquest.com/trade-journals/private-equity-funds-focus-on-distressed-debt/docview/229103768/se-2

[215] Stephen G. Moyer, David Martin, John Martin, "A Primer on Distressed Investing: Buying Companies by Acquiring Their Debt" (2012) 24 Journal of Applied Corporate Finance 59. Authors argue that prominent private equity firms that originally focused on classic private equity in-vestments are also now active in the distressed investing market such as Apollo, Carlyle, and Platinum.

[216] Chris Howard and Bob Hedger, '*Restructuring Law & Practice*' (1st edn, LexisNexis Butterworths, 2008) sections 6.1–6.3

[217] Harner (n28) 97.

[218] Lim (n34)1325.

[219] Li and Wang(n87) 128.

2.2.3. Other Institutional Investors

Although pension funds and other institutional investors are visibly active in the distressed debt market, they are best described as passive investors. Their strategy involves periodically trading distressed securities to capitalise on pricing disparities, without directly influencing the company's operations or participating in the bankruptcy process.[220]

Even when these investors remain active in the bankruptcy process, their activism is likely to be more incidental or indirectly through hedge funds or other distressed debt funds. This should be contrasted to the more frequent and intentional hedge fund and private equity fund activism.[221] A number of identifiable factors account for this. The existence of regulatory constraints and structural barriers which discourage risk taking at the individual security level, the nature of the funds, as well as the nature of distressed debt limit their ability to directly participate in distress investing.[222] For instance, in the US, mutual funds and pension funds are required by law to maintain diversified and prudent portfolios and not to hold large stakes in individual companies. Pension funds, in particular, are subject to heightened fiduciary standards and extensive state controls,[223] which significantly limit their flexibility in trading. Distressed debt is quite illiquid and realisation on it could take several years. Similarly, mutual funds have limited capacity to invest in illiquid and especially nontraded securities due to their need to maintain an open-ended structure.[224] Finally, none of these funds pay their professionals incentive fees similar to those paid by hedge funds.

[220] Chaim J Fortgang and Thomas Moers Mayer, 'Developments in Trading Claims and Taking Control of Corporations in Chapter 11' (1991) 13 Cardozo L Rev 1,18.
[221] Harner (n28) 101
[222] Gietzmann, Isidro, and Raonic (n198) 415
[223] For example, the Employee Retirement Income Security Act of 1974 (ERISA) and the SEC's Investment Company Act 1940
[224] Jiang, Li and Wang(n34) 185.

States also invest in distressed debt, albeit to a lesser extent. Sovereign wealth funds, in particular, make opportunistic investments largely in distressed companies. They typically possess both the resources and flexibility to engage in different forms of loan-to-own transactions.[225]

Although traditional banks are primarily in the business of providing loans rather than managing tedious bankruptcy situations, some have established proprietary trading desks to participate in distress investing. However, regulatory interventions introduced after the 2008 financial crisis—aimed at preventing systemic risks—have significantly impacted their ability to engage in such activities.[226] In most cases, therefore, it is likely to find most distressed debt funds structured as either hedge funds or private equity firms.

Now that the participants in the distressed debt market have been identified, an understanding of their strategies in engaging with distressed debt investors is appropriate. This is because their strategies underscore their value creation (or destruction) in a distressed business.

2.3. Strategies of Distressed Debt Investors to Exert Influence

Distressed debt investors may adopt different investment strategies. Essentially, the desired strategy is a reflection of the goals of the distressed debt investor. In turn, these goals also influence their classification into categories (namely, passive and active investors). Passive investors who buy a portion of the debt of the distressed business at a deep discount, with the expectation of capturing a spread between the purchase price of the claim and the

[225] "Troubled Indian Group Nears Sale of Top London Hotel to Qatar" Arabian Business (February 3, 2016) <https://www.arabianbusiness.com/industries/travel-hospitality/troubled-indian-group-nears-sale-of-top-london-hotel-qatar-620586&gt

[226] Some investment banks (e.g. Goldman Sachs) closed down their proprietary trading desk, others (e.g. JPMorgan Chase) had plans to spin off their proprietary desks. See Ben Protess, Banks Face Obstacles with Volcker Rule, Report Finds NY TIMES (DEAL BOOK), Aug. 5, 2011. <https://dealbook.nytimes.com/2011/08/05/banks-face-obstacles-with-volcker-rule-report-finds/>

ultimate pay-out at the maturity of the debt.[227] Passive investors may also sell the debt for a profit shortly after its purchase, but before maturity or redemption.[228] One inference which can be made is that these investors typically have short-term investment horizons without any direct influence on the insolvency process.

Others with long-term investment horizons seek to make a profit after facilitating the creation of a recovery strategy in which the debt overhang problem is reduced through a debt-for-equity swap and the company's or business' operations are maintained or fixed to ensure that the company is rescued before selling or floating it. This strategy is a characteristic of active investors.[229] However, the investor generally will want to accumulate a control position that grant dominant power in the insolvency negotiations. This can only be achieved by amassing a concentrated position in the capital structure, typically the 'fulcrum' claims, or by injecting the most needed fresh capital (either debt or equity).[230]

2.3.1. Purchasing Existing Debt Claims

Investors in distressed debt usually trade in to reach the 'fulcrum' position. The fulcrum is the point in the company's capital structure at which the value of the company's assets at emergence from insolvency first fails to pay the outstanding claims in full.[231] Fulcrum creditors hold the greatest voting power in a reorganisation plan. This is because the most senior, unimpaired creditors are paid in full and are therefore deemed to have accepted the plan without needing to vote.[232] In contrast, fulcrum creditors—who are only partially repaid—typically hold a presumptive right to the equity of the newly reorganised company.

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227 Levitin (n29) 80
228 Harner (n28) 709.
229 Altman(n167); Harner(n28) 710
230 Mark S. Lichtenstein and Matthew W. Cheney, 'Riding the Fulcrum Seesaw: How Hedge Funds Will Change the Dynamics of Future Bankruptcies' (2008) 14 New Jersey Law Journal,191,102.
231 Karl Clowry, 'Debt-to-Equity Conversion in the UK and Europe' (2010) 7 Eur Company L,51,56
232 11 USC1126

Any claims junior to the fulcrum will receive no interest in the new company and are thus presumed to reject the plan, making their votes less critical. Therefore, the vote of the fulcrum creditors becomes the only one that truly matters.[233]

However, identifying the fulcrum point is not a straightforward process. Part of the complexity arises from the fact that, when a debtor has sufficient collateral to refinance or reinstate all of its secured debt, the fulcrum security is likely to fall within the unsecured debt. Conversely, if the debtor can repay or reinstate its first-lien secured lenders but not those holding junior secured claims, the fulcrum security may lie within the second- or even third-lien secured debt.[234] In situations where a debtor is solvent, prepetition equity interests are the fulcrum security.[235]

This means that for the identification of the fulcrum security, the valuation of assets is critical. The valuation may vary depending on assumptions, methodologies, and future business models. The contrast between estimates can be quite astonishing, as illustrated by valuations of artworks from a prominent auction house compared to the actual sale prices at auction. This serves as a stark example of the challenges in providing accurate valuations for assets that lack an established market price.[236] Factors such as market conditions, timing of the sale, and the pool of potential buyers all contribute to the uncertainty of arriving at a definitive figure. When the legal framework does not clearly specify whether the valuation should be based on a 'going concern' or a 'break-up' sale, assessing the value of the assets in question becomes particularly challenging.[237]

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[233] Moyer, Martin, Martin, (n215)61.
[234] Harner (n103) 159.
[235] Paul M Goldschmid, 'More Phoenix than Vulture: The Case for Distressed debt investor Presence in the Bankruptcy Reorganization Process' (2005) 2005 Colum Bus L Rev,191, 199.
[236] Robert J. Stark, Jack F. Williams, and Anders J. Maxwell, 'Market Evidence, Expert Opinion, and the Adjudicated Value of Distressed Businesses'(2013) 68 The Business Lawyer,1039,1040.
[237] Vanessa Finch, '*Corporate Insolvency Law: Perspectives and Principles'* (Cambridge University Press, 2002) at 123; Payne (n51)142 ''The approach of the English courts to the issue of valuation is still in its infancy''

More importantly, as the target company is moving through the negotiation phases and reorganisation process, its performance and earnings are subject to fluctuation. Additionally, shifts in the market for its assets, overall business environment, and industry conditions can all affect the company's valuation.[238] As a result, the fulcrum security may correspondingly change during the reorganisation process.

In the same vein, predicting the ultimate size of a company's liabilities involves a considerable degree of uncertainty. In the UK, for instance, the term 'liability'[239] has been broadly interpreted to include existing and future, as well as contingent and non-contingent, claims.[240] This broad definition, coupled with the difficulty in determining the value of certain liabilities—particularly unquantified existing obligations and contingent claims[241]—complicates the assessment. The final size of liabilities can also be influenced by the debtor's broad powers to reject executory contracts[242] and by the emergence of previously unknown claims, such as environmental[243] or tort liabilities.[244]

Notwithstanding that the results of empirical studies that occurred outside the UK point to the popularity of the unsecured debt to accumulate the 'fulcrum' security. Jiang, Li and

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[238] Wachtell, Lipton, Rosen & Katz, Distressed Mergers and Acquisitions (Wachtell, Lipton, Rosen & Katz 2009)

[239] The term "liabilities" is defined for the purposes of winding up in r 13.12(4) of the Insolvency Rules 1986. Rule 12.12(4) which states that it is immaterial whether the liability is present or future, whether it is certain or contingent, or whether the amount is fixed or liquidated, or is being capable of being ascertained by fixed rules or as a matter of opinion. And also Pursuant to r.14.1(6) Insolvency Rules 2016 ('IR 2016') to include any liability under an enactment, any liability for breach of trust, any liability in contract, tort or bailment, and any liability arising out of an obligation to make restitution'. and according to r.14.1(5) IR 2016, it is immaterial whether the liability is present or future, certain or contingent, fixed, liquidated or subject to determination.

[240] Roy Goode, '*Principles of Corporate Insolvency Law'* (4th edn, Sweet &Maxwell, 2011) at 134-137

[241] Alice Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997) 40

[242] Harvey R Miller and Shai Y Waisman, "Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?" (2004) 78 Am Bankr L J 153, 160.

[243] Such environmental liabilities arose in *Doonin Plant Limited*, the environmental clean-up costs for hazardous wastes deposited by the company without appropriate permits was also categorised as an expense of liquidation and therefore prioritised over the satisfaction of creditors' claims. In *Re Doonin Plant Limited* [2018] ScotCS CSOH 89

[244] For example, 425 new lawsuits filed every month against Johns Manville Corp by victims exposed at worksites to asbestos. Frank R. Kennedy, 'Creative Bankruptcy--Use and Abuse of the Bankruptcy Law-Reflection on Some Recent Cases' (1985) 71 Iowa L Rev 199,202.

Wang found that the distressed debt investors owned about 40% of the unsecured debt claims across the 474 cases proxied by their presence on the unsecured committee.[245] Lim similarly found that distressed debt investors accumulate control positions by purchasing unsecured claims in 187 cases (40% of the sample in contrast to the preference for secured claims that found in 103 cases (22% of the sample).[246] There are likely two reasons for this. First, unsecured debt enjoys a lot of option-like payoffs. Second, the value of the unsecured debt is sensitive to the action of distressed debt investors.[247]

If investor's valuation analysis is not accurate, a different debt class of creditors may hold the fulcrum security. However, previous studies have evidenced the role played by distressed debt investors in exercising significant influence over the valuation process of court-supervised bankruptcies to shift control rights in their favor. Gietzmann, Isidro, and Raonic have evidenced that when distressed debt investors acquire debt claims of relatively low seniority in the capital structure of the distressed firm, they negotiate for higher fresh-start valuations.[248] This strategy helps ensure their claims are only partially impaired—rather than fully—allowing them to become the new owners of the reorganised firm upon its exit from bankruptcy. In contrast, when distressed debt investors acquire debt claims of relatively high seniority, they tend to prefer lower fresh-start valuations. This approach minimises the recovery for lower-priority creditors, who receive little or no equity in the reorganised firm, thereby increasing the distressed debt investor's share of ownership.[249]

In addition to influencing the reorganisation valuations to shift control rights in their favour, distressed debt investors may identify and purchase the distressed company's fulcrum

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[245] Jiang, Li and Wang(n34) 180.
[246] Lim (n34)1323
[247] Jiang, Li and Wang(n34) 181.
[248] A mechanism under US chapter 11 which require, firms emerging from Chapter 11 to estimate and report the fair values of assets and liabilities of the reorganized entity.
[249] Gietzmann, Isidro, and Raonic(n198) 415

security shortly before the claimants vote on the reorganisation plan. Ivashina , Iverson , and Smith examined a sample of 136 large debtor firms that filed for bankruptcy protection between 1998 and 2009 and found that distressed debt investors own a relatively small portion of the debt claims of a bankrupt company (total of 7.1%) at the beginning of the bankruptcy case.[250] However, by the time that claimants vote on a bankrupt company's plan of reorganisation, distressed debt investors double their representation in the company's capital structure to consolidate control and/or blocking positions that improve their bargaining leverage over the insolvency process.[251] This makes sense as confirmation of a plan of reorganisation through Chapter 11 process depends on favourable votes by creditors holding 'two-thirds in amount and more than one-half in number of the impaired class'.[252]Accordingly, distressed debt investors seeking to gain control of the reorganised company upon exit from insolvency will need to buy claims equal to one-third in amount of the creditor class.

However, it is worth mentioning that in sheer contrast with Ivashina, Iverson, and Smith's findings, Ellias examined a sample of 506 traded bonds claims issued by 204 large firms that filed for bankruptcy in the US between 2002 and 2012 and found that investors generally enter the bankruptcy early in the process and do not largely change over the course of the Chapter 11 case. The same investors continue to hold largely the same amount of debt throughout the case.[253] One explanation for this sharp contradiction is that the study by Iverson and Smith was based on a sample of traded corporate loans originally provided by non-financial corporations and banks. In contrast, Ellias's study focused on bonds, which benefit from a well-established trading infrastructure and tend to be more liquid, often held

[250] Ibid 411
[251] Ibid 411
[252] 11 USC, s1126
[253] Ellias(n110) 775

by sophisticated investors even before the firm becomes financially distressed. The existing group's investor sophistication and company-specific knowledge may also independently discourage the entry of new investors.

Distressed debt investors may accumulate claims other than just the fulcrum security, as they remain highly attentive to the possibility of having a reorganisation plan confirmed through a cramdown.[254] Cramdown is a powerful and unique feature of the US Bankruptcy Code[255] that enables the court to confirm a reorganisation plan even though a dissenting'impaired' minority' class of creditors has voted against— provided the plan meets the 'fair and equitable' standards and does not unfairly discriminate against the dissenting class.[256] This means that the plan can still be implemented despite the objections of distressed debt investors. Therefore, to strengthen their influence over the process, it can be advantageous for these investors to hold significant positions in other creditor classes in addition to the class holding the fulcrum security. They may also assemble together multiple positions to 'hedge' their exposure. An investor may hold both senior debt and junior debt in order to mitigate the effects of a decrease in the in troubled company's value. If the company's worth increases, both investments yield returns.[257]

2.3.2. Providing New Capital

In general terms, businesses in a healthy state may finance their operations through a variety of options. Broadly speaking, there are three types corporate financing strategies, retained earnings, equity, and debt. [258] In other words, financing may be obtained in any of these

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[254] 11 USC, s1129 (b) (1)
[255] The enforceability of the plan through the cram down mechanism is also possible in the UK. *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch)
[256] 11 USC s1129 (b) (1), (2) Unfair discrimination test ensures that creditors of the same priority level receive similar treatment. While, the "fair and equitable" test ensures that priorities are preserved among the different types of claims and interests.
[257] Lipson (n111)1612.
[258] Eric A Chiappinelli, *'Cases and Materials on Business Entities'* (Aspen Publishers,2006) 152

ways, or a combination of them.[259] Given that the financing options available to a company are dependent on being in a healthy state, it is likely that financial distress would lead to the expansion of the financing options or the possible exclusion of particular options of financing. As for the use of internally retained earnings, it will usually be preferred as a form of financing over external sources for healthy businesses.[260] However, this is not always possible, especially as the business slides into financial hardship (becoming over-indebted or illiquid) and struggles to generate sufficient internal funds through retained earnings while attempting to meet its current cash obligations. As a result, the business will likely need to seek new sources of financing to replace retained earnings.[261]

New financing may be obtained by the way of infusion of new equity or other form of debt instrument (e.g. loans or bonds). Businesses may be more inclined to finance themselves through equity. Equity financing can be sourced either externally or internally, as businesses have the right to issue new equity. This newly issued equity may be purchased by existing shareholders or by entirely new investors. There are several reasons why issuing equity may be beneficial for distressed businesses seeking to finance their operations. In addition to providing much-needed capital, equity financing can help reduce the company's debt burden, thereby increasing the likelihood of avoiding liquidation and enabling the business to continue trading.

Unlike debt, new equity does not incur interest payments, meaning the company is not obligated to make periodic repayments. As a result, equity enters the capital structure without adding further financial strain. Particularly in distressed situations, the interest rate

[259] Louise Gullifer and Jennifer Payne, '*Corporate Finance Law Principles and Policy*' (2nd edn, Hart, 2015) 59

[260] Robert Watson and Nick Wilson, 'Small and Medium Size Enterprise Financing: A Note on Some of the Empirical Implications of a Pecking Order' (2002) 29 Journal of Business Finance & Accounting, 557. showing that for SMEs in the UK, retained earnings may be the most preferred source of financing, followed by debt, and then new shares to outsiders).

[261] Ibid 558

on debt is typically high to reflect the lending risk, which can increase the borrower's susceptibility to bankruptcy.

Distressed business may decide to shelve payment of dividend, unlike in the case of debt where the failure to keep up with payment schedule may trigger bankruptcy proceedings.[262] New financing provided with optimism on the part of the shareholder at the time of distress increases the likelihood of a successful restructuring.[263] Evidently, from a managerial point of view, there is no need to waste resources on eliminating the shareholder creditor-agency problem.[264]

The third option for businesses is to finance their operations through debt. Companies may prefer to rely on credit[265] when the cost of borrowing is lower than the cost of raising capital through equity.[266] A highly influential select committee known as The Cork Committee, which laid down the foundations for the UK insolvency framework, described credit as 'the lifeblood of the modern industrialised economy'.[267] Credit, in general, enables enterprises to optimise capital allocation and make wealth-maximising decisions. The prominent role played by creditors in enhancing the performance of corporate managers is well established.[268] The risk of default imposes discipline on managers,[269] which in turn boosts

[262] Lemma W Senbet and Tracy Yue Wan, 'Corporate Financial Distress and Bankruptcy: A Survey' (2010) 5 Foundations and Trends in Finance 4 (noting that an all-equity firm can be economically distressed, but can never be financially distressed because there are no creditors involved)
[263] Martin Gelter, 'The subordination of Shareholder Loans in Bankruptcy'(2006) 26 International Review of Law and Economics,478.
[264] Sarah Paterson, 'The Paradox of Alignment: Agency Problems and Debt Restructuring"[2016] 17 European Business Organization Law Review, 497,503 (noting that excessively risky behaviour on the part of shareholders may impose costs on the company and its creditors if it is not eliminated)
[265] A broad definition of debt which includes money, goods or services, be it a loan of cash or extension of timelines for repayment.
[266] Saul Levmore, 'Monitors and Free Riders in Commercial and Corporate Settings' (1982) 92 Yale Law Journal,49,51.
[267] Insolvency Law and Practice: Report of the Review Committee (Cmnd 8558,1982) (Cork Report).
[268] Armour and Frisby (n18)78
[269] Patrick Bolton and David S. Scharfstein, 'Optimal Debt Structure and the Number of Creditors' (1996) 104 Journal of Political Economy 1,3.

the competitiveness of the enterprise sector and supports the continued provision of credit.[270] Therefore, it would be impossible to imagine the world without credit.[271]

Commercial banks have historically played a leading role in providing debt financing, particularly in the UK. Banking has been a virtual oligopoly for a long time. Evidently, a few powerful deposit-taking or 'clearing' banks dominate the market and provide the vast bulk of finance in the economy.[272]

Banks may be inclined to keep existing lines of credit open when their borrowers become distressed for various reasons. In cases where a bank has unsecured exposure, it may offer new financing with the intention that the collateral securing the new loan will also cover the outstanding balance of the original, unsecured loan. Similarly, as a strategic move, a bank seeking to maintain its priority position may provide new financing to prevent a new lender's claim from ranking ahead of its pre-distress claim, thereby protecting its position from being undermined. Banks are also mindful of the reputational risks associated with a corporate collapse. As such, they may choose to provide new financing to support the restructuring of a distressed debtor, aiming to protect their reputation and demonstrate a commitment to responsible lending practices.[273]

From the perspective of distressed businesses, the bank with which they have an existing financing relationship is often their first option for refinancing. The existing relationship will usually mean the bank is in possession of more timely information about the debtor's business than other outsiders.[274] Therefore, the bank is in a better position to assess the

[270] IMF (1999), '2 - General Objectives and Features of Insolvency Procedures' pg.3
[271] Goode (n240) 2
[272] Paterson (n179) 337.
[273] Payne and Sarra(n69)184.
[274] The argument made by John Armour and Sandra Frisby who state that the bank has invested in information gathering about the debtor's business and in better position to take decisions objectively on whether or not to put the company into formal proceedings, Armour and Frisby(n18) 79

financing requirements of the distressed business.[275]It is often the case that new financing is needed on urgent basis to ensure continuity of the business and it will be time-consuming to source credit from new lenders.[276] Even where a new source exists, it is likely to be on shorter maturity and higher interest rates basis.[277] Banks are considered to be better equipped with business support units (BSU) whose distinct objective is to speedily renegotiate rescue strategies and curtail the further deterioration of the distressed business.[278]

However, the bank may provide financing to businesses with no prior lending relationship. The reasoning behind doing so is that new financing can be provided with a security interest on unencumbered assets or as a second claim on security interest on already encumbered assets where the value of the encumbered asset is sufficiently more than the amount of the pre-existing secured obligation.[279] Furthermore, lending to a distressed but viable business with manageable credit risks—especially one that successfully overcomes its financial difficulties—can result in a valuable long-term customer for the bank. To manage the associated risks, banks may choose to finance such businesses through loan syndication with other lenders, thereby achieving greater diversification and spreading the risk across multiple parties.[280]

However, the reality remains that banks may choose to refrain from providing financing to, or maintaining financial exposure in, distressed businesses. This may be attributable to

[275] Frisby (n14) (noting that in one case the clearing bank who are probably at the forefront of restructuring and trying to work things through, even to the point of putting more money in to sort the problem out"
[276] Bruce Henoch, 'Postpetition Financing: Is there life after Debt?'(1991) 8 BKRDEVJ 575,580.
[277] Douglas G. Baird, Barry E. Adler, and Thomas H. Jackson, *'Cases, Problems, and Materials on Bankruptcy*' (4th edn, Foundation Press,2007) 479
[278] Franks and Sussman (n10) 69
[279] Payne and Sarra (n69)182
[280] A.Foglia, S.Laviola, and P.Marullo Reedtz, 'Multiple banking relationships and the fragility of corporate borrowers' (1998) 22Journal of Banking & Finance,1441, 1450.

several reasons, chief among them being regulatory constraints. [281] These constraints include supervisory requirements imposed on banks to enhance depositor confidence and ensure that deposits are not used to fund risky ventures or activities with low probabilities of success.[282] Consequently, in the face of such lending constraints, banks may be disposed to invest in safe government securities instead of throwing good money after bad.[283] Moreover, the development of new and more sophisticated finance transactions like securitisations, combined with the explosion of the volume of credit derivatives resulted in reduction of the monitoring capacity of banks and their willingness to provide new financing when their borrowers are distressed.[284] The use of products like CDO, TRS and CDS as a protection in the event of borrowers' 'default, insolvency, or restructuring' enabled bank lenders to mitigate their exposure by transferring credit risk to another party.[285] In this sense, a bank that has protected itself against the possible default of the debtor may very well care less about the fate of the debtor and its business. In this case, new lending to protect its prior exposure may be unnecessary. Finally, the absence of free assets over which security interest may be created might disincentivise the already hesitant bank to provide financing to distressed businesses.[286] All these factors, it could be argued, reduced the extent of the banks' involvement with the healthy businesses and to a greater degree with distressed businesses. However, these factors have also given pace to the emergence of the distressed debt market as a source of distressed financing and broadened

[281] Ian Bell and Petrina Dawson, 'Synthetic Securitization: Use of Derivative Technology for Credit Transfer' (2002)12 Duke Journal of Comparative and International Law, 541, 545.
[282] The loss of confidence in one of depository institution can easily spread to other financial institutions and cause irreversible recessions, credit crunches, and financial crises on a large scale.
[283] For more on how regulations such those contained in Basel III and other localized regulations such as the Dodd Frank/Volker Rule are drying up traditional sources of credit see, Michael C. Jensen, "Corporate Control and the Politics of Finance" [1991] 4 Journal of Applied Corporate Finance,13.22.
[284] See generally Michael Lewis, '*Flash Boys – A Wall Street Revolt'* (W. W. Norton & Company, 2014) (providing examples of swaps impacting the bank's monitoring incentives).
[285] Frank Partnoy and David A. Skeel, 'The Promise and Perils of Credit Derivatives' (2007) 75 University of Cincinnati Law Review,1019,1021.
[286] Kenneth Ayotte and Edward Morrison, 'Creditor Control and Conflict in Chapter 11 Bankruptcy' (2009) 1 Journal of Legal Analysis,511, 514.

risky, but lucrative, investment opportunities for new breeds of financiers to serve in that role.

Distressed debt investors took up the baton to provide new financing to distressed businesses. The motivation for providing new financing depends on the goals of the distressed debt investor. These goals also influence their broad categorization as 'loan-oriented investors' and 'loan and control investors'. For instance, as a loan-oriented investor, the investor may simply provide financing to receive profits from such lending. It is clear that such lending is very lucrative. In essence, the amount of interest rates paid on the loan along with other substantial fees is high, this is so especially in comparison with normal lending to businesses that are not suffering financial distress. However, the tools that might be utilised for striking the appropriate balance between the protection of existing lenders and the incentivisation of new financing as well as the impact of such financing on the likelihood of the business's survival are debatable issues and beyond the scope of this thesis.[287]

The focus is more on the 'loan and control investors' who extend financing to the distressed business with the intention to assert their control over the insolvency process and/or convert the financing provided into equity upon the business's emergence from the process.[288] To achieve this end, the new financing may take the form of debt, structured equity, or direct equity investing. The debt (or debt like financing) is invariably structured as senior to the existing indebtedness. The investor may end up as the distress financer of the debtor. There may, of course, be good reasons for occupying a high position in the capital structure of

[287] For more see, Sandeep Dahiya et al, "Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence"[2003] 69 Journal of Financial Economics, 259,266; Payne and Sarra (n69) 185
[288] David Skeel Jr, 'Creditors' Ball: The "New" New Corporate Governance In Chapter 11' (2003) 152 The University of Pennsylvania Law Review, 917,920.

business. When the business has adequate collateral, it is often the case that it will be pledged to the distressed debt investor, further concentrating control rights in its hands.

Even in the absence of an adequate collateral, the investor will include a series of restrictive covenants within the loan agreement to ensure that the restructuring process goes as planned.[289] Ultimately, the investor is in a position to access crucial information on the debtor's state of affairs. With the risk assessment and prudent analysis of the obtained information, the investor will make the decision as to whether maintain a mere lending relationship with the business, or to pursue a debt-equity swap in the distressed business.

Li and Wang have shown empirically the distressed lending strategies through which distressed debt investors exert influence in the bankruptcy process. Their findings were based on 658 large firms that filed for formal bankruptcy in the US between 1996 and 2013. 13% of the companies received new financing from post-petition distressed debt investors in 1996.[290] However, Notably, the prevalence of such financing has increased significantly over time, with a four-fold rise observed between 1996 and 2013. In contrast, pre-petition bank lenders were found to be increasingly less likely to provide post-petition debtor-in-possession (DIP) financing during the same period.[291]

Distressed debt investors tend to target small firms suffering from poor performance, partly because these firms have more room for improvement than their less distressed counterparts, allowing the investors to benefit more from their activism.[292] These results align with Lim's findings, which indicate an increasing use of new financing by distressed debt investors to gain positions of control in distressed firms. The author found that distressed debt investors extended new loans to distressed firms in 131 cases (28% of the

[289] Henoch (n276) 580.
[290] Li and Wang(n87) 127
[291] Ibid 127
[292] Ibid 128

sample) and made new direct equity investing in 111 cases (24% of the sample).[293] This is also supported by Li and Wang who found that distressed debt investors adopted a 'loan-to-own' (LTO) strategy to take control of the bankrupt companies in 34% of the sample. The authors also note the gradually displacing of traditional banks with distressed debt investors as the providers of financing to companies during their financial hardship.[294]

2.5. The Value Impact of Distressed Debt Investors Strategies (Value Creation or Destruction)?

2.4.1. Evidence of Negative Impact of Distressed debt Investor Activism

Early on, Lipson identified distressed debt investing as comparable to shadow banking, a sector that had expanded rapidly since the 1990s and contributed significantly to the eruption of the global financial crisis in 2007–08. He argues that the crisis did not originate within the heavily scrutinised financial institutions, but among a plethora of largely unregulated obscure entities and vehicles that had proliferated and played a decisive role in the deregulated credit market.[295] In the same way, shadow bankruptcy grows and thrives in an area that is surrounded by regulatory gaps and ambiguities. The argument goes that these sophisticated private investors, operating with minimal regulatory oversight or public scrutiny, increasingly exploit gaps in bankruptcy and related laws to conceal their identities and motives. This behaviour generates an excessive amount of uncertainty, complexity, cost and other difficulties in the reorganisation process. As a result, they burden the judicial system through internecine disputes which in essence result in unnecessary harm to the interests of reorganising debtors. To protect their exogenous interests, they usually rely on

[293] Lim (n34) 1330
[294] Jiang, Li and Wang (n34) 182 (Noting that hedge funds have become a new force in providing DIP financing since 2003)
[295] Lipson (n111)1609, citing Financial Stability Board "Shadow Banking: Scoping the Issues", 12 April 2011, p.3. https://www.fsb.org/2011/04/shadow-banking-scoping-the-issues/

complex derivative instruments that may effectively short-sell a debtor's rescue efforts and result in the unnecessary depletion of the debtor's estate and the premature liquidation of promising, albeit financially distressed companies. Shadow bankruptcy, thus, threatens to do for the corporate reorganisation system what shadow banking did for the larger financial system: privatising gains and socialising losses.[296]

Harner finds distressed debt investors to be in a position akin to corporate raiders who, in the 1980s, targeted companies with the aim of exerting direct control over their management. The key difference is that, in the present scenario, distressed debt investors achieve this objective through the use of debt instead of equity. This occurs within the context of financially distressed companies desperately seeking reorganisation and requiring new capital infusions.[297] Market control mechanisms—primarily in the form of hostile takeovers—are believed to discipline or replace incumbent management, enhance overall accountability and corporate performance, and ultimately promote a more efficient allocation of corporate resources.[298] For these reasons, many institutional shareholders encourage corporate boards to eliminate defensive tactics.[299] However, this does not negate the fact that equity-based takeovers can also have adverse effects on a company and its operations. In particular, such activity may disrupt productivity by diverting management's attention and focus during the takeover process. This activism can also have detrimental effects on employees' interests or on other corporate constituencies. Short-term returns

[296] Lipson (n111)1609.
[297] Harner(n103) 160
[298] Michael C. Jensen, 'Takeovers: Their Causes and Consequences' (1988) 2 Journal of Economic Perspectives,21,23; John Parkinson, *'Corporate Power and Responsibility*' (Clarendon Press Oxford, 2002) 113
[299] Common defences include shareholders' rights plans (commonly called a poison pill), voting rights plans, staggered boards, greenmail, the use of white knights, and the pac-man response for more, see Marcel Kahan and Edward Rock," Anti-activist poison pills' (2019) 99 Boston University Law Review, 915,920.

were in fact reaped by the new owner at the expense of the other stakeholders.[300] These characteristics led to the impression that the investor raided the corporate coffers.

The aforementioned impression may be especially acute in debt-based takeovers pursued by distressed debt investors in which existing equity and the legitimate claims of junior creditors are extinguished, and any value generated by the strategy flows primarily to the investor with little benefit to debtor company.[301] Even more problematic is the observation that corporate control in the shape of debt-based takeovers is not subject to the same disclosure requirements designed to protect against abuse in the context of equity-based takeovers.[302] Even though potential risk to the target company and its stakeholders remains the same.

In equity-based takeovers, the bidder typically makes an offer to shareholders to purchase a sufficient number of shares—often at least 50%—to acquire control of the target company. Shares are acquired on a first-come, first-served basis, meaning that only those shareholders who tender their shares quickly are included in the transaction. To minimise acquisition costs, the bidder may also employ coercive 'divide and conquer' tactics, pressuring shareholders into selling quickly and enabling the company to be acquired at the lowest possible price.[303] For instance, a bidder may initially offer a favourable price to shareholders who quickly accept the offer, with the goal of securing control of the company. Once control is achieved, the bidder may then lower the offer price, leaving remaining shareholders with the choice of accepting the reduced offer or retaining their stake in a

[300] Simon Deakin, 'The Coming Transformation of Shareholder Value' (2005) 13 Corporate Governance: An International Review, 11,14.
[301] Harner(n103) 162
[302] Williams Act 1968 in the US requires certain disclosures when an investor intending to pursue a tender offer, or upon acquiring five percent or more of a public company 's stock. Similar rules exist in the UK, see for example City Code on Takeovers and Mergers 2009
[303] Lucian A. Bebchuk, 'The Pressure to Tender: An Analysis and a Proposed Remedy' (1987) 12 Delaware Journal of Corporate Law, 911.912

company now under the bidder's control. In this way, the structure of the bid effectively penalises those who do not tender their shares quickly.[304]

Shares trade on a central exchange and this creates an informationally efficient environment in which shareholders are aware of the existence of offers extended to their fellow shareholders and whether those shareholders intend to accept the bid.[305] Notwithstanding that takeover regulations exist to provide great protection for minority shareholders in the target company.[306] Similar to traditional takeovers, distressed debt investors often acquire a blocking position in a class of debt enough to influence the terms of reorganisation. Other creditors may be compelled to tender their claims at lower prices—even when the offer is not in their best interest—out of concern that the distressed debt investor will employ 'divide and conquer' tactics.

The threat posed by such investor tactics is particularly acute for minority creditors, as debt is typically traded in over-the-counter markets, which are less informationally efficient than equity markets. As a result, creditors often face significant challenges in accessing information about the offers extended to their fellow creditors or in determining whether those creditors intend to accept the bid.

Unlike shareholders who may protect themselves through contractual protections against potential bidder pressure tactics, contractual protections that creditors obtained outside of bankruptcy disappear in favour of state-supplied corporate insolvency laws. In this sense, distressed debt investors have the opportunity to manipulate the market and strengthen their

[304] C. Steven Bradford, Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers" [1990] Nebraska College of Law: Faculty Publications,80, 82.
[305] Jennifer Payne, 'Schemes of Arrangement, Takeovers and Minority Shareholder Protection' [2015] 11 Journal of Corporate Law Studies, 67,73.
[306] See for example the protection provided by The City Code on Takeovers and Mergers and Directive 2004/25/EC

bargaining position at the expense of vulnerable creditors. This of course would worsen the plight of the vulnerable creditors.[307]

Another line of criticism has also pointed out that bankruptcy law exists to manage the symbiotic relationship between the debtor and its creditors as well as the vital relationships between the creditors themselves. Bankruptcy law emerges as a forum, in which these stakeholders are encouraged to negotiate among each other to preserve maximum the debtor's economic value.[308] An open market for claims provides an opportunity for distressed debt investors to leave and enter negotiations.

The interchangeability of strange investors with different agendas prolongs the length of time needed to complete the process, increases confusion at the negotiating table, makes the process harder to administer, and hinders the preservation of going-concern value. In short, the involvement of distressed debt investors in the restructuring process undermines the traditional premises of formal bankruptcy law.[309]

The presence of distressed debt investors within the capital structure of a target company may remain undisclosed to the debtor and other creditors until a financial restructuring or bankruptcy filing takes place. These investors may discreetly acquire various layers of the company's capital structure, including equity and out-of-the-money junior claims. In some cases, the debtor may default on loans that are subsequently sold to investors with divergent strategies—such as one aiming to acquire control of the company and another seeking to maximise returns through debt recoveries. These differing objectives can give rise to significant conflicts of interest, potentially undermining the creditors' collective ability to

[307] Harner(n103) 159
[308] Finch (n237) 125
28-33
[309] Thomas(n33) 221

reach an optimal restructuring outcome.[310] Indeed, it will become difficult for parties to the negotiation and may be impossible to assess each other's intentions. It becomes also unclear for the debtor company to identify who owns what. While the insolvency law exists mainly to solve an anti-commons problem that arises because of the lack of a debtor's assets to meet the creditors' claims.[311]The presence of distressed debt investors in the insolvency process exacerbates it.

Critics rely on actual case reports of large US bankruptcies to prove their assertions.[312] For example, an intercreditor conflict was raged on the choice of the restructuring path for *American Remanufacturers*. The senior secured distressed debt investor sought to extend post-petition financing to the debtor in order to be used as a consideration for a timely fashion purchase of debtor under section 363.[313] Junior distressed debt investors disagreed and preferred to act as the debtor's post-petition lenders, advocating for a reorganisation plan under the conventional Chapter 11 process instead of a sale under Section 363. The resulting litigation, costs, and delays from the inability to reach an agreement ultimately forced the company into Chapter 7 liquidation, despite its viability and the potential for restructuring to preserve its value.[314]

Similarly, distressed debt investors on the creditors' committee of *FiberMark* fiercely disputed post-confirmation control, prompting court intervention and the subsequent appointment of an examiner to facilitate a settlement. Under this settlement, two investors sold their controlling interest in the debt of the reorganised company to a third investor. Despite the settlement, the examiner's report revealed that creditor disagreements

[310] Baird and Rasmussen(n33)660.
[311] Thomas(n33) 233.
[312] See for example, Miller(n50)393; Douglas Baird and Robert Rasmussen, Chapter 11 at Twilight' (2003) 56 Stan LR 673
[313] The United States version of pre-pack sale. 11USC, s363.
[314] Harner (n28) 100

significantly delayed the plan confirmation process, ultimately reducing the funds available for unsecured creditors by $60 million.[315]

Similar to other informal workouts, creditor coordination problems and informational gaps often materialise in the insolvency procedures, and therefore, reaching the requisite level of support needed for the optimal arrangement (i.e. restructuring or liquidation) becomes impossible or very costly to achieve.[316] To overcome these challenges, corporate insolvency laws often authorise creditors to form committees to perform a variety of functions (e.g. collecting confidential information, negotiating on behalf of their constituents, investigating the acts, conduct, assets, liabilities, and financial condition of the debtor). Creditors with the seven largest claims against the debtor company would be usually appointed to serve on the committee(s) and the expenses incurred by these members might be paid by the estate.[317]

The creditors on the committee owe a fiduciary duty[318] to act in the best interest of their constituents. Distressed debt investors are commonly among the largest claimholders, and therefore, they are able to serve on the creditors' committees. There may be opportunism and opportunistic conflicts/risks. Distressed debt investor may use committees as a useful platform to receive inside information in order to pursue their own investment agendas at

[315] Ibid 101
[316] Alan Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107 Yale LJ 1807,18011.
[317] See for example 11 U.S.C. s1102(b)(1); In the UK, Creditors' committee members are not paid, but may receive their reasonable travelling expenses as a cost of the administration. R3, Administration a guide for unsecured creditors, https://www.r3.org.uk/stream.asp?stream=true&eid=22307&node=117&checksum=F945853B6094D7A1FEB65ED369E80281#:~:text=The%20creditors'%20committee%20receives%20reports,a%20cost%20of%20the%20administration accessed 30/09/2022
[318] A fiduciary in simple terms is someone who undertakes to act for or on behalf of another in a particular manner in circumstances which give rise to a relationship of trust and confidence." For example, the board of directors owes fiduciary duty to handle the company's affairs in the best interests of the corporation and its shareholders. For more see, Andrew Keay, 'Directors' Duties and Creditors' Interests' (2014) 130 Law Quarterly Review,443,445; Gautam Sundaresh, 'In Whose Interests Should a Company be Run? Fiduciary Duties of Directors During Corpore Failure in India: Looking to the UK for Answers'(2019) 8 MICH. BUS. & ENTREPRENEURIAL L. REV 29,31.

the expense of other creditors. This would be a breach of their fiduciary duty and may trigger court-imposed sanctions and criminal penalties. To avoid such risk, distressed debt investors may stay in the shadows or form an unofficial committee with other creditors. Members unofficial committee usually have no statutory entitlement to reimbursement of the expenses incurred during the insolvency process. However, such members have the ability to share the expenses on a pro rata basis. [319]

> "Ad hoc committees are popular with distressed investors . . . because they permit their members to share costs and to exert greater influence as a group without the statutory duties and some of the trading restrictions and disclosure obligations imposed on an official committee".
>
> ''Large creditors are active and pursuing their own agendas (such as gaining control of the corporation), and they cannot be trusted to represent everyone's interests when serving on the committee. Moreover, because committee members receive confidential information which could prevent them from continued trading, some large players no longer even want to serve''.[320]

This tends to cause harm to unsecured creditors as it becomes harder to find creditors willing and able to sit on official committees.[321] Through ad hoc committees, distressed debt investors may coordinate strategic actions (hold-out or hold-up) so as to obtain additional private benefits not afforded to the other creditors. Distressed debt investors pursuing as a 'loan-to-own' strategies may form ad hoc committees to chill bidding and depress the value of the estate.[322]

In addition, distressed debt investors are often criticised for their short-term investment horizons. It is worth noting that insolvency laws that facilitate corporate rescue are useful

[319] Thomas(n33) 222
[320] Baird and Rasmussen (n33) 665
[321] Levitin (n29) 81
[322] Ibid 82

to a financially distressed company which can be rehabilitated to reach an appropriate level of solvency. In contrast, liquidation procedures provide a straightforward process for the winding down terminally ill companies that are no longer economically viable.[323] It is more likely, however, that even financially distressed businesses may also have operational problems that must be resolved, if they are to carry on successfully post-rescue.[324]The main elements of investigating the causes of distress, creating a viable business and workable plan, and identifying the optimal moment to emerge from the process are essential for the creation of a sustained rescue strategy.

Investments in hedge funds are often redeemable. In anticipation of redemptions from their LP investors, which may happen at any time, distressed debt investors tend to maintain high levels of liquidity and cannot afford to have their funds tied up in long-term ventures.[325] For these reasons, there is constant pressure on distressed debt investors to ensure an expeditious handling of the insolvency process towards asset sales, initial public offering, or mergers and acquisitions events, in which the investors can liquidate their investments. However, this emphasis on swift exits can come at the expense of addressing the operational needs essential for the long-term viability of the business.[326] Eventually, the company will relapse into bankruptcy a second or third time, months or years later. Miller attributes the high prevalence of the 363 sales in the US to the distressed debt investors' penchant for quick returns.[327] The implementation of short-term rescue strategies raises concerns over

[323] A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group, The Insolvency Service (London: HMSO, 2000) (The 2000 Report), para. 24.
[324] Thomas Laryea, 'Approaches to Corporate Debt Restructuring in the Wake of Financial Crisis' (2010) IMF Staff Position Note 10/02, Washington: International Monetary Fund http://www.imf.org/external/pubs/ft/spn/2010/spn1002.pdf accessed on 23 Jan 2022
[325] Tarun Ramadorai, "The Secondary Market for Hedge Funds and the Closed Hedge Fund Premium" [2012] 2 Journal of Finance, 479,482.
[326] Harvey R. Miller, 'Chapter 11 Reorganization Cases and the Delaware Myth' (2002) 55 Vand L Rev,1987,1990.
[327] Miller(n50)393

'phoenix trading'[328] and 'liabilities-dumping'[329] which ultimately undermine trust in the insolvency system.[330]

Moreover, empty voting has dominated research on insolvency corporate governance. Corporate debt customarily conveys both cash flow rights and control rights. The assumption stemmed from the long standing legal and economic theories is that the elements of this package of obligations and rights work in tandem and cannot readily be decoupled.[331] The alignment means that the creditors will have an incentive to exercise their control rights in an economically rational way on how best to maximise firm value in bankruptcy and to negotiate as to how that value should be allocated upon emerging from bankruptcy.[332] Empty voting has emerged as a worldwide issue in the past several years. This problem has various names – for example, debt decoupling, empty crediting, empty governance, and unbundling creditor rights – but the concept simply means the separation of economic interest from voting rights, and as a consequence of, the creditor is incentivised to exercise its governance rights not to maximise firm value but to destroy it and bring ruin on the debtor. Academic works have strived in the first instance to establish the origin of this phenomenon and secondly to observe the wider implications on firm value.[333]

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[328] Phoenix trading refers to a practice in which a new company arises from the ashes of the old, insolvent, one. To achieve this goal, parties with previous connections to the insolvent companies such as directors or owners re-acquire the insolvent company's business through quick liquidation sale (often at less than their full value) and continue to operate in the same or similar business. For more see Yaad Rotem, 'Small Business Financial Distress and the "Phoenix Syndrome"—A Re-evaluation'[2012]22 International Insolvency Review,1.

[329] The controversial practice is that the management or previous owners sell the assets of the distressed company to an unencumbered newco, leaving behind merely a shell of tax liabilities, pension deficits, supplier and other debts. Peter Walton, 'When is Pre-Packaged Administration Appropriate - A Theoretical Consideration'(2011) 20 Nottingham Law Journal,1.

[330] Adebola (n109) 133.

[331] Sanford Grossman and Oliver Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration' (1986)94 Journal of Political Economy,691,695.

[332] Jackson (n147) 66

[333] Hu and Black (n45) 673.

In examining the causes behind the separation of debt-based governance rights from economic interests, Hu and Black originally highlighted, among other factors, the rise of claims trading in modern commercial markets alongside the emergence of derivatives markets. This development has contributed to a problematic scenario in which a creditor may stand to benefit from the debtor's failure.[334] Indeed, an investor who accumulate a control position at a discount with the ability to make its short position worth more if a firm for instance files for insolvency may actually profit from the company's further misfortune, and, because of their voting rights which purchased cheaply, may have the power to bring such misfortune about.[335] This proved to be extremely dangerous and led to the most contested bankruptcies of recent years.[336]

Critics of distressed debt investors have made broad claims that the assumption underlying the granting of governance rights to creditors is obsolete. They submitted an opinion to the American Bankruptcy Institute, arguing for a revision of the US bankruptcy law structure. Some of the proposed reforms are strongly associated with enhanced transparency and disclosure so that the distressed debt investors' value destructive tendencies are nipped.[337]

2.4.2. Evidence of Positive Impact of Distressed Debt Investor Activism

On the contrary, for many other authors, the involvement of distressed debt investors in the distressed business is positively associated with value enhancing, and modern capital markets should support and encourage this activism. Hotchkiss and Mooradian contribute to this debate by offering some of the earliest empirical evidence on the influence of distressed debt investors on the operational performance of financially distressed U.S. companies emerging from Chapter 11 between 1980 and 1993. Their findings indicate that

[334] Ibid 667
[335] Coco (n46) 614
[336] Janger and Levitin (n46) 1860
[337] Michelle Harner, "Final Report of the ABI Commission to Study the Reform of Chapter 11" (2014). Book Gallery. Book 97. http://digitalcommons.law.umaryland.edu/books/97,245.

approximately 60% of the firms in which distressed debt investors played an active role—either as debtholders or equity financiers—demonstrated improved performance following emergence, compared to the period when the investors initially gained control.

The improvement in post-restructuring operating performance relative to the pre-default level is more pronounced when distressed debt investors take an active role—whether by serving on the board, participating in management, or gaining control of the company.[338] In this sense, their presence can serve as a disciplinary mechanism against self-serving managerial behaviour, particularly when managers seek to use the insolvency process as a means of entrenchment.[339]

The involvement of distressed debt investors in Chapter 11 can facilitate value enhancement first for themselves, and also for other stakeholders of the business. In this regard, Jiang, Li and Wang found that the intervention of distressed debt investors in the Chapter 11 process increases the likelihood of formulating value-enhancing reorganisations.[340] This invariably means that the investor's incentive to maximise its own recovery will lead to a higher recovery of other junior claims (unsecured debt and equity).[341]

There are prominent views presented in the corporate insolvency theory literature that as the company slides into distress, each creditor has a strong incentive to seize the assets and enforce its claims against it before any other creditor does so. Rationally self-interested parties are incentivised to act in an economically optimal manner only if the other actors act similarly.[342] There are two alternatives: either the creditors' incentives are entirely aligned, which it is unreasonable to assume given the fragmentation of creditors and their

[338] Hotchkiss and Mooradian (n34) 409
[339] Bradley and Rosenzweig (n94) 1049
[340] Jiang, Li and Wang(n34) 181
[341] Ibid 181.
[342] Jackson (n147) 5

heterogeneous objectives which is increased by information asymmetry, or there will have to be a credible threat to make them overcome coordination problems.[343] The analysis of Lim is one instance of such credible threats. The author argues that the intervention from an outsider investor constitutes a credible threat, helping stakeholders overcome contracting difficulties and reach an agreement. The results of his data showed that the distressed debt investors participation as (either unsecured or secured) creditors is associated with a higher probability of restructuring being accomplished through "pre-packaged" Chapter 11 plans.[344] Pre-packaged is heralded as an efficient and effective restructuring tool. Their importance is realised in their flexibility, speed, cost-effectiveness, and the ability to counter hold out problems. In sum, the author found that distressed debt investors can play value enhancing role for the distressed business by enabling more efficient restructurings.[345]

Recall the traditional lenders' unwillingness to support distressed debtors undertaking corporate restructuring unless they have a healthy assurance of repayment. In such a scenario, distressed debt investors may provide the much-needed financing. Such financing is crucial for overcoming the debt overhang problem and improving the company's chances of survival. It can also have a signalling effect,[346] conveying to the market and the company's creditors that there is confidence in the business's prospects. In other words, new financing helps companies avoid the impending risk of liquidation. Liquidating the

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[343] Douglas G. Baird and Randal C. Picker, 'A Simple Non-cooperative Bargaining Model of Corporate Reorganizations' 20 Journal of Legal Studies 311,315; Schillig(n153) 5.
[344] Lim (n34)1329
[345] Lijie Qi, 'Managerial Models During the Corporate Reorganization Period and their Governance Effects: the UK and US Perspectives' (2008)29 Company lawyer, 131.
[346] On the signalling value of debt, the pecking-order theory suggests that companies prefer to finance their operations with internal funds, then with debt, and finally by way of issuing new equity. Similarly, the asymmetric information theory asserts that debt is preferred to equity, because raise direct capital through debt is a reliable and positive sign for investors who are not as well informed as the management about the company's creditworthiness and its capability to undertake growth opportunities. For more see Maria K. Markopoulou and Demetrios L. Papadopoulos, 'Capital structure signalling theory: evidence from the Greek stock exchange'(2009) 14 Portuguese Journal of management Studies, 217,220.

debtor's assets, especially during times of financial crisis when markets are illiquid, can result in the loss of the business's going concern value.[347]

The destruction of the going concern value would not only be considered detrimental to the interests the creditors but also to other interests such as communities or customers that benefit from the continuance of the business. The empirical evidence agrees as to the importance of distress-financing before or after the commencement of formal reorganisation. For instance, Carapeto found that companies which receive new financing are likely to be reorganised successfully; or at least, the ultimate fate of such companies is determined in a significantly shorter time, compared with companies with no access to new financing.[348] Likewise, Dahiya et al found that companies reliant on distress-financing spent much less time in resolving their debt restructurings, and in making a decision whether they are of capable of being rescued or should be liquidated, than those that did not have access to new financing. The obvious explanation for this is that post-petition lenders in the course of the restructuring conduct assessment and monitoring aimed at speeding up the process and preventing directors from propping up unviable companies which are not capable of reorganisation.[349]A role, creditors' committees, trustees and examiners fell short to perform in the past.

Expeditious handling of the insolvency process benefits creditors by preserving the company's assets, customers, personnel, and goodwill, while reducing the direct and indirect costs typically associated with lengthy, poorly organised, and potentially unsuccessful reorganisations. These cost savings, in turn, improve returns for all classes of creditors.

[347] Omer Tene, 'Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations'[2006]19Bankruptcy Developments Journal,287,289.
[348] Maria Carapeto, 'Does Debtor-in-Possession Financing Add Value?' (IFA Working Paper No. 294-1999)
[349] Dahiya et al(n287) 259.

The increasingly important role of distressed debt investors in financing distressed businesses has been highlighted in the discussion on distressed debt investor strategies. Based on prior studies, it is fair to conclude that distressed debt investing enhances overall liquidity in capital markets and reduces the cost and difficulty of obtaining credit. The question of costs, administrative hassle, adversarial relationships, liquidity constraints, speculative returns, and regulatory risk are inherent elements of any distress scenario. Distressed debt investing provides a means for those who do not have the resources, expertise, or desire to hold their claims until the resolution of the reorganisation to cut loose and exit the process at a certain price and a predictable level of loss. Simultaneously, investors seeking to generate profit—either through an increase in the trading price of the debt or the equity allocated during the restructuring—may enter the process. These new investors may also assume a monitoring role, providing oversight and contributing valuable expertise to the reorganisation process.[350] The existence of an economic exit through a liquid market for claims, in turn, may make the debt itself more valuable, and may thus make lenders more willing to lend at a lower cost, especially for potentially troubled companies.[351]

Moreover, distressed debt investors often have the capacity of consolidating smaller claims into their hands, thereby enhancing bargaining efficiency during the restructuring process.[352] Contrary to the claims that the interchangeability of claimants makes it harder for managers to negotiate with investors trading in and out of the firm's capital structure, empirical evidence suggests that distressed debt investors typically enter the insolvency process early and maintain a consistent presence over time.[353] This suggests that distressed

[350] Goldschmid (n235)195
[351] Adam Levitin, 'Bankrupt Politics and the Politics of Bankruptcy' [2012] 97 CORNELL L.REV,1399,1445.
[352] Ivashina, Iverson, and Smith (n113) 321.
[353] Ellias(n110) 773

debt investors do not represent a threat to the environment of negotiation envisioned under bankruptcy laws such as Chapter 11.

Concerns of short-term rescues (the recidivism problem) are not borne out by the data. In the study conducted by Harner, Griffin, and Crickenberger, only 38 out of 311 cases (12.2 percent) of companies that emerged from insolvency between 2000 and 2013 involved a subsequent re-filing for insolvency. They also found that debtors with distressed debt investor involvement refiled for Chapter 11 at the same rate as those without such involvement.[354] There are three reasons which may well account for this. First, distressed debt investors are quite successful in achieving their stated objectives.[355] Second, their unique monitoring role in corporate governance. Third, the choice of their companies usually of those with less insolvency risk and higher profitability. Specifically, distressed debt investors tend to companies in financial distress rather than companies facing economic distress[356], a reflection of their firm-picking skills.[357]

The empty creditor argument has faced extensive criticism for lacking a solid foundation in observable evidence. Under ordinary circumstances, most creditors are no more than contractual counterparties and rarely exert direct control. Instead, they exercise influence over corporate activity primarily through the credible threat of withdrawing capital if debtors engage in self-serving, high-risk activities at the creditors' expense—such as

[354] Michelle M. Harner, Jamie Marincic Griffin, and Jennifer Ivey-Crickenberger, 'Activist Investors, Distressed Companies, and Value Uncertainty' (2014) 22 American Bankruptcy Institute Law Review, 167,173.
[355] Alon Brava, Wei Jiangb, Frank Partnoy, and Randall Thomas 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) 63 The Journal of Finance,1729,1734 (the authors noting that activist hedge funds in the United States propose strategic, operational, and financial remedies and attain success or partial success in two-thirds of the cases)
[356] Xu M, "Three Essays in Chapter 11 Bankruptcy: Post Bankruptcy Performance, Bankrupt Stock Performance, and Relationship with Hedge Funds and Other Vulture Investors" (PhD thesis, University of Massachusetts Amherst 2010) 22
[357] Jiang, Li and Wang(n34) 188

issuing dividends to shareholders, executing significant asset transactions, or increasing leverage.[358]

An essential mechanism to achieve this influence resides in a range of positive and negative covenants enshrined in the lending agreements that restrict the debtor's ability to engage in corporate acts that might conflict with creditors' interests. However, covenants are only as binding in practice as the extent to which corporate managers fear the consequences of breaching them. A creditor's strongest leverage lies in the power to accelerate repayment and enforce claims. However, if the debtor can refinance at a sufficiently low cost, this leverage becomes ineffective. Put differently, if the debtor has enough cash to repay the principal, the creditor effectively has no grounds for complaint.[359] This means that for an empty creditor to succeed, it must be able to frustrate the debtor's ability or least exacerbate its inability to access to cash just when cash is needed. Targets will invariably have allies with incentives and, often, with means to supply liquidity in order to thwart and punish the empty creditor. A party or consortium of parties who have sold CDS protection on the target, DIP financing providers, and the target's own investors are all incentivised to keep the company in a solvent state, and thus it would be reckless to bet against these possible financing sources.[360]

In order to economically construct short positions, the distressed debt investor is required to accumulate large control, and/or blocking positions in at least one tranche of the target's bonds or notes and with the ability to buy protection against credit events. Therefore, betting against the success of reorganisation entails a large capital outlay because the activist profits only to the extent its short position in CDS is larger (in notional terms) than its long position

358 Michelle M. Harner and Jamie Marincic, 'Behind Closed Doors: The Influence of Creditors in Business Reorganizations' (2011) 34 Seattle University Law Review, 1155,1156
359 Buccola, Mah, and Zhang (n47) 2035
360 Ibid 2040

in the target's debt. However, buying protection against insolvency in the credit derivative markets is very costly as companies near failure.[361]This implies that the activist cannot actually make much profit by betting against the success of the reorganisation.

Empirical studies on the empty creditor phenomenon remain limited and have produced mixed results. Bedendo, Cathcart, and El-Jahel, using different proxies for the existence of insured creditors in selected non-financial US-rated companies, found no link between the presence of bondholders with access to CDS protection and the restructuring choice of distressed companies. This means that concerns that insured creditors are more likely to push distressed companies into insolvency even when an out-of-court debt restructuring would be the most efficient choice are not born out by data. Although, it is acknowledged that data limitations make it hard to come to definitive conclusions, their data contradicts the view that creditors insured via CDSs would be more willing to scupper debt renegotiations following signs of financial distress to worsen the company's financial plight.[362] In sum, the authors found that the key determinants of the chosen restructuring method—such as insolvency costs, capital structure, short-term liquidity, current assets, and leverage[363]—remain consistent even for companies whose bondholders may have access to credit default swap (CDS) protection.[364]

On the contrary, the empty creditor hypothesis finds support in the findings of András, who examined a sample of 82 U.S. distressed exchange offers, where companies with public debt offered cash or securities in exchange for existing bonds in an effort to avoid

[361] The cost of insuring against default on $10 million of General Motors bonds in the credit-default swap market was $8 million — payable upfront — plus $500,000 a year for up to five years. That was almost six months before G.M. finally filed for bankruptcy on June 1.
[362] Mascia Bedendo, Lara Cathcart, and Lina El-Jahel, 'Distressed Debt Restructuring in the Presence of Credit Default Swaps' (2016) 48 Journal of Money, Credit and Banking 165
[363] Edith S Hotchkiss, Kose John, Robert M Mooradian, & Karin S Thorburn, 'Bankruptcy and the Resolution of Financial Distress' in B. Espen Eckboeds (ed), Handbook of Empirical Corporate Finance (Elsevier, 2008) 235
[364] Bedendo, Cathcart, and El-Jahel(n362) 166

insolvency. The study revealed that creditors holding CDS protection against default were more reluctant to participate in such exchanges. This reluctance, in turn, hindered the company's ability to reduce its debt out of court and increased the likelihood of inefficient insolvency proceedings.[365]

Proponents of distressed debt investors argue that critics' concerns are largely grounded in theory, common sense, and anecdotal evidence from bankruptcy courts, rather than robust empirical data.[366] They maintain that the current structure of Chapter 11 is well-equipped to accommodate the rise of the distressed debt market, along with other financial innovations. From their perspective, any attempt to reform the system could undermine debt market liquidity and ultimately raise the cost of borrowing.[367]

However, it is worth noting that the American Bankruptcy Institute (ABI) established a commission to conduct a comprehensive three-year review of Chapter 11. The commission paid particular attention to the expansion of the distressed debt market and recommended regulatory reforms to ensure that the existing Chapter 11 framework continues to serve its two core policy objectives: preserving going-concern value and facilitating the successful rehabilitation of financially distressed debtors.[368] However, the ABI's panel of leading practitioners deliberated over the commission's findings and recommendations and fell considerably short in reaching a consensus as to what, if anything, should be reformed in light of conflicting evidence.[369]

[365] Danis András, 'Do Empty Creditors Matter? Evidence from Distressed Exchange Offers' (2017) 63 Management Science, 1285,1288.
[366] Ellias(n110) 774
[367] Ibid 772
[368] American Bankruptcy Institute, 'Final Report and Recommendations, Commission to Study the Reform of Chapter 11 (American Bankruptcy Institute, 2014) 2 ["ABI Report"]. Online: <https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h> accessed 21 July 2022
[369] Michelle Harner, 'Final Report of the ABI Commission to Study the Reform of Chapter 11' (2014) Book Gallery <http://digitalcommons.law.umaryland.edu/books/97> 213

2.5. Summary and Conclusion

The chapter examined the literature relating to distressed debt investor activism. One inference which can be made is that the great contribution of previous research has been provided by US scholars, often about the policy concerns raised by distressed debt investors activities in the US. One possible reason could be the fact that the distressed debt market first emerged in the US, in the 1980s and 1990s and gathered pace under the Chapter 11 of the US Bankruptcy Code. Several interrelated factors contributed to its rise. These include the high inflation of the 1960s, the advent of modern securitisation techniques, and the growing flexibility to trade securities at any time, which allowed investors to diversify portfolios and manage risk more efficiently. Additionally, the proliferation of high-yield bonds and highly leveraged bank loans, the expansion of the derivatives market, and the introduction of regulatory capital requirements[370] created new incentives and opportunities for trading distressed assets. The amended language of Rule 3001(e)(2) further facilitated claim trading, while banks, under pressure to meet shareholder return expectations, began to shift away from traditional relationship banking. Collectively, these developments paved the way for the emergence of deep and liquid secondary markets—especially for distressed debt—in the US.

Despite doubts cast on the value enhancement role played by distressed debt investors in corporate insolvency, evidence both implicitly and explicitly points to the salutary impact of these investors. Notably, the value created through their involvement reflects a tangible reality previously observed by legal scholars such as Goldschmid, who argued that the enhancement primarily arises from mitigating the residual actor problem.[371] The argument goes that once a company enters into insolvency, the creditors become the owners of its

[370] Fortgang, and Mayer (n220) 4
[371] Goldschmid (n235)195

assets. However, the creditors – as owners – are not a homogenous group. Senior creditor classes, whose debt may be highly over-secured — i.e. its security covers the debt outstanding— will have strong reasons to favour risk averse strategies that maximise the probability of speed recovering the full value of their loans. Junior creditors, who face low probabilities of appreciable recovery, will prefer high-risk strategies because there is little to lose and potentially something to gain by 'swinging the fences. These different (economic) interests will lead to clashes on the most important decision of insolvency: whether to liquidate or rescue the company.

Chapter 11 functions to recreate an efficient residual claimant class whose interests are closely aligned with those of the company. To achieve this end, valuations ought to be carried out to discern clearly the residual class which would be able to make a value-maximising decision objectively and without bias. However, the problem may persist, multiple stakeholders may fall into the group of residual claimants and clashes may also continue to develop within this group.[372] This holds true when the interests of unsecured trade creditors who may be unwilling to continue trading with the business conflict the interests of employees, who are likely also to be unsecured, but prefer to continue working for the insolvent company. Residual claimants may also lack sources, knowledge, patience, and abilities to participate in the restructuring or even make decisions that may be in their own best interest, let alone those which would steer the company from troubled waters toward an economically efficient, value maximising direction.

Distressed debt investors with sufficient resources and profit incentives, often seek to consolidate multiple claims in their hands, especially in unsecured debt, with the tendency to challenge senior lenders' tendencies that better their own positions during process at the

[372] Lynn LoPucki, 'The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's "The End of Bankruptcy" (2003) 56 Stan LR 645,650.

expense of the company and other junior creditors. This argument is also invoked in the shareholder activism by hedge funds.[373] The argument goes that hedge fund managers will, in the course of making profits for their own investors, reduce information asymmetry and agency problem of widely-held companies by replacing underperforming managers with maintaining quality ones, challenging inefficient strategies, and ensuring that merger and control transactions are consistent with the interests of shareholders. In so doing, hedge funds increase the value of the companies they invest in, benefiting not only their own investors but also the other shareholders of those companies.[374]This may well explain why the presence of distressed debt investors in the Chapter 11 process is argued to help balancing the power between the debtor and secured creditors, enhancing the prospects of a successful reorganisation and resulting in significantly higher overall returns for junior claimants.

Related to the aforementioned argument, the dominant valuation methods in Chapter 11 are the discounted cash-flow (DCF) and the comparable transaction multiple (CTM) in which a company's future earning capacity are taken into account.[375] This approach would indeed entail a higher valuation for the debtor's assets or business that makes unsecured debt is the fulcrum security. In most cases, distressed debt investors acquire portions of the debtor's unsecured debt and challenge fully secured creditors, who may be indifferent to reorganisation efforts or even favour a fire-sale liquidation, potentially to the detriment of unsecured creditors.

However, if the fulcrum security is the secured debt, the distressed debt investor may accumulate secured claims or interests. Even though unsecured creditors might benefit from

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[373] Goldschmid (n235)199
[374] Kahan and Rock(n195)1023
[375] Howard Seife, 'Valuing a Chapter 11 Debtor for Plan Confirmation' (2004) 121 Banking L.J. 541,550.

a higher company valuation, or in cases where they are 'out-of-money,' they still possess the power to extract concessions from the distressed debt investor. To achieve this end, unsecured creditors may raise objections over the valuation of the company or threat to dispute the plan of reorganisation in the bankruptcy court. Dispute tactics may include forming a creditors' committee which can hire counsel and advisors and whose fees will be reimbursed by the distressed company as an administrative expense. This litigation threat is credible in the eyes of the distressed debt investor and, therefore, they would be hard-pressed to avoid prolonged and expensive litigation and confirm a plan of reorganisation. In this way, value flows to unsecured creditors. Moreover, concerns of insider lending/trading, chill bidding, wealth transfer, and empty crediting are minimised or nipped by the extensive court oversight over the process.

The fact remains that distressed investing continues to expand beyond the shores of the US.[376] In particular, a number of US investors recently arrived in the English market to implement investing strategies which they had pursued in the US market for some time.[377] In fact, according to the survey evidence of Harner, 9 distressed debt investors (12%) out of 82 institutional investors investing in distressed situation are based in UK. However, regardless of their locations, 2.8% of all respondents invest only in UK based companies and 31% investing in both US and UK based companies.[378]

In the UK, the residual actor problem is solved by the prior adoption of a residual management displacement device[379] known as the floating charge which gives a single bank dominant control in the event of financial distress.[380] Moreover, market tests and liquidation

[376] Harner (n28) 713
[377] Paterson (n179) 337
[378] Harner (n28) 99
[379] Rizwaan Mokal, 'The Floating Charge - An Elegy' in Sarah Worthington (ed), Commercial Law and Commercial Practice (Hart 2003) Chapter 17, Section III
[380] Andrea Polo, Secured Creditor Control in Bankruptcy: Costs and Conflict (Saïd Business School, University of Oxford 2012) SSRN 2084881.

valuation remain the dominant method in the UK. The company's business or assets are market-tested through an auction process or similar sales process, without considering the company's earning capacity in the near or distant future. As a result, the fulcrum debt typically resides with the senior creditors, leading to outcomes that may differ significantly from those expected under American bankruptcy law. However, it is important to note that there is limited literature on activist distressed debt investing in the UK.

The focus has remained very much on the diminishing effectiveness of the London Approach, which has been widely recognised as having enabled multi-bank support for the distressed company to be put in place.[381] The argument suggests that the Approach developed an era when the structure of the finance market was dominated by a relatively small number of like-minded banks operating in a cohesive, collegiate manner. Therefore, consensus, persuasion, and banking collegiality—along with trust and cooperation from the involved banks—are crucial components of rescue efforts under the London Approach. Fundamentally, the banks agree to this collective response because it aligns with their mutual self-interest. Typically, it involves the banks sharing the benefits and costs of facilitating a value-maximising restructuring equally and pro rata, based on their seniority and exposures at the time they agree to suspend enforcement of their rights against the company.[382]

However, the London Approach, as an effective mechanism to enforce cooperative behaviour among banks, is also supported by the threat of regulatory sanctions from the Bank of England for those who fail to act in a mutually cooperative way. Additionally, the threat of exclusion from future business by other banks proved to be particularly credible

[381] Armour and Deakin (n12)26

[382] Karen Hopper Wruck, 'Financial Distress, Reorganization and Organizational Efficiency' (1990) 27 Journal of Financial Economics 419

in the eyes of non-cooperative banks. Distressed debt investors are often perceived as unconcerned about the risk of exclusion from the market, which, in turn, weakened and ultimately undermined the effectiveness of the London Approach.[383] There has been movement away from market-led solutions towards formal legal proceedings. There is, therefore, a real need to extend the literature by investigating the impact of concentrating governance rights in the hands of distressed debt investors, who may recourse to the full weight of the legal remedies which may be available.

[383] Paterson (n179) 335

Chapter Three: A Theoretical Review

3.1 Introduction

There has been an extensive debate on the role and purposes of corporate insolvency law.[384] At the heart of this debate lies the question of how best to address the situation of a distressed company that is unable to meet its debt obligations as they fall due.[385] This raises three options: immediate liquidation and dissolution through a piecemeal sale of assets; trading out of its difficulties; or a disposal the business as a going concern after the company's position has stabilised. The latter two options reflect efforts aimed at rescuing and rehabilitating the company or its business operations.[386] However, any form of intervention inevitably raises the question of how a company's assets are utilised and who exercises control over them. Creditors are naturally concerned with ensuring that control rests in capable hands during stable periods, but their concern becomes significantly more acute during times of financial distress. When a company faces such difficulties, directors may be tempted to pursue riskier strategies in an effort to turn the business around and safeguard their own positions.[387] However, if these strategies fail to yield the intended results, a significant portion of the company's value can quickly erode, ultimately leading to lower recoveries for creditors.

The conventional view held by insolvency scholars is that once a company becomes insolvent, the shareholders' interests are effectively wiped out, rendering their claims negligible. At that point, creditors—now the residual claimants—assume primary economic

[384] Douglas G Baird, 'The Uneasy Case for Corporate Reorganization' (1986) 15 Journal of Legal Studies 127,133; Donald Korobkin, 'The Role of Normative Theory in Bankruptcy Debates' (1996) 82 Iowa LR 75.
[385] Douglas G Baird & Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 97,98
[386] Jennifer Payne, 'Debt Restructuring in English Law: Lessons from the US and the Need for Reform' (2014) 130 Law Quarterly Review,282,285.
[387] Aurelio Gurrea-Martínez, 'Towards an optimal model of directors' duties in the zone of insolvency: an economic and comparative approach' (2021) 21Journal of Corporate Law Studies, 365,365.

interest in the company and, correspondingly, a legitimate basis to exercise meaningful control rights over its operations and restructuring decisions.[388]This allocation of rights stems from the premise that ownership of debt customarily conveys economic,[389] voting and other governance rights[390] and imposes discloser obligations.[391]

Long standing legal and economic theories assume that the components of this package cannot readily be decoupled.[392] In fact, there is a general expectation that economic ownership gives creditors an incentive to exercise voting power in an economic rational way. So, economically viable companies are rescued, and other terminally ill companies are wound up. With this in mind, it is submitted that the creditors' claim reflects their true economic interest in the company, and the creditor is thus presumed to use its governance rights in the insolvency process to maximise the value of the company, and in turn its claim. However, profound shift in logic and practice in the field of finance have rendered this foundational assumption obsolete. Debt-based governance rights can now be separated from economic interests quickly, at a low cost, on a large scale, and often hidden from the public view. This phenomenon has been described as 'empty crediting', and it has promoted the use of insolvency procedures for strategic purposes. i.e. to go 'short' on the debtor and benefit from its misfortune.[393]

Empty voting can manifest in more ways than one might initially think. However, one significant scenario in which 'empty crediting' is rumoured to be prevalent involves investing in the debt of financially troubled companies. Therefore, a thesis like this, which

[388] Rasmussen (n150)55; John Armour, Gerard Hertig, Hideki Kanda, 'Transactions with Creditors' In: Reinier Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach The anatomy of corporate law: a comparative and functional approach* (2nd edn. Oxford University Press, 2017) 110
[389] Repayment of the principal and interest on the credit extended to the debtor.
[390] For example, voting powers under Insolvency (England and Wales) Rules 2016 (SI 2016/1024) r 15.34 (1), Companies Act, Part 26, s 899(1); 11USC, s1122(a).
[391] See for example disclosure and solicitation rules under 11USC s1122.
[392] Grossman and Hart (n331)692.
[393] Hu and Black (n45)665; Baird and Rasmussen (n33) 687

aims to analyse the roles of distressed debt investors in debt restructuring and the impact of their involvement on the restructuring process, must examine this issue in greater depth. To begin, an overview is required, exploring the core traditional principles within corporate insolvency. Following this, focus will be directed to discovering the emerging phenomenon within the field.[394]

3.2 Creditors Primacy as the Traditional Paradigm of Corporate Insolvency

Company's creditors, under ordinary circumstances, are no more than contractual counterparties. However, once a company becomes insolvent or its financial distress becomes apparent to others, creditors who have not been paid are entitled to seize and sell the company's assets to protect their own interests. Upon this action taking place, the creditors change roles: they become, in a meaningful sense, the owners of the company's assets.[395] In essence, the purpose of insolvency law is to introduce a new structure for the company whereby the creditors, rather than the shareholders, become the owners of the firm's assets. [396] Jackson states that 'When one is dealing with insolvent firms, the question is how to convert the ownership of the assets from the debtor to its creditors, not how to leave assets with the debtor'.[397] Hart also argues that default on debt allows the creditors to remove assets from debtor's control.[398] Bebchuk argues that upon an insolvency the creditors should assume ownership rights over the business on the basis of initial right.[399] English courts also in the cases of *Re David Lloyd and Co*[400], *Nicholson v. Permakraft (NZ)*

[394] Ibid 685

[395]Jean Tirole, *'The Theory of Corporate Finance'*(Princeton University Press,2008) 97; Patrick Bolton, 'Corporate Finance, Incomplete Contracts, and Corporate Control'(2014) 30 Oxford University Press, 64,70.

[396] What sets insolvency apart from poverty is that the debtor has in some way spent or utilised the money of some other party rather than just spent his own. See Vernon Dennis, *'Insolvency Law Handbook'*(2nd edn, The Law Society,2007) 1

[397] Jackson (n147) 7

[398] Oliver Hart, *'Firms, Contracts, and Financial Structure'* (Clarendon Press,1995) 186

[399] Bebchuk(n155) 775

[400] *Re David Lloyd & Co* 6 ChD 339 (1877).

Ltd[401], and *Kinsela v. Russell Kinsela Pty Ltd*[402] view the creditors' collateral as their property not part of the debtor's estate.

Creditors' interests in the company, as well as their time and risk horizons, are likely to be much more heterogeneous than those of shareholders. A creditor who is angry or upset is less likely to be able to correctly identify the best beneficial outcome for all parties.[403] Also, lenders within a single syndicate may have divergent interests. In such cases, one may seek to remove the loans from its balance sheet through either selling its portion of the loan on the secondary market or through the enforcement and realisation of debtor's assets for repayment, whilst another may be open to exchanging of debt for equity.[404]

Differences may be compounded by the presence of asymmetric information regarding the company's financial prospects and the positions of other creditors. Therefore, deciding the company's future—whether through a sale, closure, or balance sheet restructuring—faces challenges from intercreditor conflicts, which in turn can diminish the overall value of the company's assets. The debate on how to deal and resolve intercreditor conflicts has been broad ranging. The normative debates on the governance of companies undergoing an insolvency procedure have taken numerous forms, but there now seems to be some consensus on two main models, namely concentrated creditor model of governance (in which control of the insolvency procedure is vested in secured creditors) and dispersed creditor model of governance (in which greater control rights are conferred on the creditors collectively).

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401 *Nicholson v. Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA)

402 *Kinsela v. Russell Kinsela Pty Ltd* [1986] 4 ACLC 215; [1986] 10 ACLR 395.

403 John Armour, 'The Rise of the "Pre-Pack": Corporate Restructuring in the UK and Proposals for Reform' in R. P. Austin and Fady J. G. Aoun (eds), *'Restructuring Companies in Troubled Times: Director and Creditor Perspectives'* (Sydney: Ross Parsons Centre, 2012) at45; Schillig(n153)6.

404 Paterson(n130) 339

3.2.1 The Dispersed Creditor Model of Governance

There is a general agreement on the role of corporate insolvency law in maximising value of distressed businesses for the benefit of the pre-distress stakeholders.[405] Achieving this end requires the isolation of the insolvency law from the secured-credit law. The secured-credit regime is based upon two pillars: priority over other creditors and control of the charge. Basically, priority pertains to the order of distribution of the debtor's assets, while control relates to the management of the debtor's assets.

Prior to default, the debtor's sole obligation is to preserve the availability of the assets for potential future default, while retaining control of those assets.[406] In the event of a single default, where the secured party's debt is not unpaid, the secured creditor gains the right to directly control its collateral. This includes the ability to seize the assets—either through self-help or judicial action—and broad discretion in the method of sale or other realization. This invariably means that outside of insolvency situation, the secured party has complete control of the private recovery process.[407]

In case of a debtor's multiple defaults in which the debtor is not paying its debts generally,[408] insolvency law comes to the fore and negates the control aspect of secured credit in favour of a system of public, judicial or administrative control of the recovery process. This suggests that the debtor and other creditors are afforded discretion to remove the secured party's control by filing an insolvency proceeding. At the same time, insolvency law should honour the priority rights aspect of secured credit and leave it intact to achieve

[405] Controversy rather focuses on the extent to which, and how corporate bankruptcy law should concern itself with how value is distributed. Generally, the theories may be divided into two groups characterised in the literature as 'Proceduralists' and 'Traditionalists. The former groups state that insolvency law exists primarily to maximise the extent of recoveries for the benefit of creditors of the insolvent company. The latter are theorists who hold the view that stakeholders in general who have an economic interest in the company should be included. Fore more, Charles W. Mooney, Jr, 'A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure, (2004) 61Washington and Lee Law Review,931.
[406] Mokal (n379)
[407] See Westbrook (n1) 799.
[408] Elizabeth Warren, 'Bankruptcy Policymaking In An Imperfect World' (1993) 92 Mich L Rev,336,342.

the socially useful purposes of debt finance.[409] Security interest in insolvency simply means the right to be paid first, in full, from the proceeds of disposition of the designated collateral.[410]

Depriving secured creditors of their control of collateral in favour of a collective decision-making mechanism that balances the competing interests of creditors and prevents one creditor from dominating stems from the premise that insolvency disputes are characterised as creditor-versus-creditor, with competing creditors struggling to push the losses of default onto others. The secured creditor holds significant power to force the debtor into immediate asset liquidation due to their status. This can result in the piecemeal dismemberment of the insolvent debtor's assets, which may be more valuable if kept together.[411]

In Korobkin's view, insolvency law is fundamentally different from debtor-creditor law in that it performs a 'distinct function' which is forcing dispersed and heterogeneous 'co-owners' of the common pool to decide how best to deploy the pool of assets as if they were a sole owner. On this view, insolvency law should deal with financial distress in an inclusive and rational way, not necessarily to recover debt. In this sense, where secured creditors are able to control the process, they have an incentive to seek to liquidate the distressed company's assets as quickly as possible. However, by enabling unsecured creditors to review and comment on sale process, it is expected that they will object to the sale if they believe an alternative to the sale of insolvent debtor's assets, such a restructuring plan for the company's operation is more appropriate.[412]

[409] The benefit was thought to be a reduction in borrowing costs and an increase in the availability of credit although the efficiency of secured credit in delivering these results from the perspective of the credit system as a whole is hotly disputed.
[410] Douglas G. Baird & Robert K. Rasmussen, 'Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations,(2001) 87Virginia Law Review,921,923.
[411] Warren (n408) 336
[412] Donald R Korobkin, 'Rehabilitating Value: A Jurisprudence of Bankruptcy' (1991) 91 Columbia Law Review,717,723.

When the secured indebtedness exceeds the value of secured assets, general creditors essentially have no entitlement. Nevertheless, a mechanism is still needed to determine whether this condition holds true, as the manager, shareholder, and senior creditor cannot be solely trusted to safeguard the rights of third parties. Therefore, the establishment a reliable process to objectively assess and address such situations is of a major important. Insolvency law should encourage and incentivise the general body of creditors to actively participate in the process. In this way, insolvency serves to eliminate the risk of excluding stakeholders who might be the residual owners but ill-informed and cannot make their voice heard.[413]

Plurality of voice has been advocated as an indispensable element of insolvency law by insolvency scholars who subscribe to the 'forum' view of insolvency. Janis suggests that

> ''bankruptcy and insolvency law should have as both policy objective and key policy instrument the establishment of a forum where all the interests can be heard regarding the possible restructuring of the insolvent corporation. Suppliers, employees, customers, and local government may all have an interest in the workout, even if that interest cannot be translated into current capital claims''.[414]

Corporate insolvency regime in the US demonstrates the dispersed creditor model of governance. Unsecured creditors are given the right to form a creditors' committee that has investigative powers.[415] The Bankruptcy Code defines 'claim' broadly to pull future creditors into the court-supervised plan and to require participation by anticipated claimants.[416] Chapter 11 is also based on one of the fundamental principles, namely *pari passu* which permits pro rata distribution of the debtor's value amongst the unsecured creditors. This same pro-rata principle is implemented for governance rights through the

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[413] Baird and Picker (n343) 315
[414] Janis Sarra, '*Creditor Rights and the Public Interest: Restructuring Insolvent Corporations'* (University of Toronto Press, 2003) 52.
[415] 11 U.S.C. 1103(c)(2)
[416] 11 U.S.C. § 101(4)

principle of 'one dollar, one vote" of value. In this sense, decision-making power is shared proportionally in the same way the distributional burden is shared.[417] Finally, secured creditors, can be crammed down (i.e. forced to accept a reorganisation plan against their wishes).[418] This list is suggestive rather than definitive, but it serves to show that the US Chapter 11 has endorsed the dispersed creditor model of governance in insolvency

3.2.2 The Concentrated Creditor Model of Governance

The concentrated creditor model of governance refers to the secured-creditor management of the recovery process. This implies that the company's directors and other creditors have very little input into the decision-making process. This understanding is deeply rooted in the creditors' bargain theory, which emerged from the law and economics movement in the US during the 1970s and has remained the predominant perspective in the field ever since.[419] To this theory, insolvency law is designed to acknowledge and respect creditors' pre-insolvency negotiated rights as they stand, honouring both the powers and limitations established by non-insolvency law without altering them.[420] In essence, the legal powers of secured creditors should not be compromised to confer a benefit on unsecured creditors, and preventing secured creditors from enforcing their collateral during the recovery process without appropriate compensation is viewed as unacceptable.

> 'The creditors' bargain view of insolvency law argues that solvency state rights should be preserved in insolvency states. In particular, command over assets should be the same in insolvent states as in solvent states'.[421]

417 Janger and Levitin (n46) 1860
418 11 U.S.C. § 1129(b)(2)(A).
419 Jackson(n147) 64
420 Samuel E Etukakpan, 'Business Rescue and Continuity of Employment: Analysing Policy Through the Lens of Theory' (2011) 3 Company Lawyer, 4,8.
421 David C Webb, 'An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain?' (1991) 43 Oxford Econ Pap,152,160.

In addition, Roy notes that a secured creditor holds a powerful position because it was contractually negotiated. In contrast, unsecured creditors entered into agreements with an awareness of insolvency laws, thereby implicitly consenting to the position they find themselves in when the company becomes unable to meet its financial obligations.[422] In this sense, unsecured creditors can also manage their exposure by limiting the volume of business they conduct with the company.

From a corporate finance perspective, companies fund themselves through debt, equity, and retained earnings. Money that enters the capital structure as equity does not attract the payment of interest which might be high enough to reflect the lending risk in distressed situations. Consequently, the borrower is not obligated to make periodic payments and may also decide to shelve payment of dividends. In contrast, financing operations through debt involves costs in the form the principal, the interest on the debt and fees chargeable and being unable to keep up with payment schedule can amount to sufficient evidence for insolvency proceedings to be initiated. However, debt financing can be very advantageous. Creditors employ market mechanisms amid at reducing total agency cost and enhancing the value of the companies. Jensen, and Meckling highlighted the role of the various positive and negative covenants and monitoring clauses contractually imposed in lending agreements as a market control mechanism.[423] Through covenants, secured lenders can monitor company performance, dislodge underperforming managers, control risk-taking behaviour, challenge ineffective strategies, and, at the first sign of distress, bring management to the table or, if necessary, trigger insolvency proceedings. The secured creditor is entitled to regular, detailed updates on the company's affairs, and therefore, he is in a position to make an evaluation as to the financial viability of the company. Upon this

[422] Sarah Paterson, 'Debt Restructuring and Notions of Fairness' (2017) 80 The Modern Law Review, 600,615.
[423] Jensen and Meckling (n17) 305

evaluation taking place, the secured creditor will decide whether to rescue the company or to liquidate the company's assets.[424]

Formal insolvency procedures are typically lengthy and involve direct costs, such as professional fees and administrative expenses. In contrast, negotiating debt rescheduling or interest rate reductions is generally more cost-effective, faster, and more straightforward for both the debtor and the creditors. Exercising the right of enforcement and sale is appropriate for the lender to the extent that doing so is less costly and yields greater returns than renegotiation. Giving control over enforcement to the concentrated creditor, even when its priority right is adequately protected, allows it to make use of the information it has gathered through its business relationship with the company to determine the most appropriate course of action under the circumstances. In this sense, allocating control to the senior lender toughens the disciplinary effect of debt finance, obviates the need for a procedure at which all stakeholders would participate in decision-making. This model, in short, lowers transaction costs and facilitates optimal decision making for the benefit of all stakeholders.[425]

The replacement of secured concentrated model with a more dispersed model may make all stakeholders worse off. Unsecured creditors may have nor knowledge about insolvency procedures neither have they information about the financial state of a company's affairs, and their claims tend to be relatively small. The end result, they may have no sufficient economic incentive to actively engage with and participate in the insolvency procedure. In fact, the costs of participating could outweigh the benefits (dividends) they stand to gain from the procedure.[426]

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[424] Armour and Frisby(n18) 77

[425] Ibid 78

[426] Vanessa Finch and David Milman, '*Corporate Insolvency Law'* (Cambridge University Press 2017) 94; Christopher F. Symes, '*Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor*

More importantly, there may be a significant lack of uniformity among unsecured creditors. They do not form a homogeneous group, and their commercial interests can vary considerably. For instance, employees may be willing to continue working for the company, while suppliers or other trading partners may choose to cease trading with or supplying to it.[427] The number and the heterogeneous objectives of the unsecured creditors may make reaching an optimal solution (i.e. liquidation or restructuring) difficult, impossible or very costly. Moreover, unsecured creditors may have little to lose and, as a result, could use the control rights allocated to them to delay or obstruct the insolvency process—potentially to the detriment of secured lenders, who have a significant stake in the company's restructuring.[428]

A dispersed control model may give rise to a free-rider problem, [429] where certain parties benefit from the efforts of others without contributing themselves. Similarly, some unsecured creditors may refrain from participating in the control of the process, instead relying on other unsecured creditors to take on that role—without bearing any of the associated costs. The overall effect is that no unsecured creditor ends up exercising control over the process. Unsecured creditors often assume that someone else will take on that role, but in reality, no meaningful oversight occurs at all. However, they can still free-ride on the

Status' (Routledge Taylor & Francis Group, 2008) 126-127; Lynn M. LoPuck, 'The unsecured creditor's bargain' (1994) 80 Va.L.Rev. 1887,1900.

427 *Gertner v CFL Finance Ltd* [2018] EWCA Civ 1781; [2018] B.P.I.R. 1605; Dennis Cardinaels, 'Differentiation between groups of unsecured creditors: a solution to reduce vulnerability?'(2019) 32 Insolvency Intelligence 116

428 Schillig (n153) 7

429 The free-rider problem is a market failure. It occurs also when the company is solvent. Some shareholders may rely on other shareholders to monitor the directors' behaviour, thus obtaining the full benefit of improvement in managerial performance without bearing any costs. More problematic when all shareholders think the same way and seek to free ride. The outcome of such behaviour will usually result in little or no monitoring at all taking place. Oliver Hart, 'Corporate Governance: Some Theory and Implications'[1995]105 The Economic Journal,678,681.

ability of their more powerful secured counterparts to control and monitor the insolvency process.[430]

Informal workouts are often cost-effective and quick, they are negotiated and implemented without requiring court involvement or the engagement of an insolvency practitioner. They enable early resolution of a company's difficulties, and they can help avoid the negative perceptions associated with formal insolvency procedures.[431] However, being contractual in nature, all of the creditors bound by the agreement must agree to it, meaning that even a single, small creditor can potentially exercise hold-up rights to extract additional private benefits.[432] However, the hold-up risk may also materialise in formal insolvency processes due to excessive veto rights. The feature of collectivisation may incentivise a creditor to exercise a veto in pursuit of a personal additional benefit, which reduces the likelihood of achieving an optimal outcome for all creditors.[433]

The UK has been actively involved in legislative reforms ostensibly aimed at balancing the power of different groupings and promoting collectivism, and defusing the risk of a 'tyranny' of the secured creditors. Assessing whether the UK's corporate insolvency law, in reality, embraces the dispersed creditor or the concentrated creditor model in the insolvency decision making process requires the examination of the structure of the UK's corporate insolvency regime.

[430] Stuart Gillan and Laura T. Starks, 'Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective', (2003)13 Journal of Applied Finance,4,9.
[431] Paul J. Omar, 'The Convergence of Creditor-driven and formal insolvency models' (2005) 2 International Corporate Rescue 251,255; John Armour, 'Should we redistribute in insolvency? In Joshua Getzler and Jennifer Payne (eds), Company Charges: Spectrum and Beyond (Oxford University Press, 2006) 219
[432] Payne (n386) 287.
[433] Schillig (n153) 8

3.3 Practical Application

3.3.1. Administration and Administrative Receivership

The current UK insolvency framework provides a number of formal mechanisms for addressing and resolving corporate insolvency.[434] The main statutory mechanism is administration, which was first introduced in the Insolvency Act 1986 and later reformed in the EA2002 to raise the profile of the rescue culture. In an administration, an insolvency practitioner known as an administrator is appointed to handle the affairs and operations of the insolvent company.[435] The administrator may be appointed in one of the following ways: the first is through a court order made upon the application of the debtor, its directors, one or more of its creditors, a qualifying floating charge holder, or the liquidator.[436] Second, by way of an out-of-court appointment, either by the debtor or its directors,[437] or by the holder of a qualifying floating charge.[438] Upon this initiation taking place, statutory moratorium comes into effect[439] and during which creditors are kept away from the company's assets, and all legal actions are suspended. For example, no administrative receiver may be appointed,[440] no resolution can be passed for the winding up of the company,[441] no winding up order may be made, no actions can be taken to enforce security over the debtor's property, no repossession of goods under any hire-purchase agreement,[442] or entering into any leased premises, subject to leave of the court.

[434] Such as Company Voluntary Arrangements (CVAs) under Insolvency Act 1986, Part I and Sch A1 and scheme of arrangement under Companies Act 2006, s 899
[435] Insolvency Act 1986, Sch B1
[436] Insolvency Act 1986, Sch B1, Para 10, Para 35, Para 37, Para 38
[437] Insolvency Act 1986, Sch B1, Para 22
[438] Insolvency Act 1986, Sch B1, Para 14
[439] Insolvency Act 1986, Sch B1 paras 42-43
[440] Insolvency Act 1986Sch B1, Para 40, Para 42
[441] Insolvency Act 1986, Sch B1 para 43(6A).
[442] Insolvency Act 1986, Sch B1 para 43(3).

A broad statutory stay of this kind can provide the company with a 'protective cloak' and much-needed breathing space, allowing it to properly assess its situation and determine the best course of action without being interrupted by creditors seeking to enforce their legal or contractual rights during the initial stages of the process.[443] The moratorium remains in effect pending the disposal of an administration order application in the case of a court-appointed administrator) or when an administrator is not appointed in the period following the giving of notice of an intention to make such an appointment. The moratorium will not be lifted unless the administrator consents to the creditor's application. If he refuses, the creditor may apply to the court to challenge his decision.[444] The administration process automatically terminates at the end of a year from the date on which it took effect. An extension of time is possible subject to the consent of the debtor's creditors or the permission of the court.[445] In the former case, the extension cannot exceed 6 months.[446]

Upon the entry into administration, the administrator effectively displaces the company's existing management as the prime decision maker. While the directors and managers often remain in place, the administrator takes over the day-to-day control and management of the company. Within eight weeks of taking office, the administrator must submit a proposal to the company's creditors outlining the intended course of action for the distressed company. In this regard, the administrator must perform his functions with three objectives. Firstly, he must attempt to rescue the debtor company as a going concern.[447] Secondly, if, the administrator believes that, this goal is "not reasonably practicable" or would be less beneficial to the creditors as a whole than a winding-up, the administrator is permitted to consider the second objective and wind-up the company.[448] Thirdly, if neither of these

[443] Andrew Keay and Peter Walton, '*Insolvency Law Corporate and Personal'* (3rd edn, Jordans, 2012) 108
[444] *Innovate Logistics Limited (in administration) v Sunberry Properties Limited* [2008] EWCA Civ 13212
[445] Insolvency Act 1986, Sch B1 para 76(1) and (2)
[446] Insolvency Act 1986 para76(2)(b).
[447] Insolvency Act 1986 para 3(1)(a)
[448] Insolvency Act 1986para 3(1)(b).

preferred objectives is reasonably practicable, and if doing so does not unnecessarily harm the interests of the creditors as a whole, the administrator may choose to realise assets for distribution to secured and preferential creditors.[449]

It is crucial to explain the historical context in which the EA 2002 reforms were introduced. The roots of administration may be traced back to the Cork Report.[450] The report advocated for an alternative to outright insolvency or winding up, leading to the introduction of the administration procedure under the Insolvency Act 1986. However, the procedure differed from the current one in various important respects. Firstly, administration under the Insolvency Act 1986 did not function on a stand-alone basis. So, companies had to combine administration with some other statutory procedures in order to restructure their debt. Common combinations were the use of administration twinned with a Company Voluntary Arrangement (CVA) under the Insolvency Act 1986[451], or a scheme of arrangement under the Companies Act 1985.[452] Secondly, because of the judicial supervision over the process, administration under the Insolvency Act 1986 was perceived as more costlier and potentially lengthier than other procedures.[453] Thirdly, and perhaps most importantly, although administration under the Insolvency Act 1986 showed the advantage of being able to grant a moratorium on most types of enforcement actions, it did not prohibit the appointment of an administrative receiver by a floating charge holder. In particular, the appointment of an administrator could not be approved unless the consent of the all-floating charge holders is granted. If this is the case, successful applications for administration orders will either come from creditors or from the debtor company with the approval of

[449] Insolvency Act 1986 paras 3(1)(c) and 3(4).
[450] Cork Report (n267)
[451] Insolvency Act 1986 Part I
[452] Finch (n91) 366, citing Harry Rajak, "The Challenges of Commercial Reorganization in Insolvency: Empirical Evidence from England" in Jacob Ziegel (ed), Current Developments in International and Comparative Corporate Insolvency Law (Oxford: Clarendon Press 1994).
[453] Insolvency Service, Company Voluntary Arrangements and Administration Orders: A Consultative Document (HMSO 1993) 29.

creditors. The need for the administrator himself to seek the approval of creditors invariably means that the administrator tends, once appointed, like an administrative receiver, to act in favour of the creditors, even though he is technically the agent of the company and must conduct his duties in the best interests of the creditors as a whole. This was a major shortcoming of the regime, as it significantly curtailed an administrator's abilities and arguably created a conflict of interest.[454]

Moreover, given the ability of the receiver under administrative receiverships to only prioritise the repayment of his appointer and ignore the general body of creditors. In sharp contrast to receivership, an administrator's discretion and power did not extend to making distributions to creditors. As a result, floating charge holders were further incentivised not to consent to the appointment of an administrator and instead opted to appoint an administrative receiver. [455] These imbalances cast doubt on the credibility of administration as a rescue mechanism, which consequently led to its rare use.[456] In 1986, however, these flaws in the architecture of the administration regime were widely considered unproblematic. The Cork Committee, which had recommended the creation of the administration process, actually endorsed administrative receivership as the primary mechanism for resolving corporate insolvency.[457]

Administration was developed in the 1986 legislation, as a secondary option and to supplement the existing receivership model receivership. Specifically, the Cork Committee recognised the importance of control facilitated by the extension of secured credit. The Cork Report, identified credit as 'the lifeblood of the modern industrialised economy'.[458] Cork recognised that not every insolvent company would have a creditor possessing a floating

[454] Webb (n421) 153.
[455] Finch (n237) 369
[456] ibid 368.
[457] Cork Report (n267)
[458] Cork Report (n267)

charge with adequate resources and incentives to appoint a receiver. This implied that some companies would be deprived of the supposed advantages associated with receivership. The Insolvency Act 1986 drew attention to these concerns and proposed the administration provisions to extend the 'benefits' of receivership to such companies.[459]

It is important to outline a distinction between administration and administrative receivership. In a receivership, the receiver takes control of the company and its assets, with the principal duty to sell off business/individual assets for the best possible price or hive them down to a new debt free company which could be sold off so as to satisfy the chargee's claim, irrespective of whether this led to other creditors receiving nothing or resulted in the liquidation of the company. The receiver was not under an obligation to rescue distressed companies, and creditors other than the chargee may enforce their claims against a company that has entered receivership. In short, by permitting creditors to act in their individual self-interest, the receivership model automatically puts distressed companies into liquidation even if rescuing the company would generate more value.[460] The cumulative intention behind the EA reforms was therefore clear: to remove administrative receivership and establish a more efficient model, better suited to rescuing distressed companies.[461]

The influential white paper that preceded the EA 2002 reforms contributed to defining concerns regarding the intricacies of receivership. It highlighted that receivership increased the potential for value-destructive behaviour and led to fire-sale liquidation, as opposed to the continuation of the business.[462] At the same time, the feature of selecting a receiver by a creditor holding a floating charge at almost no notice and the fact that the receiver was

[459] Cork Report (n267) See also Rizwaan J Mokal, 'Administrative Receivership and Administration – An Analysis' (2004) 57 CLP 355,360.
[460] Webb (n421) 153
[461] Sandra Frisby, 'Making a Silk Purse out of a Pig's Ear -Medforth v. Blake &Ors' (2000) 63 MLR 413-423
[462] Government white paper, 'Productivity and Enterprise: Insolvency – A Second Chance', DTI, Cm 5234, July 2001, see http://www.insolvency.gov.uk/compwp.htm (assessed 10th July 2022)

primarily accountable only to the appointing creditor and not to the general body of creditors raised serious questions regarding the lack of transparency and accountability within the process. Finally, the paper raised concerns that when the appointer is over-secured, [463] receivers may not take sufficient care to keep the process costs down and to ensure that the assets are realised at the best price.[464] These sentiments were echoed by the government ministers in the subsequent parliamentary debates when the EA 2002 was introduced.[465] In particular, the government sought to put company rescue at the heart of the revised administration procedure, ensuring that companies with a decent chance of survival are not driven to the wall unnecessarily.[466]

Despite significant efforts to keep the administrative receivership within the corporate insolvency law toolbox.[467] The EA 2002 virtually, but not completely, abolished receivership.[468] It was considered that the changes in the EA 2002 'herald a new era of corporate insolvency law for the United Kingdom... aimed, at least ostensibly, at encouraging company rescue in two ways: 1) removing administrative receivership and substituting the process with a with a streamline administration procedure, and 2) by shifting power from secured to unsecured creditors'. The transfer is affected through two mechanisms of accountability: a) legal duties to all creditors[469] b) the requirement for approval by a creditors' meeting,[470] with some exceptions.[471]

[463] Empirical evidence supporting the view that the holders of floating charges are over-secured in most cases. For more, See Mokal (n459) 360
[464] Insolvency Service, Productivity and Enterprise: Insolvency – A Second Chance (HMSO 2001) 2.2
[465] HL Deb 22 July 2002, vol 638, col 766.
[466] Productivity and Enterprise: Insolvency - A Second Chance Cm 5234 (London: HMSO, 2001), para 2.6
[467] For example, Armour and Frisby argued that by concentrating control in the hands of a single creditor, the receivership model had the potential to reduce monitoring and enforcement costs, to the benefit of all creditors. Armour and Frisby (n18) 77
[468] Administrative receivers may be still appointed to enforce a security taken prior to 15 September 2003. s 72A. Exceptions have also been inserted into IA 1986 allowing for the appointment of administrative receivers to manage certain specialised companies. 72B-72F.
[469] See Insolvency act 1986, para 3, Sch. BI.
[470] Insolvency Act 1986 B1 para 52
[471] Insolvency Act 1986 B1 Para 52 (1)

In fact, the transfer of power to unsecured creditors was incomplete and the 'new' administration procedure still places the secured creditors in a strong position relative to unsecured creditors. The floating charge holder is responsible for the selection and appointment of the administrator. Banks operate a panel for the selection of the accountants to act as their insolvency practitioners. The main incentive, therefore, will be for the administrator to develop and maintain a reputation as 'bank friendly' because those appointees who take steps contrary to the banks' interests during an appointment may be unlikely to be appointed again.[472]

Moreover, and perhaps more importantly, the EA 2002 did not provide for a regime of 'super-priority' financing as part of the administration process.[473] In other jurisdictions,[474] financiers who provide funds to a company undertaking a restructuring may enjoy priority repayment over existing debt, equity, and other claims.[475] The super-priority status entitles the new financiers to regular information about the company's affairs and a high level of control over its rescue attempts.[476] In the absence of such regime, a new financier needs the consent of the existing banks for a priority position over cash coming into the business or for the accommodation of new security interests on assets already encumbered by the banks. It is unlikely for a bank keen to maintain its priority and protect itself from risks of non-repayment to grant such consent. As a result, the fundamental lack of statutory provisions

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[472] John Armour, Audrey Hsu, and Adrian Walters, "The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK" (2012) 8 Review of Law & Economics, 1,4.

[473] Professor McCormack suggests that the law impliedly permits the administrator to furnish a prospective lender with super-priority status. Because certain powers outlined in Schedule B1 paragraph 99 of the Insolvency Act 1986 allow the administrators to exercise their statutory powers to borrow new money and grant security over a company's property and the costs of finance may be ranked ahead of administration expenses. Gerard McCormack, 'Super-priority new financing and corporate rescue' (2007) Journal of Business Law, 701.

[474] 11 USC, s364. Colloquially known as 'super-priority', post-petition financing, or debtor-in-possession financing.

[475] Approval of the court is required to provide adequate protection to existing creditors. US, 11 USC, s364 (c)

[476] Vatsal Gaur, 'Post Petition Financing in Corporate Insolvency Financing: A Comparative Study Across Various Jurisdiction' (2012) 111 SCL, 17.

relating to ‘super-priority’ financing has ensured that the company’s bankers preserve their control of funding during the administration process. This clearly presents a position where an administrator can not pursue a particular course of action contrary to the favourable by the secured creditor.[477]

In addition, despite the intention to introduce a moratorium to ensure successful restructurings, some commentators have questioned its effectiveness, arguing that courts are often reluctant to deny secured creditors leave to exercise their security rights when the company is in administration. The courts, in fact, have long recognised that the administration procedure should not be used if significant loss would be caused to those who were secured creditors hen the administration order was made, as an alternative to a winding-up order. This loss may include any type of financial loss, direct or indirect, as well as losses caused by delay, and, in some circumstances, it may also encompass non-financial loss.[478] Other creditors may also escape the binding effect of the stay. For example, the court recognised the right of landlord to exercise re-entry right.[479]

Another fundamental principle of administration is the absence of a cramdown mechanism. As a result, administration cannot be used as a cramdown tool for secured debt, meaning that a proposal for resolving the debtor’s insolvency cannot be approved against the will of secured creditors. However, where a class of unsecured creditors (or equity holders) is unwilling to support a plan preferred by secured creditors or is to be offered nothing within it, secured creditors may combine the scheme of arrangement procedure[480] with a pre-packaged administration to facilitate a de facto cramdown of the unsecured creditors.[481]

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477 Armour, Hsu, and Walters (n472)5
478 *Bristol Airport plc v. Powdrill* [1990] Ch 744
479 *Razzaq v. Pala* [1998] BCC 66; Air Ecosse Ltd v Civil Aviation Authority (1987) SLT 751
480 Companies Act 2006, s 895(1).
481 *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch).

Based on the above, it is easy to see why administration has been described as a "receivership plus"[482] —combining the exceptional powers of a floating charge receivership with a renewed emphasis on the concept of rescue, which has been recognized in the UK for some time. However, the role played by secured creditors in insolvency proceedings has led to the highly contested practice of pre-packs,[483] which are often concluded without presenting proposals to, or receiving input from, unsecured creditors.

3.3.2 Pre-pack

The pre-pack is an insolvency process in which a distressed company with a selected group of creditors agree to a sale of all or part of the distressed business or assets of the company prior to initiating formal administration procedures.[484] As mentioned above, provisions within the Insolvency Act 1986 permit the appointment of an administrator either with or without approval by the competent court.[485] In a pre-pack, the administrator is appointed out of court and then implements the pre-arranged deal immediately upon, or shortly after, appointment.[486] In practice, pre-packs are presented as an alternative to the traditional administration process, in which a sale is only permitted under a plan that has followed a prior trading period and received approval from the statutory majority of creditors.

There are different reasons why pre-packs have always been regarded as satisfying the obsession of the secured creditors for high level of control and certainty. Firstly, secured creditors are typically the only parties participating at the negotiations of the pre-pack with

[482] Gerard McCormack, `Control and corporate rescue - an Anglo-American evaluation' (2007) 56 International & Comparative Law Quarterly,515,536.
[483] Polo (n380)
[484] Insolvency Service, 'Report on the First Six Months', Operation of Statement of Insolvency Practice 16', (2009), para 2.1.
[485] Insolvency Act 1986, Sch B1, Para 14
[486] Vanessa Finch, 'Corporate Rescue: A Game of three Halves' (2012) 32 Legal Studies 302, 303.

existing management and the administrator who is chosen by them. Secondly, secured creditors usually will have knowledge of all relevant information about the company than other stakeholders. Thirdly, since the pre-pack is a short process, they tend to be executed more quickly than other insolvency proceedings.[487]

While administrators are typically obligated to present proposals for a vote at a creditors' meeting within eight to ten weeks of their appointment,[488] exceptions exist. One crucial exception is when there are inadequate proceeds to distribute to unsecured creditors, or the company cannot be rescued as a going concern. In such cases, the requirement for a creditors' meeting may be bypassed,[489] essentially authorising the administrator to initiate measures leading to a pre-pack without formal creditor consultation. Consequently, unsecured creditors find themselves uninformed about the deal and effectively presented with a *fait accompli*.[490]

With this in mind, most stakeholders will have limited opportunities to scrutinise and challenge the terms of pre-packs. As such, most stakeholders will depend on the administrator to bring an element of fairness to all parties concerned and to maximise the value locked in the assets of the distressed entity. However, there is a trend occurring which shows that administrators also see these speedy collection mechanisms with favour.[491] This is because they can offer their advisory services not only during the formal insolvency procedure but also in the period leading to the insolvency filing.[492] An administrator's inclination to pursue pre-packs may also arise from the greater uncertainties and prolonged

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487 Bo Xie, Comparative Insolvency Law: The Pre-pack Approach in Corporate Rescue (Edward Elgar 2016) 90

488 Insolvency Act 1986 para 52 of Sch. B1

489 Insolvency Act 1986 para 45, sch B1, [52].

490 Paterson (n422) 605

491 Bo Xie, "Protecting the interests of general unsecured creditors in pre-packs: the implication and implementation of SIP 16"(2010) 31 Company Lawyer,189,195.

492 Eugenio Vaccari, 'English Pre-Packaged Corporate Rescue Procedures: Is there a Case for Propping Industry Self-Regulation and Industry-Led Measures such as the Pre-Pack Pool?'(2020) 31 International Company and Commercial Law Review,170,180.

nature of the long-term negotiations involved in non-pre-pack alternatives. Finally, administrators have strong incentives not to scrutinize or challenge the terms of pre-packs, largely for the same reasons they are generally inclined to support senior secured creditors. In many cases, administrators can reasonably anticipate that a significant portion of their future appointments will come from banks. As a result, particularly when the interests of banks diverge from those of other creditors, administrators may be strongly motivated to cultivate a reputation for favouring the former.[493]

Judicial scrutiny of pre-packs appears problematic and is fraught with significant obstacles. In principle, courts have long accepted the legitimacy of this procedure, as administrators are empowered to dispose of a company's assets without seeking the court's permission.[494] In the case of *Kayley Vending Limited* the court made it clear to the insolvency professionals that the rationale underpinning the Insolvency Act 2000 and the EA 2002 is in fact to reduce the extent of the court's involvement in the initiation of insolvency processes.[495] Moreover, it is unrealistic to expect non-participating creditors to prove misconduct, as pre-pack deals are negotiated in secret, behind closed doors, making it extremely difficult to obtain the necessary information.[496] On the other hand, determining whether an administrator has acted so unfairly as to harm the interests of unsecured creditors is exceptionally difficult. Most decisions are framed as matters of commercial judgment, and courts are generally reluctant to intervene or second-guess such judgments, viewing insolvency practitioners as better equipped—by virtue of their knowledge and expertise—to make those decisions.[497]

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[493] Mokal (n459) 387

[494] *Re T&D Industries Plc* [2000] 1 W.L.R. 646; [2000] B.C.C. 956; *Re Transbus International Ltd* (In Liquidation) [2004] EWHC 932 (Ch); [2004] 1 W.L.R. 2654; *DKLL Solicitors v Revenue and Customs Commissioners* [2007] EWHC 2067 (Ch); [2007] B.C.C. 908; *Hellas* [2010] B.C.C. 295; *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch); [2009] B.C.C. 578 *Re Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch); [2010] B.C.C. 295.

[495] *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch), [2009] B.C.C. 578, para 3.

[496] Frisby (n135)

[497] *Re Zegna III Holdings Inc*. [2009] EWHC 2994 (Ch)

In many ways, the pre-pack is a 'functional substitute for receivership' which the government sought to restrict with the 2002 reforms.[498] In this sense, pre-packs have shifted the focus away from the incomplete dispersed creditor model of governance, in which creditors – secured and unsecured alike are given the opportunity to consider the purpose of the administration, toward a concentrated creditor model of governance in which the control of the company during insolvency is placed in the hands of the secured creditor, which in turn undermines the stated goals of the EA 2002.

In this light, the UK system is paradigmatic of the concentrated-creditor control model. It embraces the argument for allocating control to the senior lender, which will use its governance rights in the insolvency process to maximise the value of the debtor, and hence its claim.

3.4. Evaluating the Basis for the Use of the Concentrated Creditor Model of Governance

The fact that the secured creditors' governance rights are proportional to their economic exposure to the company's value[499] is both a justification for concentrating wide ranging-powers, over the managing of the company during insolvency, in the hands of the secured creditor and an illustration of the alignment of the secured creditors' interests with that of the distressed company. Long standing legal and economic theories support the notion that debt ownership customarily conveys a standard package of economic rights (repayment of the principal amount with interest), contractual control rights (to enforce, waive, or modify the terms of the debt contract); other legal rights (including rights to participate in

[498] Adrian J Walters, 'Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom' (2015) University of Illinois Law Review, 543,550.
[499] Klaas Vanneste, 'Decoupling Economic Rights from Voting Rights: A Threat to the Traditional Corporate Governance Paradigm' (2014)15 European Business Organization Law Review 59

insolvency proceedings.[500] Policy makers assume that the elements of this package are generally bundled together and work in tandem. It is assumed that secured creditors are normally interested in keeping a solvent firm out of insolvency and in maximising the value of an insolvent company. Such assumptions have been expressed as the main reasons as to why 'Debtor in Possession' (DIP) model[501] was rejected by the EA 2002 and left private sector lenders to vet administration proposals and support only those with a decent chance of survival.[502]

Private sector lending in the UK was dominated by powerful deposit-taking or 'clearing' banks which provided the vast bulk of finance in the economy. banks tend to be supportive of their business customers in financial distress[503] and often prefer to avoid formal insolvency proceedings, seeking instead to preserve value through informal restructuring where possible. As Baird and Rasmussen note, traditional lenders such as banks typically have a vested interest in avoiding the adverse consequences of insolvency. To that end, they often strive to preserve the long-term viability of their borrowers—or at least the underlying business.[504] This approach is unsurprising for several reasons. Banks are reluctant to associate their reputations with corporate failures and prefer not to be seen as the agents responsible for pushing companies into insolvency.[505] Additionally, appointing insolvency practitioners is generally perceived negatively, as it signals the presence of a bad debt. Even when such an appointment becomes unavoidable, banks often encourage company directors

[500] Grossman and Hart (n331) 695
[501] DIP model, in short, allows directors to remain in control the debtor company and attempt reorganization. For more on the merits and demerits of the model see David Hahn, 'Concentrated Ownership and Control of Corporate Reorganizations' (2004) 4 Journal of Corporate Law Studies 117. See also; McCormack(n482) 515.
[502] Dennis (n396) 120.
[503] Triantafyllos Spahos, 'Bank Liability on the Withdrawal of Credit and the Exercise of Default Remedies' ((PhD thesis, University of Oxford, 2002)
[504] Baird and Rasmussen (n61) 670
[505] Alexandra Kastrinou, 'European Corporate Insolvency Law: An Analysis of the Corporate Rescue Laws of France, Greece and the United Kingdom' (PhD thesis, University of Leicester, 2009) 247

to initiate the process themselves.[506] Banks have strong incentives to pursue informal rescues, as they aim to preserve and extend existing customer relationships. Informal proceedings are also widely regarded as cost-effective, efficient, flexible, and contractually sustainable methods for resolving a debtor's financial difficulties. While negotiations are not without cost, the expected expense is typically lower than that of formal insolvency proceedings—particularly when conducted confidentially, as this helps to minimise indirect costs such as reputational damage and loss of goodwill.[507] It follows that they view formal rescue procedures as mechanisms of last resort for salvaging value over and above the break-up value of the company's assets that would be obtained on a winding-up.[508] Frisby observed a big case, where there was a clearing bank taking its debtor company's interests at heart and trying to turn things around in an attempt to save the business, even to the point of extending more money in to sort the problem out.[509]

The willingness of banks to intervene at an earlier stage in corporate troubles has increased since the turn of the millennium.[510] Major clearing banks have established 'Business Support Teams' to address the problems of their financially distressed customers at the earliest opportunity.[511] A common scenario leading up to transferring the company to the support team will begin when the bank becomes concerned about the company's financial health. At this stage, the team assesses the quality of the company's management, evaluating their performance in navigating the troubled times and their ability to overcome difficulties independently, or whether the company requires active assistance to manage the

[506] Frisby (14)
[507] Robert A Haugen and Lemma W Senbet, 'The Significance of Bankruptcy Costs to the Theory of Optimal Capital Structure' (1978) 33 Journal of Finance 383
[508] Armour, Walters and Hsu(n13)155
[509] Frisby (n14)
[510] Finch(n14) 726
[511] The British Banks Association endorsed corporate rescue in their 1997 paper, 'Banks and Business Working together', (London, 1997), para 3 which states that: 'Banks have long supported a rescue culture and thousands of customers are in business today because of the support of their bank through difficult times'.

associated risks.[512] If it is the case that the company is incapable of meeting the challenges it faces, additional or replacement personnel will inevitably be introduced through specialist suppliers. This may include bringing in turnaround specialists to address the situation.[513] The turnaround specialists will then advance a process involving the development of a turnaround strategy, the establishment of arrangements for reorganising and refinancing, and the implementation of a program to execute the necessary changes.[514] Based on interviews, Armour and Frisby suggest that these anticipatory approaches to corporate troubles yield significant efficiencies, as only a minority of companies reviewed by support teams eventually enter formal insolvency proceedings.[515]Similarly, using a database of information from the private records of three UK commercial banks, Franks and Sussman state clearly that 'although liquidation rights are highly concentrated in the hands of the main bank, their typical response to distress is an attempt to rescue the firm rather than liquidate it automatically'.[516] The fact that banks' inclination to offer advice and assistance outside insolvency reflects their commitment to the corporate rescue ideology in general.[517]

For large distressed companies with multi-bank lending arrangements, differing preferences among banks can create coordination problems. However, since the 1980s, these issues have been addressed under the guidelines provided by 'the London Approach'. This is a non-statutory and informal framework emerged through the efforts of Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring.[518]

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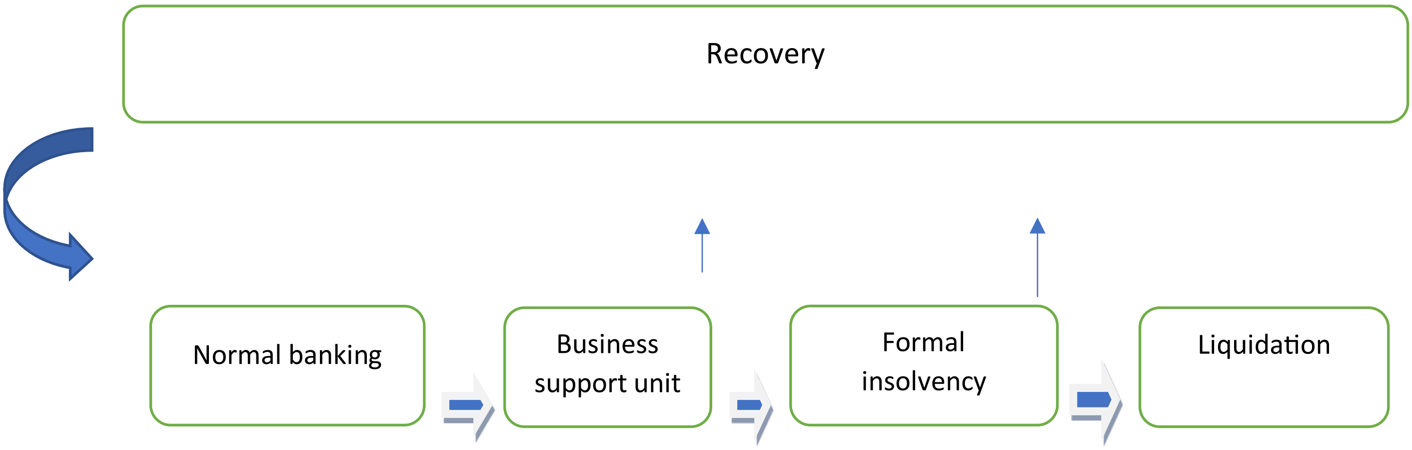
[512] Finch (n14) 715
[513] They can also be referred to as company doctors, independent business reviewers, risk consultants, business recovery specialists, solutions providers, intensive care units, asset-based lenders, Specialised Lending Service Divisions, debt management companies, credit advisers, and cash-flow managers.
[514] Finch (n14)699
[515] Armour and Frisby (n18) 77
[516] Franks and Sussman, (n11) 71
[517] Frisby (n14).
[518] Armour and Deakin (n12) 22.

The normative force of the London Approach was founded on two key aspects. First, there was the perceived threat of regulatory sanctions from the Bank of England, which played a supervisory role as a banking regulator. This role encouraged parties to maintain a positive working relationship with the Bank of England, thereby granting it a degree of authority over their practices. Additionally, the Bank of England was known for its reputation as an honest and impartial broker in in large deal restructurings of large corporates. The other banks, too, played a role in enhancing the ability of the London Approach to facilitate cooperation and coordination among multiple secured banks through decentralised enforcement mechanisms, such that there was the threat of exclusion from future business such as loan syndication for any non-cooperative bank. In the small, homogenous lending community of the time, banks were very concerned about the risk of exclusion from that market.[519]

The emphasis has always been on market-led solutions to deal with financially distressed companies. Only where informal negotiation is exhausted, unavailable or undesirable will formal insolvency proceedings be commenced. By the time a distressed firm reaches formal insolvency proceedings, banks have an incentive to preserve the company and sell it as a going concern rather than piecemeal.[520] The Franks and Sussman's study show that there is some evidence that the banks show an interest in the going concern value of the company, and do not confine themselves to valuing the company's collateral.[521] It is thus justifiable to infer that the interests of the bank and the company are aligned that the bank is expected to focus on the viability of the company and maximising its recovery and incentivised to do

[519] Ibid 30
[520] Polo (n380)
[521] Franks and Sussman (n10) 72.

so or at least has no incentives for a smaller recovery from the debtor or the liquidation of the debtor company.



3.5 The Problem of Empty Crediting

The assumption that creditors governance rights and economic rights are coupled together and work in tandem cannot be longer relied on. Hu and Black[522] introduced the empty creditor theory with the view that governance rights might be decoupled from economic rights quickly, at relatively low cost, on a massive covert scale. Creditor may have greater control rights than economic ownership. Consequently, they may have incentives to cause the company's fall of value or push it into inefficient liquidation, presenting the greatest threat to the effective reorganisation of viable distressed businesses and to the maximisation of value in distressed businesses, which are the two primary goals of the modern insolvency systems.

[522] Henry T. C. Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 S Cal L Rev 811

To use the language of cooperative game theory, the core may be empty.[523] The creditor in control should have an incentive to minimise the costs of achieving an optimal use of the debtor's asset. Institutional creditors, banks in particular, are generally assumed to act rationally, and will typically opt for informal workouts as a first resort. This preference is based on the assumption that the implementation costs of informal arrangements are lower than those associated with formal insolvency procedures. Armour and Deakin argue that the controlling creditor is likely to resort to formal insolvency procedures for viable companies only in extreme circumstances, preferring instead to use the threat of resorting to insolvency law to facilitate a voluntary workout.[524] This view is supported by the findings of Gilson, Kose and Lang which show a positive correlation between out of court restructuring and a company's reliance on bank debt.[525] This means that the bank participation in distress scenarios is vital in defusing the hold-out creditor problem and the common-pool problem, often seen as the impediments to contractual arrangements. An empty core problem occurs when the controlling creditor is not in the best position to determine the most viable resolution of the debtor's distress.

Initially, the empty creditor theory has lacked extensive input from academics. However, over the last years, substantial progress has been made in developing the theory of Hu and Black further with important contributions by authors including Bolton, Oehmke,[526] Klaas[527], Partnoy and Skeel,[528] Rasmussen and Baird[529], Brav and Mathews,[530] Janger, and

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[523] Telser lester, 'The Usefulness of Core Theory in Economics' (1994) 8 Journal of Economic Perspectives,151.
[524] Armour and Deakin(n12)30
[525] Stuart Gilson, John Kose, Larry H P Lang, 'Troubled Debt Restructuring : An Empirical Study of Private Reorganization of Firms in Default' (1990) 27 Journal of Financial Economics, 315,353.
[526] Patrick Bolton & Martin Oehmke, "Credit Default Swaps and the Empty Creditor Problem", (2011) 24 The Review of Financial Studies 2617
[527] Vanneste(n499) 62.
[528] Partnoy and Skeel Jr (n285) 1121
[529] Baird and Rasmussen(n61)
[530] Alon Brav and Richmond D. Mathews, "Empty Voting and the Efficiency of Corporate Governance" (2011) 99Journal of Financial Economics 289

Levit,[531], Konstantinos. and Ioan F,[532] As already highlighted by Hu and Black in contrast to the traditional legal and economic theory, creditors with negative or zero economic ownership may have incentives to reduce the value of all debt claims or the value of the claims they formally hold in hopes of profiting from a higher pay out on an array of other complicated financial instruments and derivatives. The fundamental assumption that the creditors' economic exposure in the debtor is reflected in the control rights and that they will act so as to maximise the value of firm has been rendered obsolete by profound shift in logic and practice in the field of finance.

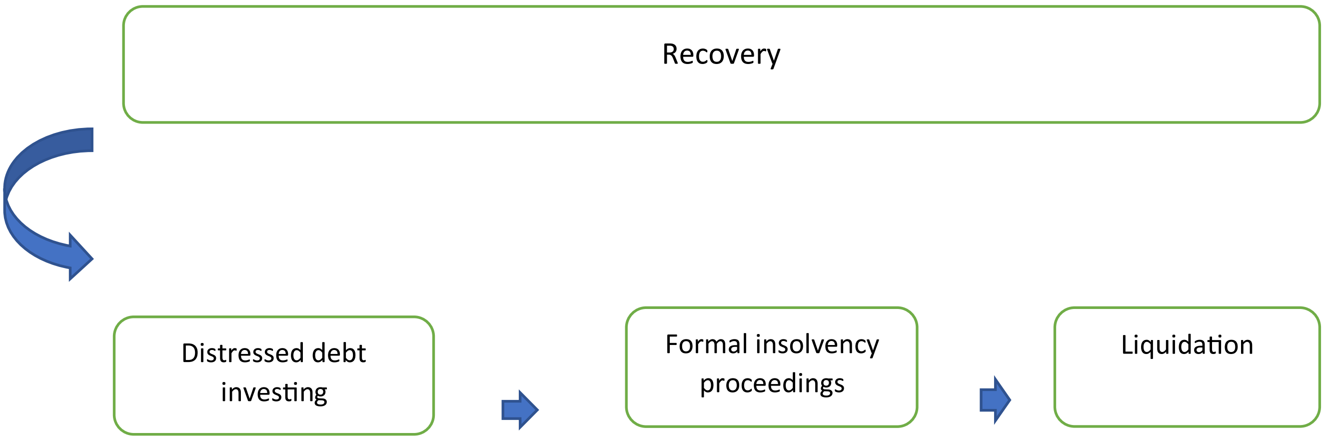
It is widely believed that widespread decoupling is due, more than any other reason, to the rise of investing in the debt of financially troubled companies.[533] Investors purchase bankruptcy claims—and thus governance rights—at a discount with the ability to employ diverse spectrum of derivatives strategies for the purpose of hedging positions. Hedging positions of this nature enable investors to limit their exposure to the financial risks of the company, effectively separating their governance rights from their economic interests. However, when these hedged empty creditors are economically 'short' they may have an incentive to capitalise on the company's further misfortune. By virtue of their voting rights, they hold the authority to influence—and potentially contribute to—such adverse outcomes.[534]

Derivatives can be used to construct such a decoupling; however, they are not the only means of doing so. Distressed debt investors may also hold interests in a competitor of the debtor, and these interests often gain significantly in value if the debtor fails to reorganise and is forced to liquidate. Not only can a distressed debt investor acquire an interest in a

[531] Janger and Levitin (n46) 1866
[532] Zachariadis, Konstantinos (Kostas) E and Olaru, Ioan F (2016) Hedge funds are heavily involved in the distressed debt market. LSE Business Review (08 Nov 2016). Blog Entry.
[533] Hu and Black (n522) 822; Janger and Levitin (n46) 1866
[534] Ibid 817

competitor of the debtor, but it can buy into multiple parts across the capital structure of the same debtor.[535]

The increasing role of distressed debt investors in owning the secured debt of distressed companies calls into question the long-standing assumption that senior lenders are biased toward market-led solutions to deal with financially distressed companies. In contrast to traditional lenders, distressed debt investors occupying the same position in the capital structure of debtor companies often pursue entirely different strategies. Instead of viewing formal rescue procedures as mechanisms of last resort, they embrace them. Rather than seeking to preserve and prolong existing customer relationships, they focus on the relatively short-term profit at the conclusion of the insolvency proceedings. Moreover, their negotiations are not guided by established market conventions but are instead grounded in the strict enforcement of their legal rights.



However, without further empirical evidence, there is a risk that the assumptions on how distressed debt investors exercise their control rights in comparison to the traditional banks

[535] Ibid 818

will remain a matter of anecdotal evidence. In order to replace conjecture and anecdote with hard facts, it will be necessary to examine the roles distressed debt investors and the effects of their presence on the nature and outcome of the insolvency process from a quantitative and qualitative empirical perspective.

Chapter Four: Quantitative and Qualitative Outcomes of Administration Cases

4.1. Methodology

This study is based on a hand-collected sample of companies that entered administrations between 2014 and 2019. This period was selected because the distressed debt market in the UK was generally small and fragmented compared to other countries but took off after the financial crisis.[536] Many banks pursued deals to offload performing and non-performing loans at a value discount in 2014. Lloyds Banking Group, for example, sold about 4,000 non-performing Irish mortgage loans to a distressed debt investor.[537] UK Asset Resolution, a government vehicle that acquired the loan books of defunct lenders Northern Rock and Bradford & Bingley, sold a portfolio of performing residential mortgages to a distressed debt investor.[538]

Notices published in the London Gazette were the starting point to form the sample. The total number of administrations that commenced between 01/01/2014 to 31/12/2019 was 9205. To avoid the issue of exclusion and selection bias, all companies that went into administration during the sample period were examined to establish the presence of distressed debt investors in all cases.

For a company to be included in the final sample. First, the administrator must indicate that the company's debt was transferred to or provided by a third party (investor) during the administration or before the commencement date. Second, the third party must be a distressed debt investor. The investor is classified as a distressed debt investor if it is

[536] EUROPEAN COMMISSION, TARGETED CONSULTATION ON IMPROVING TRANSPARENCY AND EFFICIENCY IN SECONDARY MARKETS FOR NON-PERFORMING LOANS https://finance.ec.europa.eu/system/files/2021-06/2021-non-performing-loans-consultation-document_en.pdf

[537] Fiona Reddan, 'Lloyds sells 4,000 Irish mortgages to Lone Star' The Irish Times, (Dublin,16 Oct 2014) https://www.irishtimes.com/business/financial-services/lloyds-sells-4-000-irish-mortgages-to-lone-star-1.1965834

[538] Emma Dunkley, "UK banks seek to offload old mortgage books" Financial times (London 29 Oct 2014) https://www.ft.com/content/bd8527f6-59d2-11e4-9787-00144feab7de

reported by specialised publications Preqin (an online provider of information on corporate debt situations)[539] and press reports as such or if the investor's own website lists distressed debt investing or special situations investing as part of its major business.[540] Concerns regarding the potential oversight of distressed debt investors can be alleviated by the fact that activism in financially troubled company is dominated by a few groups of investors. This process leads to identifying a sample of 120 cases.

The final sample was then populated using information from reports filed by administrators with Companies House. It is well-known that when a company is placed into administration, the administrator regularly submits reports to the Companies House on the progress of the case.[541] The following reports were reviewed in each administration case: (a) Statement of Affairs, filed upon or shortly after the commencement of administration proceedings; (b) Statement of Administrator's Proposal, filed shortly after commencement; and (c) Administrator's Progress Report(s), filed at different stages of the process.

The data collected permits nuanced detailed analysis and produces robust conclusions. Both because the information used in the sample is in the public domain,[542]enabling other researchers to validate any conclusions, and the reports produced by administrators must meet with certain statutory requirements.[543]

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[539] For example, Preqin identifies Lone Star Fund which is the most active distressed debt investorin my sample as a private equity fund that acquires distressed debt and equity assets including corporate and commercial real estate, single-family residential assets, and consumer debt products. https://www.preqin.com/data/profile/fund-manager/lone-star-funds/472

[540] The prominent distressed debt investors such as Better Capital, Aurelius equity opportunities, Greybull Capital, Rutland Partners, Endless, and Alchemy Partners all state investing in distressed and undervalued or underperforming businesses and other special situations through debt and equity as their main investment strategies in their websites, see for example Aurelius equity opportunities https://www.aurelius-group.com/; Rutland Partners https://rutlandpartners.com/

[541] Insolvency Act 1986, schedule B1, paragraph 41(4); schedule B1, paragraph 78(5)(b); Insolvency rules 1986, rule 2.47(4).

[542] Companies House, 'Get Information about a Company' https://www.gov.uk/get-information-about-acompany accessed 22 April 2022

[543] Insolvency Act 1986, schedule B1, paragraph 41(4) and paragraph 78(5)(b), rule 2.47(4).

Empirical data and results may vary widely due to different interpretations of what amounts to value creation or destruction. Different stakeholders may also disagree about whether the involvement of distressed debt investors in a particular case creates or destroys value.[544] Therefore, various proxies for value creation and destruction were identified. Such as points of distressed debt investor entry into the capital structure, rescue attempts conducted before the formal filling, the nature and outcome of the case, and returns to different classes of creditors.

4.2. Notes on Quality and Completeness of Data Sources

It is crucial to identify the limitations of the data used in this research. To identify the presence of distressed debt investors, this thesis includes administration cases in which the administrator indicates that the debt was transferred to a third party ‘‘a distressed debt investor’’ either prior to the commencement of, or during, the administration process. This transfer may occur by way of assignment or through the direct injection of debt by an identified distressed debt investor. Transfers of debt by way of sub-participation were excluded from this analysis. Under the structure of sub-participation agreements, the original bank (the lender of record) transfers only an economic interest in the loan to the sub-participant—often a distressed debt investor—without assigning legal title or direct creditor rights. In essence, the parties enter into an entirely separate agreement which, although linked to the underlying loan, was legally independent of it. Therefore, the distressed debt investor is unable to exercise any direct control/enforcement rights against the debtor company. The direction and control are exercised through the lender of the record for a fee behind the curtain. The sub-participation agreement is not disclosed to the company, leaving the debtor and the administrator unaware of the distressed debt investor's

[544] Harne, Griffin, and Ivey-Crickenberger(n354)168 (The authors argue that answering the question of whether the distressed debt investors involvement in the bankruptcy process creates or destroys enterprise value rests with, and depends on whom you ask and the positions they acquire in a particular debtor's capital structure.

presence and influence.[545] The trading volume of both par and distressed loans in the secondary market by way of sub- participation is substantial but it is not captured in my data set.

4.3. Coding Procedure and Outcome

The following variables were tracked across each case:

Points of entry: the position of the distressed debt investors in the capital structure (including secured debt, unsecured debt, equity)

Total debt: The sum of all of the company's debts, namely secured, unsecured and preferential debts.

Distressed debt investor debt: Debts held by distressed debt investor, in GBP, as recorded in the Statement of Affairs (including any revised figures provided in subsequent IP reports).

Outcome: Whether standard administration, going concern sale administration, piecemeal sale administration or pre-pack administration.

Total realised: Sum of proceeds, in GBP from sale of assets and surplus from trading (if any), as recorded in IPs' reports.

Distressed debt investor debt returns: Total recoveries, in GBP, of distressed debt investor debt.

Other stakeholders return: Total recoveries, in GBP, of other stakeholders.

The exercise of analysing reports also picks up cases where distressed debt investors seize control of the newly reorganised business by, for example, a debt-to-equity swap, and

[545] See for example, The current LMA Master Funded Participation Agreement (PAR/DISTRESSED) (29 October 2018)

whether standard administration or its abridged version, the pre-pack were used to implement the swap.

4.5. Results and Analysis

4.5.1. Points of Entry

Distressed debt investors strategically choose their positions within the capital structure of targeted companies based not only on profit motives, but also on their intention to actively influence the direction and outcome of the company's restructuring process. The prevalent approach to gaining substantial influence in a financially troubled company involves becoming a creditor through the acquisition of existing blocks of debt, especially secured debt. Distressed debt investors in the sample obtained a creditor position by purchasing secured claims in 93 cases (77% of the cases) and unsecured claims in addition to secured claims in 2 cases (1% of the sample). Distressed debt investors can also exert influence over the insolvency process by offering new financing to the distressed company. A pre-distress lender may not be able to provide financing to companies in distress for several reasons: *inter alia* the existence of regulatory and liquidity constraints and such constraints impose a major obstacle that thwart the efficient implementation of a rescue plan. In my sample distressed debt investors provide new capital to distressed companies on secured basis in 25 cases (20% of the cases)

UK insolvency law has consistently demonstrated deference to the rights of secured creditors, reinforcing the widespread perception of the United Kingdom as a 'bank-friendly' jurisdiction.[546] However, strong control rights now play into the hands of investors in the distressed debt market. Recall that distressed debt investors are generally categorised as

[546] Insolvency systems and the forms of insolvency proceedings they provide to companies are traditionally described on a scale between creditor and debtor friendliness. The absolute protection of creditors' rights, great creditor control, and the lack of automatic stays on creditors' enforcement actions are key characteristics of a creditor-friendly regime. While, debtor control over the process, the availability of a stay of actions against the company to promote recovery are significant features of a debtor-friendly system. For more see McCormack(n482) 520

passive and active-control investors. One can reasonably infer that distressed debt investors in the UK are more likely to be active in the insolvency process, effectively decide to place the company in administration and determine the fate of the distressed company. More importantly, this finding counters the argument that the participation of distressed debt investors in the insolvency process benefits unsecured creditors. This argument is based on the assumption that distressed debt investors' positions will be unsecured and used to challenge the tendencies of secured creditors toward fire sales and undervaluation, ultimately leading to more optimal outcomes. The dynamics of this engagement will therefore preserve and maximise the value for distressed debt investors and their fellow unsecured creditors. The fact that these investors are investing in secured debt positions present a fundamental flaw to the argument supporting the salutary impact of these investors on unsecured creditors. The findings of this research also scupper the argument put forward earlier by scholars[547] in the context of US bankruptcy law that distressed debt investors presence as unsecured creditors helps balance power between the debtor and secured creditors as the fulcrum debt would most likely reside with the secured creditors.

4.5.2. Strategies of Distressed Debt Investors and Choice of Procedure

Distressed debt investors employ different strategies to realize their target rate of return on distressed debt. However, those strategies were categorised as follows:

<u>Short-term investment</u>: The debtor purchases distressed debt at a deep discount to par or face value with the intention to obtain a higher pay out through a sale to a third party either through standard administration, or its short version, 'the pre-pack'. In some cases, the administrator pursues this sale on a going concern basis. In other cases, on a piecemeal, a.k.a. "break-up" basis.

[547] Jiang, Li and Wang(n34)

Long-term investment: An investor purchases controlling distressed debt or lends money directly to the distressed company with the intention to acquire ownership of business through a sale to a new company owned by the distressed debt investor either through administration, or its short version, 'the pre-pack'.

The investors' investment objectives and strategies had significant correlations with choice of procedure. Sales through standard administration were far more common where the distressed debt investor seeks to monetise its debt claims for a profit through a sale to a third party (65 cases). A sale to third parties can be on either a piecemeal or going concern basis. Of these 65 cases, the sale was sold on a piecemeal basis in 22 cases, as opposed to 43 cases of going-concern sales. Distressed debt investors supported a pre-pack sale to third parties in 10 cases and in 1 case to a party connected to the company. Pre-packs in fact were more common where the investor intends to acquire the company's business (31 cases). Distressed debt investors asserted their ownership agenda through a standard administration in 9 cases. In these cases, the ownership is accomplished through a sale to a company owned by the distressed debt investors, and the implementation of CVAs or schemes of arrangement.

Pure rescue, where the entire company emerges intact from the process with the support of distressed debt investors, continuing substantially the same operations, with the same workforce and under the ownership of the same people, was extremely rare (only 3 cases). One of these companies managed to repay the distressed debt investor's claim in full and rebanked elsewhere.

On a side note, since distressed debt investors aim to boost their payouts, it makes sense that they would be more willing to support going concern sale administrations. Previous studies, such as the Wolverhampton Report,[548] seem to suggest that going concern sales tend to yield greater overall returns than pre-packs and piecemeal sale administrations. However, pre-packs create opportunities for distressed debt investors to cancel the interests of the original shareholders and other debtholders. Therefore, it makes sense that they would be more willing to support pre-packs as the preferred course for acquiring of distressed businesses “free and clear” of any interests.

Debt-based takeovers implemented through pre-pack administrations explain the high incidence of lender-led pre-packs trend that has prevailed over the last years. Pre-packs are typically supported by the debtor’s incumbent management because they remain in control of the ailing company affairs for the period leading to the initiation of formal administration and even during the procedure and they may emerge as the management of the new company with significant equity in the new business. Existing owners of the distressed company prefer pre-packs because they can shed unsecured pre-distress by liquidating the distressed corporate shell and continue to own all of the shares in the newly incorporated company. Secured creditors often support pre-packs because they would be provided with significant control over the insolvency process to shift the risks and costs of insolvency onto other stakeholders in a way that ensures swift recovery of their debt.[549] However, pre-pack becomes an important route for the “debt-based takeover” strategy.

These results are generally consistent with observations that, in recent years, the active involvement of distressed debt investors in the lending distress space is behind the

[548] Peter Walton and Chris Umfreville, Pre-Pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration, Final Report to the Graham Review (University of Wolverhampton 2014) <https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration>, accessed 21 July 2022[“Wolverhampton Report”].

[549] Alfonso Nocilla, 'Asset Sales and Secured Creditor Control in Restructuring: A Comparison of the UK, US and Canadian Models,(2017) 26 International Insolvency Review 61,61

increasing frequency of going concern sales in insolvency.[550] Despite the fact that of the EA 2002 reforms were designed to promote the preservation of distressed companies, not just businesses.

4.5.3. Returns to Creditors

Going concern sales are generally considered favorable to the junior claims of unsecured creditors and shareholders, as the assets are believed to have greater value when kept together as a functioning unit rather than being broken up and sold piecemeal. In this sense, going concern will always maximise the collective return to all creditors. Put it simply, the more likely that going concern is preserved, the more value is maximised and the more favourable distributions unsecured creditors will be able to obtain.[551]

Although the presence of distressed debt investors in the insolvency process increases the likelihood of a going-concern sale, the benefits generated by such sales largely flow to the distressed debt investors. Distressed debt investors recover on average between 44% and 56% of the face value of their loan or full ownership of the business. However, distressed debt investors typically purchase these loans at a discount against the face value of these loans. However, little is known about discounted price because the investors' desire to maintain secrecy and keep the information confidential. Additionally, debt is traded in over-the-counter markets, and there is no requirement for transfer registration. Nor is there a requirement for the administrator to monitor such transfers or record the price. Generally, the discount rate varies depending on the individual circumstances of the debtor or the projections of the investors. It is estimated that the discount can range from as low as 20% to as high as 60%, or even 80%.[552]

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[550] B. Espen Eckbo and Karin S. Thorburn, 'Creditor Financing and Overbidding in Bankruptcy Auctions: Theory and Test' (2009) 15 Journal of Corporate Finance 10. See also Edith S. Hotchkiss and Robert M. Mooradian, 'Auctions in bankruptcy' (2003) 9 Journal of Corporate Finance 555
[551] Finch and Milman(n426)117
[552] Harner (n28) 85

Distressed debt investors presence appears to be correlated with significantly low returns or no return at all for unsecured creditors. In the majority of cases (61%) no distribution was made to unsecured creditors at all. In the 59 cases where a distribution was made, the median payment was 4.3 pence in the pound. Perhaps unsurprisingly, the small distribution was made by virtue of the prescribed part.[553]

The practical problem, in the past, was that the secured creditors, typically banks, have an incentive to ensure a full recovery of the face value of their debt. Maximising the company's asset pool may impose high costs even though the senior lender is only entitled to receive the full value of its claims. The senior lender is, therefore, likely to take enforcement action that ensure the full repayment of its loan, but which may not maximise value in the assets for the creditors as a whole.[554] In fact, this problem may be especially acute in cases where the secured creditor is a distressed debt investor that purchased the debt at a discount against the face value of the debt. One can reasonably infer that distressed debt investors are not necessarily incentivised to ensure a full recovery of the face value of their discounted claim. Rather, they need only to obtain profits on their investment through recoveries on the debt in the insolvency process. In fact, an analysis of the data gathered in this study suggests that even when the distressed debt investor does decide to sell a company as a going concern, it may not have an incentive to push for a high sale price. As a result, there may be little left over for junior claimants.

A pre-pack is also a sale of all or substantially all of the assets of the debtor on a going-concern basis. However, the distressed debt investor is not necessarily incentivised to maximise the value of the insolvent enterprise, as they typically use their claims—acquired

[553] The prescribed part provisions allow for a certain percentage of proceeds realised from the sale of assets to be reserved for the satisfaction of unsecured creditors' claims. Insolvency Act 1986 Section 176A.
[554] Armour and Mokal (n6) 29

at a discount—as consideration for purchasing the debtor's assets. This means that it is in the interest of the distressed debt investor as a secured creditor with too much control over the insolvency process to freeze out other bidders and minimise the sale price of the debtor assets to ensure that the value of the company not exceeding the face amount of the secured debt. This distressed debt investor also acts as a buyer who is in its interest to use its claim against the debtor as consideration for the sale instead of cash, and the fact they are permitted to credit bid the entire face amount of their claims, even if acquired at a discount encourages other cash bidders (if any) not to participate in the sale process. In short, the distressed debt investor emerges from the process with ownership of the newly restructured while the rights of unsecured creditors are effectively extinguished despite the stated goals of the Enterprise Act were to strengthen their position and improve outcomes for them.

4.5.4. Trading Intensity

Debt markets allow for the composition of a debtor's controlling creditors to constantly change over time and since the identity of creditors whose agendas are different is churning, the amount of litigation being pursued and creditor conflict is relatively high and the administrator is likely to find herself in unnavigable negotiations with a revolving cast of investors, thereby, making the most beneficial outcome for the debtor and its groups of creditors becomes less likely. In fact, the data gathered in this thesis suggests that in the overwhelming majority of cases (95%) distressed debt investors initiate the proceedings and continue to hold the same positions of control throughout the entirety of the administration process.

However, a high level of claims trading intensity is a pervasive feature of the most high-profile administration cases of companies financed with bonds. The administration case of Stemcor is an example of this trend, temcor is a leading UK steel trading business with operations in 45 countries and 2,000 employees. However, the company accumulated debts of $3.1 billion to 90 lenders, necessitating the creation of an effective rescue strategy to restructure the debts and enable the company to continue trading. The company engaged X and Y (later to become the Administrators) in order to assist with the implementation of a rescue strategy. Eventually, the company emerged from administration after the debt concentrated among a set of few distressed debt investors. The case was complicated and much of the complication was attributed by the administrators to investors trading in and out of the company's debt.[555]

Similarly, Phones 4u was one of the leading UK mobile phone retailers, with 700 outlets across the UK and 5,600 employees. The company faced financial difficulties and went into administration. The £430 million secured notes issued by the company traded heavily in the debt market following the appointment of the administrators. The administrator decided to sell off the assets covered by a fixed charge, but the distressed debt investors were unwilling to join the secured creditors' committee, where non-public information is shared, nor were they willing to grant consent for the administrator to dispose of the encumbered assets. The reason for this was that the distressed debt investors did not want to risk their ability to continue trading the company's debt. As a result, the case became administratively complex and costly.[556]

This finding is consistent with those of other studies that extensive trading is most prevalent in the claims of large distressed corporations with a high likelihood that would add cost and complexity to the management of both the pre- and post-insolvency processes.[557] This can

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[555] MOORGATE INDUSTRIES LIMITED, Statement of administrator's proposal (2015) available athttps://find-and-update.company-information.service.gov.uk/company/01038435/filing-history?page=2
[556] PHONES 4U LIMITED, Statement of administrator's proposal (2014) https://find-and-update.company-information.service.gov.uk/company/03154198/filing-history?page=2
[557] Frisby (n14).

be particularly problematic as large corporations employ 40% of the U.K.'s workforce and generate 48% of the country's GDP.[558]

One of the suggestions often put forward is to rely on the capacity of distressed debt investors to take the place of the original lenders who no longer wish to remain invested in debtor business to facilitate a successful restructuring. In this sense, the intervention of distressed debt investors helps to alleviate the threat of insolvency hanging over the distressed debtor, which in turn eliminates the need for a moratorium or any incentive to ensure that creditors choose the optimal outcome.[559]However, in light of this research's findings, one could question whether such suggestions could be advocated. Distressed debt investors also prefer enforcement and sale over devising a restructuring plan in small and medium-sized companies. This is because it seems more profitable to liquidate the claim in the process of administration than reselling the claim to another investor with a relatively longer-term approach of renegotiating and containing financial losses, facilitating new financing and supporting of restructuring to benefit from maximisation of long-run profit.

4.5.5. The pre-appointment Period: Distressed Debt Investor Support and Practitioner Involvement.

The emphasis has always been on market-led solutions negotiated against a backdrop of control right that existed within the administration procedure. In essence, when there is a single secured creditor, typically a bank, distressed companies are transferred to the business support units of banks, during their period in that unit, the businesses are assessed. If viable, they are rescued.[560] Where a debtor defaulted to multiple creditors, coordination

[558] Department for Business, Energy & Industrial Strategy, "Business Population Estimates for the UK and Regions 2018", 11 October 2018. Online: <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/746599/OFFICIAL_SENSITIVE_-_BPE_2018_-_statistical_release_FINAL_FINAL.pdf> accessed 21 July 2022
[559] Paterson (n4) 700.
[560] Franks and Sussman (n10) 69

problems were dealt with under the 'London Approach'. While the companies are rescued, existing lines of credit are kept open.

Trade creditors and employees may be satisfied with receiving a more limited amount of their outstanding debts on the hope that the distressed company continue in operation.[561]

They also tend to take advantage of the banks' support systems and the turnaround professionals who conduct 'intensive care' dedicated to ensuring the company is returned to a healthy financial state. If these preventative or remedial measures fail to prevent troubles from developing into disasters, the company will be sent to a 'debt recovery unit' where formal bankruptcy proceedings are initiated.

The companies that face formal insolvency procedures are those which the banks and their recovery specialists considered to be fundamentally unviable and unprofitable and, therefore, no longer capable of being steered towards health.[562]

New patterns have taken shape, in the overwhelming majority of cases (91%) the companies were only given a deadline to pay back the debt or rebank elsewhere. The argument that powerful creditors are resorting more to administration rather than attempt a consensual settlement is a valid one. This particular finding is also consistent with argument distressed debt investors are more like vulture than phoenix.

4.6. Significance of Empty Crediting: The case studies

Giving secured creditors governance rights is based on a number of assumptions that when the company/debtor is solvent, the secured creditor, typically banks, want the company to succeed in order to collect fees on the loan for as long as possible. Banks, may also charge below-market rates of interest in the early years in the hope that the company will generate

[561] Armour and Deakin (n12) 24
[562] Finch(n14) 715

significant future business when it grows.[563] However, when the company becomes distressed, the secured creditor has a strong incentive to pursue informal strategies. The reasons for this are threefold: First, the bank's desire to preserve and prolong existing customer relationships. Second, the bank's desire to maintain its reputation and avoid being seen as responsible for a corporate collapse or dealing with bad debt. Thirdly, the introduction of the more inclusive, more uncertain EA 2002 along with new corporate reporting requirements (such as the Operating and Financial Review), has heightened banks' willingness to monitor corporate behaviour before insolvency and intervene to help debtors navigate away from financial difficulties. This is because creditors' interests (i.e. unsecured, secured and preferential creditors) as a whole take priority with the ability to make their voice heard in a more substantial way.[564]

The secured creditor no longer benefits from the comfort zone once provided by the now-abolished administrative receivership. Previously, this system allowed the bank to appoint an administrative receiver on short notice to enforce the security if the company defaulted on principal or interest repayments, regardless of the impact on other creditors or the risk of the company's liquidation.[565]

Only where informal negotiation is exhausted, unavailable, undesirable will formal insolvency proceedings be commenced, once the administration procedure begins, the banks are still placed in a strong position relative to unsecured creditors on the basis that they, as residual claimant with a wealth of information on the debtor's state of affairs, would take objective, value maximising decisions. This explains the reason why creditors control

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563 Julian R. Franks and Kjell G. Nyborg, 'Control Rights, Debt Structure, and the Loss of Private Benefits: The Case of the U.K.'(1996) 9 The Review of Financial Studies,1165,1167.
564 Finch(n14) 715
565 Ibid 716

rights over a debtor company and economic rights to receive payment and interest are bundled together and cannot be readily decoupled.

The research conducted shows that there is a pattern emerging whereby the distressed debt investors' debt-based governance rights are separated from economic interests in a variety of ways. The result is that distressed debt investors are indifferent to the benefits the informal workouts confer on them, in some situations they have an incentive to exercise governance power in ways that harm the debtor or other claimants. This was not evident from the database itself, but from the documentation of high-profile administration cases. This section devotes some attention to the ways in which the separation of economic interest and governance rights occurred.

Monarch Airlines Ltd

Monarch Airlines was one of the biggest UK passenger airlines, founded in 1968 as a family-owned company. It grew dramatically during the 2000s through a series of acquisitions and after many years of operating profitably. The company began experiencing liquidity problems as a result of high jet fuel prices and political turmoil and security concerns in the Middle East.[566] In fact, the company was on the brink of losing its licence to operate a holiday business. An investor focused on restructuring troubled companies saw Monarch's situation as an opportunity for change and profit. The investor acquired a 90% stake in Monarch. Managerial techniques and cost cutting measures were put in place. In fact, staff agreed to pay cuts and lessors agreed to rental reductions in exchange for the (possibility of) the distressed company being rescued.[567] The other key aspect of Monarch's turnaround plan was the new financing provided by the owners in the form of secured

[566] Karen Hoggan, 'Monarch: Four reasons behind its failure' BBC (London,2 October 2017) available at https://www.bbc.co.uk/news/business-41466722
[567] Nigel Richardson, 'Monarch Airlines'(Key Publishing Ltd,2023) at 9

shareholder loan facilities.[568] Security interests essentially serve to assure the lender of payment priority and significant control over the insolvency process. Although the company was saved from outright failure, it collapsed into administration two years later, stranding thousands of passengers abroad, who were flown back home at an estimated cost of £60 million to the government.[569]

Maplin Electronics Ltd

Maplin Electronics was one of the UK's biggest electronics retailers with over 2,300 employees. By 2014, the company faced a severe liquidity crisis and a distressed investing-focused private equity company acquired the retailer.[570]The new owner financed the company with loans backed by security interests at a high interest rate. The already distressed company was loaded up with nearly £102m of secured debt.[571] This means that the company was turned into a zombie and the distressed debt investors drained the company to extent of becoming insolvent. Upon insolvency, the investor as secured creditor did not have to share with junior creditors and these creditors had no way of knowing this prior to insolvency or even in insolvency.[572] It is an understanding that trade creditors are unaware of the company's distress and this gives rise to a possibility that the money

[568] Monarch Airlines Limited, 'Statement of administrator's proposal' (Companies House, 6 Dec 2017) https://find-and-update.company-information.service.gov.uk/company/00907593/filing-history

[569] HC Deb 9 October 2017m vol 629, col 25; Chad Bray, 'Bankruptcy of Britain's Monarch Airlines Strands Thousands Abroad' The New York Times (London,2/10/2017); Gwyn Topham, 'Monarch Airlines collapse: UK's biggest peacetime repatriation under way' The Guardian (London,2/10/2017); Jonathan Ford, 'Greybull eyes profit from Monarch collapse'(London ,11/10/2017)

[570] Maplin Electronics Limited, 'Statement of administrator's proposal' (Companies House, 02 May 2018) https://find-and-update.company-information.service.gov.uk/company/01264385/filing-history accessed 22 August 2022

[571] Prem Sikka, 'How a private equity takeover contributed to Maplin's demise' Left Foot Forward (2/3/2018) https://leftfootforward.org/2018/03/revealed-how-private-equity-contributed-to-maplins-demise/

[572] Maplin electronics Limited, Statement of administrator's proposal (02 May 2018) available at https://find-and-update.company-information.service.gov.uk/company/01264385/filing-history

obtained from the trade creditors was used to repay the debts owed to the distressed debt investor. The recovery rate for unsecured creditors was 1,04 on the pound.[573]

Bernard Matthews Foods Ltd

Bernard Matthews Foods Ltd was a leading British farming and food products business with operations also based in other countries. The company encountered financial difficulties in 2010 caused largely by the Avian flu and the declining commodity price of the dark meat. A private equity fund specialised in distressed debt and special situations acquired the company.[574] The new owner provided access to new capital not as equity contribution but as a loan (debt) on secured basis shortly after. The financial difficulties have persisted and another investor made an offer to acquire company in a solvent corporate takeover. However, the distressed debt investors rejected the takeover offer that would have protected the turkey producer's pension scheme in favour of an insolvency process in which the company's assets were sold free and clear of all encumbrances.[575] The design and structure of the administration process enabled the distressed debt investor to extract the highest value from the assets for itself and dump the pension scheme and other liabilities.[576]

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[573] Maplin electronics Limited, 'Administrator's progress report'(30 May 2018) https://find-and-update.company-information.service.gov.uk/company/01264385/filing-history

[574] BMF REALISATIONS 2016 LIMITED, 'Statement of administrator's proposal' (Companies House, 11 Oct 2016) https://find-and-update.company-information.service.gov.uk/company/01831006/filing-history accessed 22 Agust 2022

[575] Ben Quinn, 'Frank Field condemns plan to 'dump' Bernard Matthews pension scheme' The Guardian (London19 /09/2016) https://www.theguardian.com/money/2016/sep/19/frank-field-condemns-plan-to-dump-bernard-matthews-pension-scheme accessed 12/09/2023

[576] UK Parliament Pension Protection Fund and Pensions Regulator inquiry, 'Rutland Partners gains at expense of pensioners in Bernard Matthews selloff' https://committees.parliament.uk/work/5457/pension-protection-fund-and-pensions-regulator-inquiry/news/97922/rutland-partners-gains-at-expense-of-pensioners-in-bernard-matthews-selloff/#:~:text=The%20Work%20and%20Pensions%20Committee,a%20greater%20return%20for%20them. accessed 14/08/2023; Simon Goodley, 'Bernard Matthews seller 'lined own pockets' by rejecting pension offer' The Guardian (London 14 /04/2017) https://www.theguardian.com/business/2017/apr/14/bernard-matthews-seller-lined-own-pockets-by-rejecting-pension-offer accessed 14/08/2023

Ultimately, this came at the expense of the pension protection fund and taxpayers who were ended up covering the costs.[577]

Travelzest

Travelzest was a listed holiday company with operations in UK and Canada. The company's fortunes deteriorated due to declining revenue, finance costs and loss from discontinued operations. A distressed debt investor completed the purchase of the company's debt at a discount and replaced the company's lender. Two months later the distressed debt investor served a demand for the face value of debt on Travelzest, which was unable to pay and enforcement actions were taken to place the company into administration.[578]The distressed debt investor used its claims as consideration for a purchase of the company's business. However, a competing cash bidder told *The Times* that he had made an offer of a higher cash bid before the expiry of the 30-day and was rebuffed.[579] Ultimately, shareholders and junior creditors were wiped out.

A number of common denominators emerging from the case studies, probably the most common being a form of decoupling. Distressed debt investors used their dominant position not to take value maximising actions but to dump liabilities, expropriate value from other stakeholders, or push the losses onto others. There is also the question of how valid the argument is that secured creditors, seeking to maintain customer relationships, preserve their reputation, or avoiding market exclusion, would actively contribute to preventing and resolving the financial distress of a troubled company. The examined case studies evidenced

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[577] Bernard Matthews Ltd, 'Notice of final account prior to dissolution' (07 /10/2021) available at https://find-and-update.company-information.service.gov.uk/company/00625299/filing-history
[578] Travelzest plc, 'Statement of administrator's proposal' (Companies House, 30 Dec 2013)https://find-and-update.company-information.service.gov.uk/company/04520457/filing-history
[579] Dominic Walsh, "Sun sets on Travelzest as it's stripped of its main asset" The Times, 05,November, 2013

that distressed debt investors rarely explored turnaround possibilities or acted under reputational constraints.

Secured creditors resort to formal insolvency procedures only where informal negotiation is exhausted, unavailable or undesirable.[580] The rationale is that insolvency is expensive and time-consuming process. Thus, a wide range of inevitable losses would be suffered by the secured creditors.[581] While informal strategies confer on secured creditors cost savings and other benefits, especially in terms of flexibility and expeditiousness.[582] However, this argument does not have strength in all scenarios, as evidenced in the case studies, the pursuit of insolvency proceedings appears to be a very lucrative investment opportunity and distressed debt investors immediately resort to administration, and especially its short version, the pre-pack, for maximising their profits at the expense of other claimants who may in fact be entitled to a portion of the value available for distribution in the case but do not have sufficient bargaining power to participate in the process.

Conclusion

An active market in distressed claims is not all bad. It may indirectly function to increase the availability and reduce the cost of debt finance in the economy. This is predicated on the belief that, traditional lenders are likely to lower interest rates, knowing that the debt may be disposed-off even if at a discount. The market may also can engender other economy-wide benefits such as facilitating efficient allocation of resources to highest and best use, thereby maximising social welfare. Support for this stems from the premise that selling a claim allows the traditional lenders to cash out whereas their capital might

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[580] Finch (n237) 294.

[581] The results of empirical studies that have been done, suggest that the direct costs of chapter 11(fees billed by professionals) amount to 2-3% of the book value of the debtor's assets. Lawrence A. Weiss, ‘'Bankruptcy resolution: Direct costs and violation of priority of claims’ (1990) Journal of Financial Economics 285,295.

[582] Philipp Jostarndt and Zacharias Sautner, ‘Out-of-Court Restructuring versus Formal Bankruptcy in a Non-Interventionist Bankruptcy Setting’ (2012) Review of Finance 623,624.

otherwise be tied up in insolvency process for several years. In such situations, traditional lenders can channel their resources towards healthier companies. Moreover, distressed debt investors may serve as an alternative source of new financing and expertise for companies suffering illiquidity and financial distress. New financing of this kind can increase the company's chance of survival and enable it to continue operating in the market.

The data permit us to unambiguously argue that the presence of distressed debt investors in the troubled situations has changed the dynamics of corporate insolvency in the UK in many ways. Although there has been an emphasis on the role of informal mechanisms in contributing to a holistic approach to corporate insolvency,[583] the possibilities of gaining informal approaches to corporate rescue are diminishing, or at least becoming increasingly difficult. A trend toward a more non-traditional administration process is also emerging. The most notable is the lender-led pre-pack administration, acrimonious administrations, and administration as a mechanism for enriching distressed debt investors at the expense of unsecured creditors.

Concerns raised as to the potential abusive use of insolvency law by powerful investors acting in their individual self-interest to the detriment of the less powerful stakeholders are reflected in real life context. The information derived from the cases studies show that distressed debt investors use the procedures designed to be collective to promote their individual interests. (i.e. illegitimate wealth diverting or transfer schemes, value extraction, pension and tax liabilities write off). It is possible to imply that the existing insolvency law tools are failing to create an appropriate balance in respect of tensions that distressed debt investors create during insolvency.

[583] IMF, Orderly & Effective Insolvency Procedure: Key Issues (IMF 1999) pg.13

Chapter Five: The Limits of the Existing Value Extraction Remedying Devices

5. Introduction

In the UK, company rescue, where the distressed company is put back on track so that it can continue trading with the same workforce and under the ownership of the same people, is typically conducted informally. The threat of enforcement action by the secured creditor (bank) is credible in the eyes of debtors, which increases their willingness to cooperate in effective workouts. Secured creditors (banks), incentivised by the desire to maintain relationships and preserve their reputation, often use their monitoring systems to help the prevention the insolvency of their debtors. The preference for informal strategies also stems from the desire to avoid the negative repercussions, costs, and delays associated with formal insolvency procedures.

Administration is typically reserved for the sale of the debtor's assets, and banks exert significant influence over how this sale is conducted. They use this governance influence to achieve the optimal realisation of the debtor's assets, which is especially evident in cases where banks are over-secured. The ratio of bank-secured debt to assets is straightforward to define, making it easy to evaluate the factors that drive the bank's behaviour.

Distressed debt investors purchase secured debt at a discount from its full-face value, in turn succeeding to the rights of their selling banks. The investor might have no interest in maximising the value locked in the assets of distressed businesses beyond what is required to make a profit on the debt. They can make profit by for example buying at 20 and recovering at 30. All things being equal, the lack of incentives to maximise recoveries may lead to the premature piecemeal dismemberment of businesses that might otherwise be viable as a going concern. However, the investors may prefer selling some or all of the business as a going concern but to a new company owned by them using their discounted debt or finance provided as currency for the business. Since the investor stands on both sides of the transaction, there is always a risk of distortions, abuse, unlawful wealth transfers, and coercive behaviour.

The data gathered in this thesis suggests this is liable to happen in reality. Thus, emphasis should be placed in examining the checks and balances built in the existing system to "smoke out" the questionable practices (i.e. the coercive use of acquired claims, the diversion and destruction of value).

5.2. The Role of Administrators, Discretion and The Possibility of Bias

A key legislative change occurred when the EA 2002 abolished the administrative receivership procedure, and substituted it with an entitlement for a floating charge holder to initiate a more collective mechanism: administration. This reform aimed, at least ostensibly, to safeguard the interests of all creditors through the appointment of an administrator conducting his duties in the best interests of the creditors as a whole[584]with a requirement to refer his proposals to a vote by the unsecured creditors.[585] The administrator must convene a creditors' meeting within ten weeks of the commencement of the administration.[586] This reflects a greater emphasis on transparency and accountability in the process. The EA 2002 also prioritises the preservation or rehabilitation of the company back to a normal state with the same ownership over business rescue strategies that involve selling the company's business, or a viable part of it, as a going concern to a third party while the remaining shell is liquidated. The belief underlying this approach is that all stakeholders are better off when the company is rehabilitated.[587]

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[584] Insolvency Act 1986, Schedule B1, paragraph 3
[585] Insolvency Act 1986: SchB1, para 52
[586] Insolvency Act 1986, Sch B1, Para 51 (2) (b); *Revenue and Customs Commissioners v Maxwell* [2010] EWCA
[587] Department of Trade and Industry/Insolvency Service, Productivity and Enterprise: Insolvency—A Second Chance (Cm 5234, 2001)

However, where the company is so insolvent to the extent that there is no expectation of a return to unsecured creditors, the administrator is not required to present his proposals to the unsecured creditors.[588] The administrator is allowed to proceed with selling the company's business if he 'thinks' doing so would achieve a better result for the company's creditors as a whole than preserving the company.[589] Moreover, when an administration sale is pre-packaged, the administrator is not required to summon a meeting before the sale is completed, therefore, that creditors are effectively presented with a *fait accompli*.[590]

It can be reasonably deduced that the EA 2002 imposes a duty on administrators to manage the case in the best interests of all creditors. However, the specific methods by which administrators are expected to fulfil this duty, as well as the scope of their discretion, are not strictly defined and are largely left to their judgment. This discretionary authority operates within a shroud of secrecy, as administrators have control over the flow of information and are not explicitly obligated to provide a detailed report on their findings. This discretion and control over information flow can create a level of opacity in the process, raising concerns about transparency and accountability.[591]

In conjunction with the substantial powers of discretion, the administrator is afforded extensive protection. They would not be personally liable on any contract entered into or adopted by them in the performance of his functions,[592] unless explicitly stated otherwise in the terms of their contract of appointment. It will also be difficult to prove that the administrator personally liable for tort claims.[593] The logic behind this is that insolvency

[588] Insolvency Act 1986 c 45, sch B1
[589] Insolvency Act 1986, Schedule B1, paragraph 3
[590] Finch and Milman (n426) 377
[591] John Wood, 'Insolvency office holder discretion and judicial intervention in commercial decisions' (2020) 6 Journal of Business Law, 451, 455.
[592] *Gregory v Wallace* [1998] IRLR 387 (CA)
[593] *Williams and Anor v Natural Life Health Foods Ltd; Anor* [1998] 1 WLR 830 (HL); *C Evans and Sons ltd v Spritebrand Ltd. and Anor* [1985] BCLC 105 (CA).

situations are a sensitive and delicate matter to handle and decisions are always difficult to take as insolvency. Insolvency, by its very nature, can have devastating effects on a range of stakeholders, including underfunded pension schemes, unpaid suppliers, uncompensated—and potentially unemployed—employees, consumers, creditors, and shareholders.[594] Consequently, all parties involved should have confidence in the insolvency process, and the administrator's work should be carried out without fear of facing legal action for making challenging decisions.

It is also important to mention that there are seven recognised professional bodies ('RPBs') which may license and authorise insolvency practitioners and supervise their actions under the supervision of the Insolvency Service and the Secretary of State. RPBs make their regulations and privately decide what action should be taken if a complaint against insolvency practitioners is made. The danger of giving too much discretion to practitioners in a way that might favour their interests over the common good is generally related with the flaws of self-regulation.[595] More specifically, in the absence of any set procedural guidelines, it is unclear how exactly these complaints are to be investigated. This, coupled with the lack of a clear timeframe within which to respond to complaints. RPBs are not required to publicly provide a list of the complaints that they have received and how they are dealt with.[596] It should also be noted that whilst administrators have the right to appeal against disciplinary actions taken against them, the complainant does not possess a similar right to appeal. It, therefore, should come as no surprise that the evidence available demonstrates the perceived low level of confidence amongst creditors, particularly

[594] Rafael Efrat, 'The Evolution of Bankruptcy Stigma'(2006)7 Theoretical Inquiries in Law 365,367. The author refers to this as an acceptable reason for committing suicide.
[595] Eva Hüpkes, 'Regulation, Self-regulation or Co-regulation' (2009) Journal of Business Law 427
[596] Jim Cousins and others, 'Insolvent Abuse: Regulating the Insolvency Industry', Basildon: Association for Accountancy and Business Affairs, (2000).

unsecured, in the effectiveness and adequacies of existing complaints processes, something which was shared by many insolvency practitioners.[597]

Questions started to be raised about the safeguards in place, and especially over issues of the level of corruption and abuse within insolvency proceedings, and the lack of accountability and transparency of the process. The collapse of the Maxwell empire and the fees billed by accountancy companies acting as insolvency practitioners also revealed the underlying weaknesses and underscored the need for reforms.[598] Addressing the various concerns has been part of a long-standing debate and the RPBs collectively agreed that the best path forward was to develop a standard set of rules and obligations across the profession, that guide the implementation of the insolvency proceedings. To achieve this end, a number of codes and regulations were put in place. In particular, the regulatory bodies acting through the Joint Insolvency Committee (JIC) issued the Code of Ethics and revise it over the years. Within the Code, there are five fundamental principles that insolvency practitioners must uphold and maintain.[599] If these rules are not followed, the judiciary may step in to address any unfair harm that the administrator may be accused of causing.[600] This right is very rarely used and often end in failure.[601] In such cases, the disenfranchised creditor must prove to the court that a certain action implemented by the administrator is harmful – a difficult onus to overcome given to the difficulties to access vital information,

[597] Insolvency Service, Consultation on strengthening the regulatory regime and fee structure for insolvency practitioners (2014) 11 available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/280880/Strengthening_the_regulatory_regime_and_fee_structure_for_insolvency_practitioners.pdf.
[598] It was estimated that the total bill would exceed pounds 100m, which the Social Security Select Committee, chaired by Frank Field M.P argue as excessive, Ferris Report on the Remuneration of Office Holders and Certain Related Matters (1998)
[599] These are integrity, objectivity, professional competence and care, confidentiality and professional conduct. however, these principles are not extensive, rather the intention as deduced from the plain wordings is to offer general guidance and reassurance that insolvency practitioners maintain the highest standards and professionalism whilst carrying out his duties. Insolvency Practitioners Association, 'Insolvency Code of Ethics: Background and Overview', (November 2008), para 8.
[600] IA 1986, Sch B1, Para 74.
[601] For example, of how the threshold is high see *Re Meem SL Ltd (In Administration)* [2017] EWHC 2688 (Ch)

and courts are well-known for their reluctance intervene or second guess 'commercial judgments' made by administrators.[602]

The RPBs, in addition, issue the Statement of Insolvency Practice (SIPs) which guides the best practice in relation to pre-packs.[603] The administrator is required to provide a detailed explanation of how and why the pre-pack sale is the best course of action for the insolvent company. To provide a convincing justification to those disenfranchised by the process, the administrator is required to explain which alternatives had been considered for the company. Additionally, they must include detailed information about the purchasers, the name and qualifications of the valuer, and a summary of the basis for the valuation to the unsecured creditors as soon as practicable.[604]

The extent to which the information requirements embedded in SIP increase the transparency and accountability of the pre-pack process is debatable.[605] The SIP16 guidelines appear to be vague and this vagueness makes it difficult for a disenfranchised creditors to hold administrators to account.[606] In practice, the information is disclosed after the deal has been completed, leaving the disenfranchised creditors unable to voice their concerns during the consultation processes or cast their vote over the approval of the pre-pack. The guidelines have no force of law and operate on a 'comply or explain' basis. Essentially, the administrator should adhere to the requirements set out in the guidelines or explain in the SIP report for why he has failed to comply. Therefore, failure to abide does not constitute serious misconduct to subject the administrator to disciplinary actions.[607]The

[602] McCormack(n482)521; Wood (n591)455
[603] R3, Statement of Insolvency Practice 16 (2015) available at https://www.r3.org.uk/media/documents/technical_library/SIPS/SIP%2016%20Version%203%20Nov%202015.pdf
[604] Statement of Insolvency Practice 16 (England and Wales): Pre-Packaged Sales in Administrations.
[605] Finch and Milman(n426) 166
[606] Keay and Walton (n443) 129.
[607] The Insolvency Service, 'Report on the First Six Months' Operation of Statement of Insolvency Practice

soft-law approach was deemed preferable as it avoids the inflexible 'one size fits all' approach.[608] It also enables companies to focus on substance, while operating at their own pace during the process.[609] It may be more cost-effective, and certainly easier than hard-law approaches for unsecured creditors whose claims are often quite small.

The 'comply or explain' approach is the trademark of the UK corporate governance and it is heavily supported by both companies and shareholders. The principle of 'comply or explain' is usually attached to corporate regulations. The approach requires directors to comply with the rules imposed or provide full and meaningful explanations for why non-compliance with these rules is necessary. This gives these office-holders a certain amount of flexibility to deviate from the requirements provided that there is solid reasoning behind it. This approach is thought would achieve effective corporate governance and help avoid the problems associated with the 'one size fits all' approach.[610]

However, this approach has received a great deal of criticism. Directors frequently make use of standardised, vague, or too basic justifications which in reality don not explain at all why they disregarded these soft-law regulations.[611] The criticism was validated by the empirical studies. It has been found that only 31% of FTSE 350 companies offer comprehensive reports on shareholder engagement and 27% of the companies demonstrate good insight of how they implemented corporate governance principles outlined in the

[608] Graham Report (n548)
[609] Adebola (n109) 133
[610] Andrew Keay, 'Comply or Explain in Corporate Governance Codes: in Need of Greater Oversight?' (2014) 34 Legal Studies,279,281.
[611] Ibid at 281

corporate governance codes despite the commendable efforts of the Financial Reporting Council[612] and adherence to corporate governance codes being at its highest level. [613]

Such an adaptation in insolvency governance is more challenging. In essence, while shareholders are able to discuss their position with the company when such a company explained to them the reasons for not following a provision of the Code,[614] unsecured creditors cannot do so, as their legal rights and powers have been terminated after the pre-pack proceedings. The Insolvency Service's decision to cede its monitoring and oversight duties for SIP 16 filings to professional regulatory bodies, following the Graham Report's recommendation, has in reality further weakened the institutional support necessary for the 'comply or explain' principle to function effectively.[615]

Moreover, the Graham Review raised concerns about the low returns to unsecured creditors and the high failure rate of businesses sold through pre-pack arrangements that occurred under the Insolvency Service's oversight.[616] It is difficult to imagine that self-regulating professional bodies would be more effective in monitoring or deterring such outcomes than the Insolvency Service. Given these shortcomings, it is hard to see how the SIP codes alone can sufficiently promote transparency and credibility in the pre-pack process.

However, Kastrinou and Vullings suggest that the existing regime functions in the best possible efficient way.[617] They argue that the introduction of the SIP16 guidelines in pre-packs are of significant importance in addressing issues relating to the transparency and accountability in the pre-packs process, and, perhaps, in mollifying disaffected creditors.

[612] Financial Reporting Council is responsible for the Stewardship Code. The Stewardship Code established principles on public disclosure, management of conflicts of interest, voting and disclosure of voting activity
[613] Grant Thornton, 'Corporate Governance Review 2018' (2018) 2-4 available at https://www.grantthornton.co.uk/globalassets/1.-member-firms/unitedkingdom/pdf/documents/corporate-governance-review-2018.pdf
[614] The UK Stewardship Code on Corporate Governance, July 2014. Financial Reporting Council, 2010.
[615] Graham Report (n548) 3.1.
[616] Graham Report (n548)
[617] Kastrinou and Vullings(n116)

This assertion is supported by the fact that The Insolvency Service's Complaints Gateway[618] has received only a minimal number of complaints on SIP 16 compliance and pre-pack administrations.[619] It is argued that there are also other explanations for the small number of complaints. The Gateway can only refer complaints that are supported by evidence and this does not necessarily mean the issue never occurred.[620] Other factors, disenfranchised creditors typically lack the information, financial resources, commercial/legal knowledge to effectively scrutinise and challenge pre-packs. Indeed, filing complaints against insolvency practitioners involves costs. For creditors who have barely received any recovery in the pre-pack process, the prospect of filing a complaint against the administrator afterward may seem futile, as the costs might outweigh any potential benefits.

Some suggestions were made to set-up an independent ombudsman to investigate, and if necessary, impose fines and sanctions where warranted. However, such an independent body never became established. Instead, legislative changes were introduced which provided the Secretary of State with new powers and greater external control by the Insolvency Service was guaranteed.[621] Whether much change has been made is questionable, despite the fact that the Insolvency Service and Secretary of State independently decide whether an administrator has abided by the Insolvency Code of Ethics and SIP-codes. The issue with these guidelines lies in their broad and vague nature, as they

618 A body introduced in June 2013 and hosted by the Insolvency Service; it now acts as the single contact point for all complaints made against IPs. Upon receiving a complaint, it assesses the merits of complaints the evidence provided in support and decides as to whether or not further investigation is warranted. If it is and the evidence is sufficient, the complaint will be referred to the relevant RPB and they will determine what sanctions, if any, are required to be imposed on its member in accordance with the Common Sanctions Guidance.

619 Kastrinou and Vullings(n116) 325

620 John Wood, 'Review of the regulatory system: how effective has the Complaints Gateway been?'(2017) 30 Insolvency Intelligence, 106,109.

621 See Insolvency Service, 'Insolvency Practitioner regulation – regulatory objectives and oversight powers, December 2015.

lack specific and detailed instructions.[622] Therefore, their interpretation and application can vary.

The Gateway's main responsibility is to determine if a complaint has grounds and, if it does, the complaint will be referred to the relevant RPB to determine, if any, what sanction to impose on the IP. Grounds for a complaint range from misappropriation of funds, to communication breakdown/failure, and failing to file accurate reports or information, just to mention a few. However, it is crucial to emphasise that the RPB will not intervene in what are essentially of commercial or legal nature. A RPB, therefore, does not have the authority to compel an administrator to change, modify, or reverse a decision that the administrator deems commercially advantageous for all parties involved. The inefficiency lies here in the fact that administrators may rely on this wide exception to justify their actions and shield themselves against any potential decision of a disciplinary action. In regards to disputes of a commercial nature, these are for the courts to decide.[623]

5.3. The role of Judiciary: The deference to the Commercial Judgment of Administrators

The courts, for their part, have generally been reluctant to intervene or second-guess the 'commercial judgments' made by administrators, except in cases where there are concerns about professional fees or where the administrator appears to be notably unfair to one or more creditors.[624]

Examples of the minor role played by courts in administration include the cases of *T&D Industries Ltd*[625] and *Re Transbus International Ltd*,[626] and *DKLL Solicitor v Her Majesty's*

[622] Finch and Milman (n426) 167
[623] Wood (n591) 109.
[624] *Re CE King Ltd* [2000] 2 B.C.L.C. 297.
[625] *Re T&D Industries plc* [2000] BCC 956.
[626] *Re Transbus International Ltd* [2004] EWHC 932

Revenue and Customs.[627] In each of these cases, the courts made their decision in the affirmative that there are certain circumstances in which the administrator is not required to refer his proposals to a vote of the unsecured creditors and there is no necessity for judicial intervention in the administrator's commercial judgments. This may be attributable to various reasons. It is appreciated that different factors, including historical, cultural, economic and political realities, play a role in shaping insolvency laws in a jurisdiction.[628] The explosion of corporate collapses in the early 1970s and subsequent mass unemployment reignited the urgency to scrutinise the existing legislation at that time and investigate the possibility as to whether an alternative to the UK's outdated insolvency system could be proposed. The government opted for a private sector solution (instead of the public one) to 'problems' like insolvency to be in line with the wave of financial liberalisation and privatisations, and the endorsement of the free market ideology.[629]

The courts regard these professionals as possessing the best knowledge and skills to manage processes that involve balancing multiple objectives and conflicting interests of various stakeholders.[630] In contrast, judges are considered to lack the necessary experience and expertise for such balancing exercises.[631] This is true to a certain extent as administrators are required to pass the Joint Insolvency Examination Board (JIEB) exam and possess a minimum level of appropriate practical experience which is calculated by a certain number of working hours over a two- or three-year period, to be eligible for an IP license.[632]

[627] *DKLL Solicitor v. Her Majesty's Revenue and Customs* [2007] B.C.C. 908
[628] McCormack(n482)521
[629] Terence C. Hallidayand and Bruce G. Carruthers, 'The moral regulation of markets: Professions, privatization and the English insolvency act 1986'(1996)21 Accounting, Organizations and Society 371
[630] David Milman, 'Governance, Stewardship and the Insolvency Practitioner'(2012) Company law Newsletter,1, 2.
[631] *Lesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420, at [85].
[632] These requirements differ from body to body but see for example ICAEW, see 'Become an ICAEW insolvency licence holder', at <https://www.icaew.com/technical/insolvency/become-an-insolvency-practitioner-with-icaew/becomingan-icaew-insolvency-licensed-practitioner> accessed 11 April 2022

Moreover, an effective and efficient insolvency regime should ensure the timely, impartial, and cost-effective resolution of insolvency, aiming to maximise the total value of the distressed company while minimising both the direct and indirect costs, as well as the broader losses resulting from insolvency.[633] As a matter of cost, it is therefore opined that administrative processes are likely to be less expensive than court-supervised procedures.

Payne characterises the scheme of arrangement mechanism as complex, time-consuming, expensive, and cumbersome due to the onerous procedural requirements and the judicial oversight.[634] At this first court hearing the court ensures that creditors receive adequate notice and full and accurate information in order to enable them to attend the relevant meetings and to vote on the scheme, and oversight the organisation of creditors (and shareholders, if appropriate) into the correct classes.[635] At the sanctioning stage, the court will determine jurisdictional matters and supervise the compliance of the statutory requirements. The court will also be concerned to ensure that the arrangement is approved by the requisite majority of the company's shareholders, normally 75%, and creditors.[636] Therefore, this amount of work seems to involve time and expenses due to the intensive involvement of courts. Similarly, some academics and practitioners in the United States argue that judicially supervised corporate reorganisations under Chapter 11 impose significant costs on corporate stakeholders, as they are required to compensate those involved in formulating the reorganisation plans—such as judges, lawyers, accountants, and financial advisers.[637]

[633] United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Insolvency Law <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> 9-14
[634] Payne (n51) 18
[635] Companies Act 2006, s 896(1).
[636] Companies Act 2006, s899
[637] Bradley and Rosenzweig (n94) 1050 (The authors point out that a straightforward Chapter 11 reorganization in which a creditors' committee is appointed costs around $100,00 in 1986)

Apart from the above, judicial oversight of business decisions inevitably introduces uncertainty and slows the pace of commerce. It is crucial for the commercial sector to have confidence that decisions made by directors, or those acting on their behalf, will not be overturned except in the clearest of cases. Commercial decision-making often involves striking a delicate balance between competing considerations—a process in which the courts should refrain from intervening.[638]

The court may also be asked, by an applicant who believes that the administrator has committed misfeasance or caused unfair harm, to review the administrator's conduct during the management of the insolvent company.[639] The courts can also exercise their discretion and make an order to remove the administrator from the office. Even if this is not due to his misconduct.[640] The discretionary power of the courts appears to serve as a sufficient safeguard against abuse and unfair wealth transfers, thereby enhancing confidence in administration and supporting the smooth running of the procedure. However, several obstacles may limit the effectiveness of these safeguards. First, the onus of proof might be quite difficult to establish, as aggrieved creditors are unlikely to have access to sufficient evidence, given that they do not manage the company's affairs or participate in its operations. Gathering the necessary evidence can also be costly and time-consuming, with the expenses potentially outweighing any expected gains. Moreover, exercising such rights does not guarantee that the courts will remove or hold the administrator accountable, as insolvency practice suggests that courts are often reluctant to intervene.[641] This judicial

[638] *Cobden Investments Limited v RWM Langport Ltd, Southern Counties Fresh Foods Limited, Romford Wholesale Meats Limited* [2008] EWHC 2810 (Ch), at [754].
[639] IA 1986, Sch B1, Para 74,75
[640] *Clydesdale Financial Services v Smailes* [2009] EWHC 1745 (Ch) [2009] B.C.C. 810; see also David Milman, 'Judicial reflections on the administration process: a 2010 perspective',(2010) Sweet and Maxwell's Company Law Newsletter, 1,4.
[641] *Brake and others v Lowes and others* [2020] EWCA Civ 1491; *Hobbs v Gibson* [2010] EWHC 3676 (Ch); *Re Shruth Ltd* [2005] EWHC 1293 (Ch); *Re Edennote Ltd* [1996] 2 BCLC 389 at 398

reluctance discourages creditors from exercising their rights, and therefore, the relatively low number of cases in this area should come as no surprise.[642]

In short, the administrator is, in most cases, appointed on the application of distressed debt investors in their capacity as floating charge holders. It is likely that the administrator will steer the course of the case in favour of these investors, as they are repeat players and the administrator may act in line with their preferences in anticipation of future appointments and an enduring relationship. [643] In such circumstances, there is little scope for challenging the conduct, discretion, or 'commercial judgments' of the administrator, given the considerable deference typically afforded to their business decisions

5.4. The Role of The Pre-pack Pool: The Lack of Powers Over Lender-led Pre-packs

The practice of pre-pack sales originated in the United States[644] and gained popularity in the United Kingdom shortly after the enactment of the EA 2002. This surge in popularity is attributable, more than to any other factor, to the control exercised by secured creditors. [645] Secured creditors are able to use pre-packs as a means of dictating the method and timing of asset realisation, much as they previously did under the receivership regime.[646] The pre-pack technique is not regulated or currently legislated for within the UK Insolvency Act. However, the courts have long accepted the legitimacy of this procedure[647] on the basis that a pre-pack, by its nature, is a strategy for business sale and administrators are empowered

[642] Insolvency Service, Consultation on strengthening the regulatory regime and fee structure for insolvency practitioners (2014) 12 at para. 49 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/280880/Strengthening_the_regulatory_regime_and_fee_structure_for_insolvency_practitioners.pdf (last accessed the 23th of November 2022); The Office of Fair Trading, 'The Market for Corporate Insolvency Practitioners: A Market Study' (June 2010) at [1.13]-[1.15 https://webarchive.nationalarchives.gov.uk/20140402172033/http://oft.gov.uk/shared_oft/reports/Insolvency/oft1245

[643] Administrators are strongly inclined to implement actions that would strive to support senior secured creditors, Mokal (n459) 387

[644] Xie (n487)28.

[645] Polo (n380)

[646] Walters(n498) 547

[647] *DKLL Solicitor v. Her Majesty's Revenue and Customs* [2007] B.C.C. 908

to sell the business as a going-concern, with or without the company shell, even immediately upon their appointment. The judicial approval also rests on the belief that the administrators can affect the sale of the company without obtaining the creditor's approval.[648]

The pre-pack process has a number of advantages. First, it enables a very expeditious sale with no or limited adverse publicity and market distortion, thereby preserving value, goodwill, and stakeholder confidence more effectively than a slower, more protracted administration process. Second, the speed of pre-packs appears to reduce overall costs, as companies that remain in insolvency proceedings for extended periods are more likely to accumulate higher expenses. Third, pre-packs may facilitate the retention of employees, whose continued employment and livelihood depend on the uninterrupted operation of the business.[649] In fact, evidence shows that the rate of employment preservation in pre-pack sales is significantly higher than that in sales conducted without the pre-pack.[650] A final benefit of pre-packs is that, by avoiding the need to present proposals for a creditor vote, they help mitigate the risk of opportunistic hold-up behaviour. This risk arises in situations where a significant proportion of junior creditors obstruct the process, making it difficult to reach a contractual solution to financial distress, or where a dominant creditor attempts to derail the restructuring in order to extract additional value at the expense of others. Being a hybrid mechanism, the pre-pack is considered flexible, with its core consisting of a series of negotiations and commitments made before the formal insolvency stage begins. This flexibility allows a company to identify the root cause of its distress and develop a tailored plan that addresses its specific circumstances.[651]

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[648] Antony Zacaroli, 'The Powers of Administrators under Schedule B1 Prior to the Creditors' Meeting Transbus International Limited' (2004) 1 International Corporate Rescue, 208.
[649] Keay and Walton (n443)108
[650] Frisby (n138)
[651] Qi (n345) 135

Nevertheless, pre-packs have also attracted criticisms, since the pre-pack negotiations are done in secret, unsecured creditors are left in the dark and effectively presented with a *fait accompli*.[652] Undoubtedly, the element of secrecy also enables the debtors to hand-pick the potential buyers with whom they wish to negotiate the sale of the business. This opens the process to potential manipulation and the risk of excluding other potential buyers who may have presented more favourable offers.[653]

For the aforementioned reasons, it should come as no surprise that the overall realisations and returns to preferential and unsecured creditors are often lower compared to standard administration processes. These criticisms become even more apparent when the sale is made to a connected party. Businesses sold in connected-party pre-packs have a higher likelihood of relapsing again in insolvency compared to those sold to third parties. These short-term fixes to write off liabilities ultimately undermine the morality and effectiveness of insolvency practitioners and erode trust in the insolvency system at large.[654]

These concerns were validated in recent empirical studies and independent reviews.[655] However, to address these concerns, the government introduced voluntary and industry-led measures aimed at improving transparency and accountability in pre-pack administrations, while preserving the notable benefits these arrangements offer, such as procedural speed, cost savings, and enhanced business efficiency. To this end, a body of experts, called the Pre-pack Pool, was established to review and opine upon the purchase of a business by connected parties.[656] Compliance was voluntary, but the administrator was required to

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652 R3, 'Pre-packaged sales (pre-packs)'
<https://www.r3.org.uk/media/documents/publications/press/Prepacks_briefing.pdf>.
653 Kerry Scott, 'A fair deal?' (2009) 159 New Law Journal,421,423.
654 Peter Walton, 'Pre-packaged administration Trick or Treat' (2006) 19 Insolvency Intelligence 8
655 See for example, Walton and Umfreville (n548); See also Graham Report (n548); Sandra Frisby, A Preliminary Analysis of Pre-Packaged Administrations: Report to the Association of Business Recovery Professionals (University of Nottingham 2007)
656 Giles Hindle, 'Pre-packs- The Latest Attempt at Transparency' (Lexology, 7 December 2015) https://www.lexology.com/library/detail.aspx?g=54275706-e962-452e-8dba-

inform the connected party of the existence and purpose of the pool and to encourage them to approach it.[657]

The members of the Pool, on the basis of the documents submitted and by rotation,[658] will independently assess whether the case for a pre-pack sale is not unreasonable, or the case is not made; or the case is not unreasonable but the evidence presented has some minor flaws.

In any circumstance, the Pool is not empowered to block the approval of a pre-pack sale, even if its members believe that the case for the pre-pack is unreasonable.[659] It is important to bear this in mind, as this limitation has significant implications for the ability of the experts to mitigate the risk of the abusive use of pre-packs for the benefit of connected parties.

More in general, the Pool lacks the authority to scrutinise the administrator's actions both before and after the sale, or to determine if the company will in fact thrive in the future. Moreover, it seems prudent for administrator to inform the purchaser of their ability to approach the pool. However, the cost,[660] time and complexities associated with this mechanism pose considerable disincentives to the prospective purchaser to make a submission to the pool. Additionally, in such situation, apart from the costs, disenfranchised

[657] Graham Report (n548)
[658] Include a summary of the main causes of distress; (2) the terms of the offer to be made to the administrator; (3) an outline of the reasons why the pre-pack sale is worthwhile implementing; (4) a list of those who are anticipated to benefit and suffer from the sale; and (5) the factors that suggest that the business will survive for the next 12 months.
[659] Eugenio Vaccari, ' Pre-pack pool: is it worth it?' (2018) 12 International Company and Commercial Law Review,697,705.
[660] The application fee is £1500.00 + VAT See Pre-Pack Pool, 'Questions & Answers About the Pre-Pack Pool https://www.prepackpool.co.uk/questions-answers accessed 2 December 2022

creditors may have little faith in assessments which are based on documents provided by the purchasers.

These concerns seemed justified. The data gathered by the body disclose the low uptake rate of submissions to the pool. Only 28% of connected party pre-packs were submitted since the establishment on 1 November 2015 to 31 December 2016.[661] This disappointing beginning was followed by abysmal results in 2017, when a mere 11% of connected party pre-packs were referred to the Pool.[662] Meanwhile, pre-packs comprised 28% of all administrations in 2017 compared with 22% in the previous period, with 57% of prepacks in 2017 involving connected party sales (203 out of 356) compared with 51% (188 out of 371) in the previous period. It is possible that referrals to Pool were low at that time because the administrators and the parties were still familiarising themselves with the way in which the new Pool operated. However, referrals to the Pool remained low, and in the year to December 2020, only 13% of connected party pre-packs were referred.[663] Meanwhile, there were 481 pre-packs in 2020, with 56% (272) involving connected party sales. Thus, even as pre-packs — and particularly connected party pre-packs — became increasingly common, referrals to the Pool steadily declined.[664]

On account of the abysmal participation rates in the Pool and the heightened calls for statutory intervention to end the voluntary nature of the Pool, reform was introduced in the

[661] Pre-Pack Pool Annual Review 2017 (May 2018) online: https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2017.pdf. The report is based on Statement of Insolvency Practice 16 (SIP 16) filings during the relevant period. Every administrator is required to submit a SIP 16 form containing information on the pre-pack to the creditors of the insolvent company at the time that they are notified of the administration, with a copy submitted to the Insolvency Service.

[662] Pre-Pack Pool Annual Review 2018 (May 2019) online: https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2018.pdf.

[663] Pre-Pack Pool Annual Review 2020 (May 2021) online: https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2020.pdf

[664] Pre-Pack Pool Annual Review 2017 (May 2018) online: https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2017.pdf. The report is based on Statement of Insolvency Practice 16 (SIP 16) filings during the relevant period

Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021. The referral of any connected party sale to the Pool has becomes mandatory. The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 (ARR 2021) also introduced the role of the evaluator, who must draft a qualifying report indicating whether the consideration offered for the relevant assests and the grounds for the substantial disposal are reasonable in the circumstances.[665] As a result, the number of referrals to the Pool has increased dramatically. In 2021 there were 201 pre-pack sales with 106 involving connected party sales. Of the 106, 68 (64%) were referred to the Pool.[666] While in 2022 there were 358 pre-pack sales with 201 involving connected party sales, of which 94 (47%) were referred to the Pool.[667]

Whilst the Regulations represent an important development in addressing some of the transparency and accountability concerns raised by pre-packs, the fact remains that the evaluator can still not block a pre-pack sale from going ahead, not even when consideration to be provided for the relevant company's assets and the grounds for the substantial disposal appears unreasonable to the evaluator.[668] The administrator will, therefore, still be able to proceed with the sale to the connected person notwithstanding the evaluator's opinion but he has to explain his rationale for doing so in a statement to the creditors. That seems to restrict the role of the evaluator to one very similar to that of the Pre-Pack Pool.

Moreover, given that the choice of evaluator remains with the connected party purchaser and the evaluator's opinion is based on documents provided by the purchaser, and since the

[665] The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021, section 3(1)(b) and 7(h).
[666] Pre-Pack Pool Annual Review 2021 (May 2022) online: https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2021.pdf
[667] Pre-Pack Pool Annual Review 2022 (May 2023) online: https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2022.pdf
[668] The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021. (Pre-pack Regulations) part 2

Regulations do not provide for an appeal, there is still no opportunity to challenge their conclusions. As a result, this is unlikely to improve disenfranchised creditors' confidence in the valuation.

The role of the evaluator still does not extend to reviewing the actions and decisions of the administrator, such as the marketing of the assets. There is no explicit sanction for failing to comply with the provisions. However, this could potentially lead to the removal of the administrator[669] or the initiation of a misfeasance claim against them.[670]

Removing the administrator is difficult to achieve as case-law shows that courts are very reluctant to do so.[671] Initiating proceedings against the administrator for misfeasance is also fraught with difficulty. In addition to the difficult burden of proof and the lack of detailed information, courts may also grant relief to administrator pursuant to section 1157 of the UK Companies Act 2006. As an agent and officer of the company,[672] an administrator can obtain relief from any alleged breaches of duty if it is clear that they honestly believed their actions or omissions were in the best interests of the company. Therefore, an attempt to hold the administrator accountable by trying to remove him and/or to institute proceedings against him for misfeasance may have low probability of success.

More importantly, to fall within the scope of the Regulations, the sale must be made to a 'connected party'. Connected parties include the owners, directors, shadow directors or other officers of the insolvent company as well as any 'non-employee associates' of the insolvent company or of a director, shadow director or other officer of the insolvent company; and companies connected with the company in administration.[673] This means that

[669] Insolvency Act 1986 B1 Para 88
[670] Insolvency Act 1986 Para.75 Sch. B1
[671] *Hobbs v Gibson* [2010] EWHC 3676 (Ch); *Re Shruth Ltd* [2005] EWHC 1293 (Ch); *Re Edennote Ltd* [1996] 2 BCLC 389 at 398.
[672] Hamish Anderson, '*The Framework of Corporate Insolvency Law'* (Oxford University Press 2017) 117-121
[673] Insolvency Act 1986, Sch B1, para 60A(3) to (6)

pre-pack sales to secured lenders do not fall within the remit of the Pool. Commenting on the rationale for the exclusion of secured lenders from the definition of 'connected persons,' the drafters noted that such parties are not responsible for the failure of the company and should not be treated in the same way as directors, other officers, or connected companies. They further pointed out that any change to the definition would require primary legislation and could not be affected through the ARR 2021 regulations.[674]

The distressed debt investors tend to follow the investment strategies of purchasing the secured debt of the distressed debtor or providing the much-needed fresh capital on secured basis with the intention to acquire ownership of the distressed company. To achieve this, Pre-pack may be used to sell the entire business to a new company owned by them, in exchange for releasing the amount of their debt. A process known as credit bidding. Criticisms of pre-packs, as discussed above, manifest themselves even more strongly in such sales as the concerns around the lack of transparency and accountability are graver. Distressed debt investors may use contractual rights and position of power to receive confidential, non-public information and enhanced treatment. The debt is often purchased at an unknown discount against the face value or extended with desire to keep the trigger clauses confidential. Distressed debt investors-led pre-pack sales are not marketed in a competitive manner. The investors rush the process to lock out outbid competitors. The distressed debt investor may leave part of the secured debt in the old company so as to allow it to capture, via its secured position, any future receipts into the old company.

Moreover, pre-pack sale to the lenders may not ensure the business will in fact thrive in the future. This is precisely what occurred in the case of the Polestar Group, one of the UK's largest independent printing companies. As part of the pre-pack transaction, the distressed

[674] The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 (ARR2021)

debt investor established a bidding vehicle (NewCo) to acquire the company's assets, using a reduction in their secured debt as consideration for the purchase. The investor failed to consult wider stakeholders, and following the completion of the sale, one of the company's main customers refused to transfer its contract to the new entity. [675] As a result, the company relapsed again into administration just two months later.[676]

Short-term rescues of high-profile companies often attract huge media attention. The press popularly characterises them as evidence of asset stripping, commercial bribery, and corporate theft, and this subsequently tarnishes the reputation and effectiveness of insolvency practitioners and erodes trust in the system. In short, the design and structure of the process may heighten transparency and accountability concerns and cause more harm to the weakest stakeholders than pre-pack to connected parties. Nevertheless, such sales are not subject to Administration (Restrictions on Disposals etc to Connected Parties) Regulations 2021[677] and therefore, there is no need for an evaluator's report to mollify the concerns of disaffected creditors.

5.5. Valuation of the company: The lack of adequate guidance

Financial analyses such as valuation play a crucial role in the insolvency process. They are central, amongst others,[678] to provide adequate protection for those whose rights are being affected by the debtor's failure. Indeed, an effective mechanism of valuation can discern

[675] Johnston Press PLC, Statement of administrator's proposal(27/11/2018) available at https://find-and-update.company-information.service.gov.uk/company/SC015382/filing-history; Christopher Williams, 'Newspaper giant Johnston Press to enter administration' The Telegraph (London,16/11/2018) https://www.telegraph.co.uk/business/2018/11/16/johnston-press-brink-administration-handover-us-hedge-fund-control/
[676] Graham Ruddick, 'UK's largest independent printer Polestar calls in administrators' The Guardian (London,27/04/2016) https://www.theguardian.com/media/2016/apr/27/uks-largest-independent-printer-polestar-administration-daily-mail
[677] The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 (ARR2021)
[678] For example, it provides the hope of reorganization for debtors. Valuation leads to the identification of the debtor's fulcrum security creditors. These creditors would ensure that the value in the assets is maximised so that they can benefit from the realisations. Reorganization will almost always maximise value over and above the break-up value of the company's assets.

clearly whether the creditors or members in question have a remaining economic interest in the company and therefore, be able to participate, scrutinise, vote and agree on the terms of the proposed deal.[679]

The valuation of a company's business depends on its operational viability. In some cases, the business may have a significantly higher value if separated from its previous operations and sold on a break-up basis, rather than continuing to operate as a going concern. This indicates that the business is no longer viable, or, as the finance and economics literature terms it, that it has become economically distressed. Such companies are incapable of being reorganised and should be liquidated because the longer the assets constituting that business (e.g. the company's premises, its machinery and its intellectual property, etc.) remain tied up in a failing business, the more value will be lost for all those with claims against the company. In such cases, a piecemeal liquidation of the company's assets would likely serve the best interests of all claimants.[680] Ideally, in such a situation, the claimants' preference is to sell the property at its highest market value. To achieve this, the assets would be dismantled and exposed to the relevant markets through a comprehensive and extended advertising process, During this process, reasonable attempts would be made to identify potential buyers, and negotiations would be conducted with the identified parties to secure the best possible price.[681] When, however, the distressed company's property is disposed off in an insolvent liquidation, the liquidator typically only obtains liquidation value, sometimes referred to as a 'fire-sale' value. In this sense, liquidation of economically distressed companies raises relatively few valuation questions.

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[679] For more on the importance of valuation evidence see *Re Bluebrook Ltd*, [2009] EWHC 2114 (Ch); [2010] B.C.C 209 (Ch D); *Re Smile Telecoms Holdings Limited* [2022] EWHC 740 (Ch) [53]
[680] Rizwaan Mokal*, Corporate Insolvency Law: Theory and Application* (OUP 2005) 4
[681] Michael Crystal and Riz Mokal, 'The Valuation of Distressed Companies — A Conceptual Framework –" Part II (2006) 3 International Corporate Rescue,123,126

Distress can be a natural part of a company's lifespan, so it is important to distinguish between distress and corporate death. Distress may be merely a temporary state and is not necessarily fatal.[682] The company might be unable to meet its current cash obligations due to a temporary lack of liquidity or due to difficulties accessing financing on favourable terms. In such circumstances, the company's underlying business remains viable and fundamentally profitable. In this case and given the economic viability of the business, piecemeal dismantling of the company's business militates against the interests of the claimants as a whole. Thus, removing necessary operating assets of the business would mean taking them away from their most productive and beneficial use and reallocating them to less inefficient projects. A business which is merely financially distressed (i.e. one whose assets generate greater value if sold as a functioning unit than it would if it were broken up and sold piecemeal) is said to have a 'going concern surplus'. The best option may be to devise a strategy that allows the disposal of the business on a going concern basis to preserve the surplus value, also called 'enterprise value'.[683]

The question remains how this surplus might be valued. In general, there are two possible ways by which this value can be calculated. First, valuation methodologies which seeks to infer the intrinsic value of the company based on an estimate of its cash flows that it is expected to generate in the future as a going concern. To achieve this end, the claimants and their experts will tender their valuation analysis, which are based on evidence prepared by the management of the company, to the court to determine the debtor's enterprise value.[684]

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682 Wruck (382)420.
683 Belcher (n241) at 13
684 Stark, Williams, and Maxwell (n236) 1042

Alternatively, there are valuation methodologies based on a present value analysis of the company without taking into account any future earning capacity in establishing the company's going concern value. This happens by conducting an auction or similar marketing process, whereby the company's going concern value is determined by reference to the highest value bid received.[685]

There is no legislative guidance as to how a company's business might be valued in the course of insolvency procedures. It has been left to the courts and practitioners to develop the rules underpinning the resolution of such valuation matters. Reported case law suggests that, in general, English courts tend to prefer the implementation of market-testing approaches over competing methodologies to render a more objective valuation for the company's business.

In *Re Bluebrook Ltd*[686], the company was insolvent on a balance sheet basis but its underlying business remained economically viable and, therefore, a rescue and rehabilitation of the group was prioritised over liquidation. The account of the company showed that the value of its assets was insufficient to repay all the debts owed to the senior lenders. The junior creditors whose claims were subordinated to the senior lenders would, therefore, receive nothing at all on a straight liquidation. The possibility of having an informal workout was remote due to the high risk of junior creditors exercising hold-up rights. Junior creditors were prepared to withhold their consent in order to bargain for a better deal for themselves. To give the company a chance to pursue a restructuring for its debt without the approval of the junior creditors, a scheme of arrangement was 'paired' with a pre-packaged administration transfer (or sale) of the business of the insolvent company to a newly incorporated NewCo and the senior lenders effectively swapped their

[685] Ayotte and Morrison (n146) 1822
[686] *Re Bluebrook Ltd* [2010] B.C.C. 209

debt in the old group into equity in the newly incorporated NewCo. The junior creditors were left behind in the scheme companies, which had been stripped of their assets. They were neither consulted nor given the opportunity to participate in the scheme of arrangement, as they were deemed to be 'out of the money'.

The junior lenders challenged the reorganisation, presenting the court with a valuation range between £210 million and £700 million, based on the discounted cash flow (DCF) approach. They argued that they had a realistic chance of holding an economic interest in the company. In contrast, the senior lenders valued the group much lower, at a range of £150 million to £265 million, based on its current market price—well short of the £313 million in outstanding senior debt. This suggested that the junior creditors were, in fact, resolutely 'out of the money. The court clearly favoured valuation methods that evaluate the company at its current market price. As a result, the junior lenders were found to had no remaining economic interest in the company and their complaints held no weight.[687]

A similar situation also occurred in the *MyTravel Group case*.[688] The group struggled under the weight of insurmountable debt, and the route of a consensual plan proved insufficient in pulling the company out the troubled waters, as the bondholders rejected the proposed allocation of 2% of the shares (equity) in the newly reorganised company. The group had insufficient assets to pay the senior lenders in full. In this sense, there was no possibility for the junior bondholders to receive anything on liquidation, to wit: they were “out of the money”. As they had nothing to lose, they were expected to opportunistically employ hold-up tactics to derail the restructuring, seeking to extract a share of the overall returns for themselves, to the detriment of the senior creditors who had the greatest stake in the company’s future. To avert this problematic result, a scheme of arrangement was ‘twinned’

[687] Payne (n386) 288
[688] *Re MyTravel Group* [2004] EWHC 2741 (Ch)

with a pre-packaged administration sale. In effect, the business of the insolvent *MyTravel holding* company was transferred to a newly incorporated 'NewCo' owned by the senior lenders, leaving "out of the money" bondholders stranded with their claims intact in an insolvent company, which had become empty.[689] It, therefore, should come as no surprise that the bondholders were excluded from the process and therefore were not given the opportunity to vote against it. They contested the scheme, but the court upheld the structure of the restructuring, asserting that, since the rights of the bondholders remained unaffected, their consent was not necessary for its approval.

Of particular importance was the valuation of the group; the court conducted the valuation based on the scenario most likely to occur if the scheme were not sanctioned (i.e. the 'relevant alternative scenario'). In this particular case, the group's Air Travel Organisers' Licence (Atol) would be revoked and the relevant alternative scenario would be liquidation. Accordingly, the court used the liquidation measure to determine the highest value bid for the company's business. Notably, excluding any future cash flows from the group if the scheme sanctioned as it turned out to be the case.

In *Saltri III*,[690] the court was satisfied with the desktop valuation report which consisted of a comparable companies multiple analysis (adjusted to reflect the current market environment), a discounted cash flow valuation, and a leveraged buy-out valuation, all of which are based on the company's status at the then-prevailing market conditions of the financial crisis. The court ruled out the possibility of a competitive bidding process and a neutral expert valuation opinion. This decision was based on two key reasons. First, there was an urgent need to sell the company quickly to avoid a prolonged and damaging auction

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689 Rhys Blakely, 'MyTravel meeting to decide group's fate' The Times (London, 24/12/2004) https://www.thetimes.com/article/mytravel-meeting-to-decide-groups-fate-x63xrl3btrz

690 *Saltri III Ltd v MD Mezzanine SA SICAR* [2012] EWHC 3025 (Comm); [2013] 1 All E.R. (Comm) 661; [2013] 2 B.C.L.C. 217

process. Second, the fact that the debt was trading at a deep discount to its face value served as a 'strong corroborative force' supporting the conclusion that the mezzanine lenders were so far 'under water' that they were entitled to nothing.

The mezzanine lenders argued that the actual value of the company was directly affected by the industrial downturn in the automotive market that followed the 2008 crash and the collapse of the Chrysler and GM.[691] The mezzanine lenders traded in the company's debt on the possibility of a successful turnaround and a subsequent recovery of the restructured group in the future. However, the court stressed that it had no discretionary powers to depart from actual value valuation of the debtor's business.[692]

The courts are keen to stress that insolvency practitioner is not compelled to sell the debtor's assets at a propitious time. This view holds with reference to mortgagees. In *Silven Properties Ltd*,[693] the court concluded that there is no duty on the mortgagee in relation to the timing of the sale. In other words, once the conditions for the enforcement of a charge have arisen (i.e. a company defaults on a debt payment), the holder of charge will be free to determine when to enforce the charge without the need to delay the sale in the expectation of the market conditions change to obtain a higher price.

The reliance on the present value of the debtor's business promotes uniformity and predictability of outcomes, and serves the purpose of avoiding situations of numerous and complex assumptions, coupled with consequential error and disagreement on estimating the rate of cash flow that a company may generate in the future.[694] In *Ludsin Overseas ltd*[695] the court excluded the subjective estimates made by valuation experts attributing a much

[691] Mark J. Roe and Joo-Hee Chung, 'How the Chrysler Reorganization Differed From Prior Practice' (2013) 5 Legal Analysis,399,402.
[692] Ibid 403
[693] *Silven Properties Ltd v. Royal Bank of Scotland plc* [2004] 1 WLR 997
[694] Eugenio Vaccari, 'Promoting fairness in English insolvency valuation cases' (2020) 29 Int Insolv Rev 285,295.
[695] *Ludsin Overseas Ltd v Douglas John Maggs* [2014] EWHC 3566 (Ch)

higher value to the property on the basis that ''the best indication of the value of an asset at any particular time is what a rational and well-informed buyer would be willing to pay for it after reasonable attempts had been made to sell it''.

The "fair market value" valuation approach adopted by the UK courts often lead to a substantial devaluation of the companies in distress. There are some reasons which may well account for this. Firstly, companies may enter into financial or economic difficulty because of far and wide industry factors and changes in market conditions.[696] In such situation, the most likely buyers for the company's assets are its competitors and other companies operating in the same line of business. It may be difficult to attract such buyers, as they too may be affected by the same industry-wide challenges and may face a downturn in their own prospects. Therefore, they would be unable to meet their own current obligations, let alone devoting resources to fund expansions. In other words, in the face of liquidity constraints, industry companies may not be able to submit bids for the debtor's business. As a result, the assets are likely to end up in control of outside, lower-value users.[697] Of course, a competing car manufacturer interested in preserving the profitable part of another insolvent car manufacturer for the economies of scale arising from their merger would be prepared to pay more than an estate developer interested in closing the factories and selling the properties in the market for a profit.[698]

Secondly, industry wide factors may push a large number of companies into financial distress, creating an oversupply of similar businesses in the market. Ultimately, the ensuing low level of market demand would corrode the market price of the company's business and assets. Thirdly, the business might be large and expensive, no single investor can amass the

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[696] Pratik Datta, 'Value Destruction and Wealth Transfer Under the Insolvency and Bankruptcy Code, 2016 in Susan Thomas (eds), *Insolvency and Bankruptcy Reforms in India*, (Springer Singapore 2020) 167
[697] Andrei Shleifer and Robert W. Vishny, 'Liquidation Values and Debt Capacity: A Market Equilibrium Approach' (1992) 47 J. FIN. 1344
[698] Vaccari (n659) 295

capital needed to buy such business, and it might be challenging to assemble a new group of investors with a genuine desire and ability to undertake risky investments. Investors may only be willing to purchase the business at a discount to reflect the inherent risks. Buyers may offer lower enterprise value on the assumption that economically sound businesses would have been retained by previous owners and their debt burden being reorganised. The existence of one or all of the aforementioned factors can result in the debtor's business being sold for a price lower than would be justified by its true value-generating potential.[699]

Adequate financing and competition among bidders are both inevitable and necessary to the efficient functioning of auctions. Industrial downturn is usually correlated with financial downturn. of financial downturn. Therefore, it is doubtful that even external purchasers would be able to secure financing to acquire and rehabilitate distressed businesses, particularly large and capital-intensive ones. Moreover, participating in an auction process involves transaction and information costs, as well as time and due diligence efforts. Only the winning bidder is able to recoup these costs. Consequently, even if there are a large number of potential bidders with the capacity to raise the necessary capital, it is highly unlikely that all will choose to participate. This may, in turn, lead to a lack of competition.[700] The severity of this competition problem is exacerbated by the possible strategic behaviour of some investors, in particulars, investors who may employ investment strategies such as a "loan-to-own" strategy or streamlined sale process that may chill bidding process and depress the value of the assets.[701]

Putting aside the above limitations of the auction process, there is always a risk that in light of uncertainty regarding the finality of the auction, genuine buyers may be reluctant to

[699] Ayotte and Morrison (n146) 1824
[700] Aghion, Hart and Moore (n99)530
[701] Final Report and Recommendations, Commission to Study the Reform of Chapter 11 (American Bankruptcy Institute, 2014) 2 ["ABI Report"]. Online: <https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h> accessed 21 June 2022.

participate in the process. This means that it might prove difficult to conduct a robust auction process to determine the valuation price if prospective purchasers in doubt that market testing is not a part of an actual sale in which they have a realistic chance to acquire ownership of the distressed business, but rather a staging post to put a value on the debtor.[702]

Market-testing approaches may sometimes prove unsuccessful in extracting the highest value from the assets because they are poorly carried out.[703] The parties – in particular, creditors or other potential bidders may lack the information and time to generate higher value offers.[704] In *Wind Hellas*,[705] although the court conducted an auction process to value the debtor's business, the sale procedure was rushed, resembling more of a validation technique than a genuine effort to maximise value. Junior lenders and third parties were not provided enough time to conduct proper due diligence or submit competing bids. However, the court justified the urgency of the sale, citing the need to prevent further loss of value. Similarly, in *Goel v Grant*, a liability claim that the insolvent company potentially had against the former directors was put up for auction without conducting a preliminary valuation of the claim, resulting in only a small amount of money being obtained from its sale.[706]

Distressed debt investors would likely favor the adoption of a market-testing approach that undervalues the debtor's assets and business. As holders of senior debt, with the intention of receiving equity in the newly restructured company, they would prefer a lower valuation, as it increases the proportion of equity they are expected to receive. This also serves to

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[702] Stuart C. Gilson, Edith S. Hotchkiss and Richard S. Ruback, "Valuation of Bankrupt Firms"(2000) 13 The Review of Financial Studies 43,47; Paterson(n130) 337

[703] Robert K Rasmussen and David A Skeel Jr, 'The Economic Analysis of Corporate Bankruptcy Law' (1995) 3 Am Bankr Inst L Rev 85

[704] Lynn M. LoPucki and Joseph W. Doherty, 'Bankruptcy Fire Sales' (2007)106 Mich. L. Rev,1,5

[705] *Re Hellas Telecommunications (Luxembourg) II SCA (in admin.)* [2011] EWHC 3176 (Ch), [2011] 11 WLUK 881.

[706] *Goel v Grant* [2017] EWHC 2688 (Ch); [2018] Bus LR 393, [27].

extinguish the bargaining power of the junior creditors and shareholders, effectively leaving them with nothing.

It is the responsibility of creditors – and secured ones in particular to ensure that reasonable steps are taken to obtain a proper price for the debtor's business. Especially in cases of sales to previously connected persons.[707] One may infer that parties are provided with adequate protections. However, distressed debt investors are not incentivised to use their position as secured creditors to push the price above the value of the business. In fact, they have strong incentives to chill the bidding process and depress the value of the assets, so they can end up with significant, if not all, the equity interests in the newly restructured company. To achieve this end, they may present the case as one with great urgency to eliminate the need for robust auction in which a third party may submit a competing bid.

Meaningful valuation challenge is difficult to mount. Parties who feel disenfranchised have limited opportunities to scrutinise and challenge market-based valuations. This is because the chance of persuading a court to depart from the conclusion that the price a party is willing to pay at an auction represents the best valuation of the assets is very limited,[708] even if the auction process is poorly carried out.[709]

Creditors may seek recourse to 'unfair harm' procedures in an attempt to remove the administrator.[710] However, the problem is that proving misconduct, or that a certain action implemented by the administrator was unfair is exceptionally difficult as most decisions will appear to be based on commercial judgement, something which the judiciary has openly admitted that administrators are better placed to make than judges.[711] In *Clydesdale*,

[707] *Kwong Lam v Wong Chit Sen* [1983] 1 WLR 1349, [1355B]
[708] *Philbin v Davies* [2018] EWHC 3472 (Ch); [2018] 6 WLUK 695
[709] *Kwong Lam v Wong Chit Sen* [1983] 1 WLR 1349, [1355B]
[710] Insolvency Act 1986, schedule B1, para. 74(1)
[711] *Re Zegna III Holdings Inc* [2009] EWHC 2994 (Ch).

the court agreed to remove the administrator following an application by a 'secured creditor' for its close involvement with the debtor in concluding the pre-pack arrangement in a way that he could no longer independently review the strength/weakness of the pre-pack contract. There are also potential difficulties in obtaining sufficient information as the valuation process especially in case of pre-packs tend to be opaque.[712] The administrator may justify the valuation process by asserting that it is in the best interests of the creditors, leaving little room for challenges to this assessment.[713]

5.6. The Good Faith Requirement and Proper Purpose: The Lack of Adequate Guidance

There is a long-established principle of the common law that allows courts, on a company's application, to scrutiny into the merits of the petition or (insolvency proceedings). There may, of course, be valid reasons for this. The creditor might be using the winding-up petition for an improper purpose, and pursuing such a claim for improper purposes could constitute an abuse of process.

One may ask: what is an improper collateral purpose. In *Mann v Goldsteint*[714] the court restrained the presentation of a winding-up petition based on a debt that was disputed in good faith. In the court's view, the threat of a winding-up petition as a means of forcing the company to pay a *bona fide* disputed debt can amount to an abuse of the process which is the very essence of the whole of the court's jurisdiction to prevent it. In the judgment, emphasis was laid on the fact that mere assertion of a dispute is insufficient, it must be proven to the satisfaction of the court that there is a genuine dispute on substantial grounds. To put it another way, the dispute must have a real prospect of success and not prompted by the desire to shield the company against genuine petitions.

[712] Graham Report (n548)
[713] *Alpstream AG v PK Airfinance sarl* [2015] EWCA Civ 1318; [2015] 12 WLUK 712, [156]
[714] *Mann v Goldsteint* [1968] 1 WLR 1091

The court may restrain or dismiss a winding-up petition even where the debt is undisputed and unpaid. In *Re Crigglestone Coal Company Limited*,[715] the court justified its ruling to dismiss a creditor's petition for the need to take into consideration the interests of all others of the creditor's class. Therefore, to be properly presented, the petition must be presented on behalf of the petitioner and all others of his class rateably. The logic behind this is to ensure that filing the petition is the best course of action for the majority of creditors.

In *Re A Company*[716] it was proven to the satisfaction of the court that the presentation of the winding up petition was not in good faith or for the legitimate purpose of recovering a debt. In fact, the winding up petition was used to exert improper pressure on the company to gain control of its business premises to the disadvantage of the body of creditors. In this sense, conferring on the petitioner an advantage not shared by the other creditors amounts to an abuse of process.

More recently, in *Maud v Aaber Block Sarl*[717] the court reinstated this conclusion by holding that the pursuit of insolvency procedures on an undisputed claim will constitute an abuse in two circumstances. The first is where the petitioner presents the winding up petition not to obtain the liquidation or bankruptcy of the company or individual, but issues or threatens to issue the proceedings as a way to pressure the target to take some other action which the target is otherwise unwilling to take. The second is where the petitioner seeks to commence the liquidation proceedings against a company or an individual but he is not acting for the benefit of a class of creditors of which he is one or where the success petition will benefit the petitioner at the expense of the creditors as a whole.

[715] *Re Crigglestone Coal Company Limited* [1906] 2 Ch 327
[716] *Re A Company* (No. 006794 of 1983) [1986] BCLC 261
[717] *AABAR Block Sarl V Maud* [2018] EWHC 1414

Loan-to-own techniques and other short-term strategies, such as selling the debt for a profit shortly after its purchase and capturing returns on the claim at the end of the insolvency process, are considered perfectly proper collateral purposes. Therefore, distressed debt investors' intentions to acquire interests in, assets from, or ownership of a distressed company through debt-for-equity swaps or via a credit bid in a sale of the company's assets do not render the petition improper. In *Astra Resources Plc -v- Credit Veritas USA LLC*[718] the court, after an analysis of the relevant facts of the case, refused to restrain the presentation of a winding-up petition against the debtor on the grounds that the distressed debt investor's motive of taking control of the company from its directors to implement a creditor-led restructuring plan was in the advantage of all other creditors and in turn, he had a proper collateral purpose for bringing the winding up petition.[719]

To be regarded as improper, the applicant must prove that the winding up order is sought for causing an unjustified reallocation of value to the distressed debt investor, leaving all other claimants worse off. In *Highberry Ltd v Colt Telecom Group plc,*[720] the court restrained the presentation of a winding up petition by distressed debt investors, as it was satisfied that the distressed debt investor was attempting to enforce a transfer of value from shareholders to itself. The intentions of the distressed debt investors were clear to court because it was proven that the company was still solvent.

The cases where courts focused on deciphering the petitioning distressed debt investor's purpose and motive are few and far between. However, as seen in these cases, the challenges

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[718] *Astra Resources plc v Credit Veritas USA LLC* [2015] EWHC 1830 (Ch)

[719] Squire Patton, 'Ulterior motive not an abuse of process in winding up?'(Restructring Globle review,30/06/2015)https://www.restructuring-globalview.com/2015/06/ulterior-motive-not-an-abuse-of-process-in-winding up/#:~:text=In%20Astra%20Resources%20plc%20v,thus%20an%20abuse%20of%20process. 3

[720] *In re Colt Holding Co., No. 15-11296* (Bankr. D. Del July 2, 2015)

so far have come either from the company or other sophisticated investors.[721] There is the distinct possibility that the directors may have an incentive to support distressed debt investor's debt restructuring plans even where the company is solvent and there is still a residual interest for the shareholders in the company. This is because directors are likely to perceive the distressed debt investor involvement in distressed situation of the company as improving of their prospects, therefore, they can retain their jobs. Distressed debt investors may offer directors a significant equity stake in the newly restructured company in exchange for their support in implementing a loan-to-own strategy. While directors may already hold equity in the company as part of a compensation package designed to align their interests with those of shareholders, the new strategy can leave them in a more advantageous position. After the restructuring, the director's new equity stake would be backed by a company with less debt, improving its ranking and potentially offering higher returns compared to their previous position. In this sense, when the chances of finding new job opportunities in the market are low and the director's financial and career gains are most enhanced by supporting the interests of distressed debt investors, there is little to incentivise a director to consider the interests of shareholders and/or junior creditors.[722]

Moreover, once the company shows fundamental signs of financial distress, it is a common practice for creditors to request that an individual with technical knowledge and experience of financial difficulties is appointed to the board of the troubled company. The purpose is to assess the company's position, offer guidance to other directors, and implement a turnaround strategy if needed.[723] Creditors, particularly secured ones, play a crucial role in

[721] The existing precedent in this regard is *AABAR Block Sarl V Maud*, two distressed debt investors bought Mr Maud's debt to facilitate their acquisition of a company's assets registered in his name. After presenting the bankruptcy petition, the Petitioning investors ' relationship had broken down and they were involved in litigation with each other.
[722] Paterson(n264) 497
[723] Stuart C. Gilson and Michael R. Vetsuypens, 'Creditor Control in Financially Distressed Firms: Empirical Evidence' (1992) 72 Washington University law review, 1005,1015.

selecting the director. The turnaround director, who assumes a board appointment during a troubled period, is likely to recognise the need for frequent interaction with the creditor body.. Similar to a professional non-executive director, the 'turnaround director' seeks to develop and maintain a reputation in the market for turnaround service. However, in this particular situation, their reputation with the creditors holds more significance than their reputation with the shareholders. It is reasonable to expect this director to place greater emphasis on their reputation, specifically regarding their ability to deliver satisfactory outcomes for the senior creditors. Even when dealing with competing creditor interests, a turnaround director may not always provide the protection that their appointment promises. It would require a particularly brave individual to oppose a debt restructuring plan that has the necessary support from senior creditors and the board for its implementation, and who would protect the entitlements of weaker stakeholders who lacked the financial resources, commercial/legal knowledge, and bargaining power to protect themselves.[724]

The pre-pack sale of Johnston Press is a prime example of how directors may support distressed debt investors -led debt restructuring plans even if the company trades profitably, on an operating basis.[725] Distressed debt investors, had at different times, purchased secured notes issued by the group, at a substantial discount off of their face value. Interestingly, despite Johnston Press not having defaulted on the bonds, the distressed debt investor took steps to place it into administration. Their argument was that the group was in financially distress and likely to become insolvent in the near future. The directors supported their argument and placed the company into administration. The group completed a pre-pack sale of its business to a newly incorporated company owned by the distressed debt investors and

[724] Ibid
[725] Richard Stuart-Turner, 'Johnston Press acquired in pre-pack deal' Printweek 19/Nov/2018 https://www.printweek.com/content/news/johnston-press-acquired-in-pre-pack-deal/ accessed 20/10/2023

a majority of the board retained their jobs in the new company.[726] The shareholders and the pension protection fund did not have the opportunity to question the (actions of the) board of directors as the administrator was appointed upon the application of the directors.[727]

Johnston Press is not an isolated example, during the informal rescue negotiations of Interserve, the largest shareholder presented a modified financial rescue plan and emphasised that it is the directors' responsibility to refrain from supporting competing proposals for a debt-for-equity swapthat put forward by the company's lenders.[728]

Similar to Interserve, the directors of Hibu supported a debt-for-equity swap through administration and negotiated new roles with the distressed debt investors who bought up the company's debt at a substantial discount. The petition presented to the court achieved a reallocation of value to the distressed debt investor, worsening the position of several other claimants. However, it was challenging, if not impossible, for such claimants to apply for an injunction to restrain the distressed debt investor from presenting a winding-up petition.[729]

5.7. Shareholders loans: The lack of rules

In order to engage with business activities, companies need finance. From a corporate finance perspective, there are three fundamental types of finance that companies can utilise:

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726 Johnston Press, 'Statement of administrator's proposal' (Companies House, 27 Nov 2018) https://find-and-update.company-information.service.gov.uk/company/SC015382/filing-history; Questions over pre-pack rescue of Johnston Press, Sky news (19 November 2018 available at https://news.sky.com/story/jobs-secured-as-publisher-of-i-newspaper-is-bought-by-creditors-11557844

727 HC Deb, 'Johnston Press buyout debated in the Commons'19/11/2018 https://www.parliament.uk/business/news/2018/november/johnston-press-buyout-debated-in-the-commons/; Oli Ballard, 'Largest Shareholder in Johnston press threatens lawsuit against 'shameful' sale, Business leader(London,19/11/2108) The shareholder argues that "Today's pre-pack was not so much a corporate rescue as a blatant pre-planned corporate theft by bondholders, suitably aided and abetted by Johnston Press' incompetent and double-tongued board"

728 Rob Davies, 'Interserve's largest shareholder issues rescue deal demand' The Guardian (London, 27/04/2016) https://www.theguardian.com/business/2019/mar/04/interserve-shareholder-rescue-deal

729 Gideon Spanier, 'Exclusive: Yellow Pages investors accuse board of dereliction of duty' The Independent (London,11,09,2013) https://www.independent.co.uk/news/business/news/exclusive-yellow-pages-investors-accuse-board-of-dereliction-of-duty-8810343.html

debt, equity or retained profits or a combination of these options.[730] In essence, companies can be financed using equity contributions provided by shareholders or by means of debt provided by creditors.

The credit extended by creditors has as its most important characteristic, a return for creditors which remains unaffected by the company's performance, typically in the form of a fixed interest rate. In contrast, the return on equity is dependent on the company's success. Shareholders typically reap the benefits, whenever the company generates a profit, either through the dividends distribution or, if dividends are not issued, through an increase in the value of their shares. In the case of failure of the company, shareholders are last in line. This can be seen as a principle of both corporate law and corporate finance and is usually referred to as "equity is wiped out first".[731] This reality has long been recognised as vital in corporate governance. Undoubtedly, shareholders have an equity stake in the company, they, as residual owners, are best equipped to promote the success of the corporation.[732] Since their stake in the corporation is the first to be consumed as the company slides into distress, they are not incentivised to pursue risky strategies to the detriment of the creditors.

A shareholder may go beyond his role as an equity provider and become a creditor of the company. To achieve this end, shareholders may structure their investment in the company in the form of a loan rather than as a contribution of equity. This financing technique raises many concerns.[733] Due to their privileged access to all of the relevant information on the company's affairs and their influence on the directors, such shareholders are likely to be

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[730] Gullifer and Payne (n259) 59

[731] Frank H. Easterbrook and Daniel R. Fischel, '*The economic structure of corporate law*' (Harvard University Press, Cambridge 1991) 67–70

[732] Lynn LoPucki, 'The Myth of the Residual Owner: An Empirical Study' (2004) 82 Wash ULR 1341,1349; Robert Rasmussen, 'The Search for Hercules: Residual Owners, Directors, and Corporate Governance in Chapter 11' (2004) 82Wash ULQ, 82,85.

[733] Luigi Pecorella, 'Subordination of Shareholder Loans between Creditor Protection and Rescue Culture: An Escapable Tension?'(2021)8 IALS Student Law Review 44

the first to know if the attempts to nurse the company back to health are failing. In such a situation, they may promptly demand repayment of their loans, attempting to influence management to prioritise the immediate settlement of their claims. Left unchecked, outsider creditors would be left behind with nothing or only a little to receive. It will lead to the inadequate participation of shareholders in the entrepreneurial risk assessment of the company. Indeed, being able to limit their exposure to a minimum, they may in fact take excessive risks to the disadvantage of the creditors.[734]

In broader terms, shareholder loans have the potential to undermine the fundamental grounds of insolvency law. There is a consensus that insolvency law is creditor-focused.[735]Upon default on payment of its debts, the creditors become in a meaningful sense, the owners of the company's assets.[736] According to Jackson, creditors and secured ones in particular, can be viewed as 'owners of the firm' due to their rights in the assets. However, the risk of strategic creditor actions (i.e. the 'free-rider risk', the hold-out creditor risk, the race by the creditors to dismember the debtor risk) the heterogeneous objectives of the creditors, the diverse and large creditor base, and high creditor coordination costs render any contractual solutions on the most value maximising option extremely unworkable or impossible.[737] Insolvency laws, through a compulsory collective system, function to facilitate the value-maximising decisions (i.e. reorganisation or sale) for the benefit of the creditors. In this sense, shareholders' claims are, by definition, negligible, and the creditors become the new residual claimants with the right to decide on the way in which the assets

[734] Andreas Cahn, 'Equitable Subordination of Shareholder Loans?' (2006) 7 European Business Organization Law Review,287.
[735] Controversy rather revolves around on the extent to which, and the way in which, insolvency law should concern itself with how the debtor's wealth is distributed. Paterson (n4) 705
[736] Reinier Kraakman and others (n388) 110
[737] Elizabeth Warren and Jay Lawrence Westbrook, 'Contracting Out of Bankruptcy: An Empirical Intervention' (2005) 118 Harvard Law Review, 1197,1201.

would be used in order to generate the maximum possible returns.[738] As such, the practice of shareholder loans distorts the fundamental role of insolvency law. This is because, by virtue of their loan, they will continue to exercise their governance rights and actively participate in the insolvency decisions.

In the same vein, the transaction avoidance provisions along with the 'anti-deprivation rules, restitution for unjust enrichment rules[739], and wrongful trading and the liability of company directors[740] rules have been considered essential and integral to a well-functioning insolvency law.[741]As the debtor flounders under the strains of distress and possibly impending insolvency, the shareholders may make engage in a distribution of company's assets on the eve of the company's insolvency and prior to the onset of insolvency proceedings, by means of large dividends to themselves, preferential payments to themselves as creditors, or the creation of security interests over previously unsecured debts, the remove of assets from the estate entirely either by gifting, undertakings of transactions with assets at undervalue, or by fraudulent conveyance.[742] Therefore, there is a considerable risk that the company's estate can be severely depleted before the commencement of the insolvency procedure, to the point where there might be minimal or almost nothing left for distribution among other creditors.

In short, the transaction avoidance regime functions to maintain and enforce the fundamental rule of *pari- passu* which aim to ensure the achievement of an equitable

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[738] Jackson in The Creditors' Bargain Theory refers to this decision as the deployment question, Jackson(n47)5

[739] UK Insolvency Act, sections 238, 239 and 423 provides that creditors and liquidators may recover the value of assets transferred to particular creditors.

[740] Insolvency Act 1986, sections 213 and 214

[741] Rebecca Parry, James Ayliffe, and Sharif Shivji, '*Transactions Avoidance in Insolvencies'* (2nd edition, Oxford University Press, 2011) 8

[742] Rebecca Parry, 'Transaction Avoidance' in Rebecca Parry, Yongzian Xu, and Haizheng Zhang(ed), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Ash gate Publishing Ltd, Surrey, 2010) Chapter 8

treatment of creditors by punishing creditors repaid in detriment of other creditors[743] and limit the freedom of the debtor-company to pay dividend payment to shareholders prior to the opening of an insolvency procedure. However, if shareholders choose to make a secured loan to the company, instead of providing a capital contribution, these founding rules become meaningless, worthless and lose their significance and purpose.

The shareholder who provides a loan on a secured basis has little incentives to have dividend or intercompany claims paid prior to insolvency. This is because any assets held by the company can be used as collateral, and in the event of insolvency, these assets would ultimately go to the shareholders anyway. This outcome also undermines the usefulness of transaction avoidance rules in relation to outside parties to a level significantly below zero. Assets actually detracted from the pool could be restored to the insolvency estate on the basis of transaction avoidance, and would ultimately benefiting the shareholder as he secures the repayment of its large loans. In this way, transaction avoidance would effectively become an instrument to retrieve money from creditors for the benefit of shareholders in insolvency.[744]

Shareholders might exploit their insider position to gain an unfair advantage over external creditors. A loan might be extended informally by the shareholders. In essence, a formal loan agreement might not exist, or if there is any documentation, it could lack crucial details such as the interest rate or repayment schedule. a shareholder's ambiguous loan may create an obligation that other creditors do not even know exists. Indeed, this might reflect an

[743] Brook Gotberg, 'Optimal Deterrence and the Preference Gap' (2019) 2018 Brigham Young University Law Review,559,664.
[744] RJ de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (2018) 15 European Company and Financial Law Review 404

inaccurate picture of the financial reality and could leading to potential consequences like a supplier offering credit or goods on credit that they would have otherwise withheld.[745]

There is always a risk that the shareholders may increase the interest rates and fees chargeable on the loan. The failure to keep up with payment schedule may trigger insolvency proceedings. To avoid this consequence, the company may only have to raise new money through a sale of the company's core assets or divestment in order to generate cash to meet its financial commitments to the shareholder/lender. In such situation, resources and assets will be depleted to the extent that the company will be unable to continue in operation or compete against other companies within the same line of business and ultimately fail.[746]

This dynamic is further exacerbated if the shareholder arranges their loan as a secured loan. In the event of failure or insolvency, the shareholder could invoke its security rights and recover the full amount of its investment ahead of other creditors. When the company faces financial difficulties, obtaining collateral for their loans mitigates the lending shareholder's risk, creating an incentive to gamble on restoring their equity stake, often at the expense of unsecured creditors.[747]

Not all rescue attempts are necessarily desirable or amount to a successful rescue. It is an understating that so long as the company is economically distressed and is not capable of rescue, the longer it continues to operate, the more money that will be lost by all those with claims against it.[748] Therefore, for creditors, the continued operations of the company may result in a dissipation of even more liquidation value due to perpetuated and increased

[745] David A. Skeel Jr and Georg Krause-Vilmar, 'Recharacterization and the Nonhindrance of Creditors' (2006) 3 Faculty Scholarship at Penn Carey Law 195
[746] Gelter (n263) 480
[747] Ibid 482
[748] Mokal (n680) 62

risk.[749] In light of this, shareholders loans may be used to prop up an economically distressed company and prolong its inevitable demise in detriment of creditors.

Providing additional funds to a financially distressed company is economically beneficial if the expected value of the company after a turnaround is higher than the cash expense of additional loans and the opportunity costs of continuing the business., i.e., the foregone proceeds that an immediate liquidation would render.

Creditors with existing claims against the company are generally unwilling to provide additional loans, even if offered attractive interest rates and collateral, unless they are convinced that the company's proposed projects have a strong likelihood of success. Their reluctance stems from the fact that any further decline in the debtor company's condition will reduce the value of their pre-existing claims.[750]

Even external lenders without existing claims against the company are unlikely to lend money to a failing business, even when offered security. Third-party lenders are generally cautious in assessing the value of collateral. Production and service facilities, intangible assets, and even real estate are often far more valuable as part of the lender's ongoing business than they would be if sold at auction In fact, there may not even be a liquid market for many of the assets that a company would be able to pledge as security. Potential lenders will, therefore, subtract very significant discounts from the value that the borrower may attribute to these assets. However, if a company possesses sufficient unencumbered assets to pledge as security for a substantial loan, it suggests that the company is likely not in severe financial distress.[751]

[749] Ibid 195
[750] Cahn (n734) 289
[751] Ibid

Shareholders are likely to have a more optimistic view of the value of their company's assets offered as security. Beyond inherent entrepreneurial optimism, one reason may be their familiarity with the assets, reducing the need for independent valuation. Another reason is that, unlike external lenders, shareholders are willing and able to employ these assets in a new operation if rescue efforts fail. Consequently, shareholders could speculate at the creditors' expense, acting on the belief that their security allows them to withdraw and redeploy the assets elsewhere, without concern for the impact on preexisting claims.[752]

The economic advantage gained by the shareholder is substantial. Even in a distressed company—where profitability is not achievable—the shareholder, acting as a creditor, is entitled to receive profits in the form of principal and interest payments. Once the company or debtor becomes insolvent, the shareholder can present itself as a creditor and actively engage in the insolvency process.

For these reasons, in the US,[753] Germany,[754] Austria[755] and several other countries, either corporate or insolvency law gives courts discretion to subordinate loans granted by a controlling shareholder to the debt provided by external creditors or to treat the loans as equal to equity (recharacterisation of such loans into equity). The importance of these rules is also acknowledged in the UNCITRAL Legislative Guide on Insolvency Law.[756] It provides that '[t]he insolvency law should specify that claims by [shareholders] should be subject to scrutiny and, where justified: (a) The voting rights of the [shareholder] may be

[752] Ibid
[753] Equitable subordination rules in accordance with 11USC s 510
[754] See Insolvenzordnung (InsO – German Insolvency Code) § 39 in connection with InsO§ 135
[755] The repayment of shareholder loans which are granted in financial distress are prohibited under the Austrian Equity Repayment Act ("EKEG")
[756] The UNCITRAL Legislative Guide on Insolvency Law 2004, available in <www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf>

restricted; (b) The amount of the claim of the [shareholder] may be reduced; or (c) The claim may be subordinated'.[757]

This problem may be especially acute and exacerbated to the extreme in the UK. The UK insolvency law is known for its traditional deference to the rights of secured creditors.[758] Distressed debt investors tend to protect their risk exposure and maximise their recovery. To achieve this end, it has been empirically proven that they dress their investment to their distressed portfolio companies in the form of a loan rather than as a contribution of equity capital. It is clear that distressed debt investors are able to construct a "win-win" position. Should the company's fortunes improve or even when the company is distressed (i.e. not in a position to generate a reasonable rate of profit), distressed debt investors, acting as creditors, are entitled to profits, in the form of principal and interest payment. Once the company becomes insolvent, they would be able to present themselves as secured creditors and thus actively participate in the insolvency process. In this position, they may appoint the administrator, who is likely to be influenced by their wishes. They may negotiate a pre-pack for the purpose of ensuring a full and swift recovery or ownership at the expense of the other creditors.

In this sense, distressed debt investors' contribution of capital in the form of debt is likely to give rise to the possibility of empty voting (i.e. mismatch between the shareholder/creditor's voting power and economic interest). This is because the distressed debt investors are able to limit their exposure in the company. They may purse excessively risky projects at the expense of the unsecured creditors in the belief that, in the event of failure, they could invoke their security rights and thereby receive back in full their

[757] The UNCITRAL Legislative Guide on Insolvency Law 2004, available in <www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf

[758] The broad rights accorded to secured creditors in the UK are discussed above. See page 112.

investment. There is little reason to expect that shareholder/creditors would exercise governance rights to avoid financial distress as they are indifferent for the company being placed in insolvency or to expect insolvency procedures are the mechanisms of last resort.

The most plausible explanation for the collapse of large companies in the UK is that they were burdened with significant amounts of capital in the form of secured debt, provided by companies controlled by their shareholders or investors. When these companies fell into administration, the distressed debt investors, in their roles as both shareholders and secured creditors, positioned themselves to receive preferential treatment, effectively leapfrogging ahead of other creditors. When Monarch Airline was placed into insolvency, the shareholder/secured creditor claimed that he lost £250m.[759]However, calculations based on publicly available accounts suggest that the losses could be a fraction of that amount and he could even walk away with a modest profit.[760] The situation is not different in the cases of HMV,[761] Maplin Electronics Limited[762] and The Bernard Matthews.[763]

Nevertheless, neither the insolvency legislations nor the company law has a rule on the treatment of shareholder loans.[764] Department for transport in the case of Monarch airline called on the owners to make a financial contribution towards the cost of £40.5 million spent by the government to repatriate 110,000 customers stranded abroad when the airline

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[759] HC Deb 9 October 2017m vol 629, col 25;
[760] Ford Jonathan, 'Greybull eyes profit from Monarch collapse' (The Financial Times, London Oct 11, 2017
[761] Oliver Shah and Liam Kelly, 'Vulture fund charged ailing HMV £48m' The Times (London,30 Dec 2018) https://www.thetimes.co.uk/article/vulture-fund-charged-ailing-hmv-48m-88dnf37qsaccessed 22/12/2023; H RETAIL REALISATIONS LIMITED 'Statement of administrator's proposal' (Companies House,07 Mar 2019)https://find-and-update.company-information.service.gov.uk/company/08380689/filing-history
[762] Joel Hills, 'Was private equity to blame for Maplin's failure?' ITVX(London,28 February 2018) https://www.itv.com/news/2018-02-28/was-private-equity-to-blame-for-maplins-failure; Maplin Electronics, 'Statement of administrator's proposal' (Companies House,02 May 2018) https://find-and-update.company-information.service.gov.uk/company/01264385/filing-history accessed 20 June 2022
[763] Simon Goodley, 'Bernard Matthews seller 'lined own pockets' by rejecting pension offer' The Guardian(London, 14/April/2017https://www.theguardian.com/business/2017/apr/14/bernard-matthews-seller-lined-own-pockets-by-rejecting-pension-offer#:~:text=A%20briefing%20note%20prepared%20for,company%20and%20dump%20the%20pension; BML REALISATIONS 2016 LIMITED, 'Statement of administrator's proposal' (Companies House,11 Oct 2016) https://find-and-update.company information.service.gov.uk/company/00625299/filing-history
[764] Weijs (n744) 406

collapsed and insisted that there is 'no formal legal mechanism' that can force the shareholder/creditor to make such a contribution. The investor's response was that it would be a moral obligation (if they make a profit) at the end of the administration process to repay some of the costs incurred by the government in repatriating Monarch customers.[765] The Cork committee highlighted the problem and advocated that reform was necessary to bring a fairer system into play:

> ''The strength of the case of those who seek a change in the law and a radical at that can be seen if a simple and perhaps extreme example is taken. A wholly-owned subsidiary company is under-capitalised. It relies virtually wholly on moneys lent by the parent. Its affairs are conducted by and in the interest of the parent and they are mismanaged. There is a history of transactions between subsidiary and parent which, although not individually or collectively susceptible to attack at law, have, cumulatively, advantaged the parent and disadvantaged the subsidiary. All profits earned by the subsidiary have been paid up to the parent by way of dividend and the moneys needed by the subsidiary to conduct its business lent back by the parent. The subsidiary, at the instance of the parent, has obtained substantial credit by relying on its membership of the group of companies headed by the parent. The subsidiary indicates its membership on all documents and billings by showing a device or logo distinctive of the group. The subsidiary becomes insolvent and goes into liquidation. The parent company declines all liability for its subsidiary's debt to external creditors, and competes with them by submitting a proof in respect of its loan. The result is that, out of the total funds realised by the liquidator for distribution among the creditors, a substantial proportion goes to the parent company. We recognise that a law which permits such an outcome is undoubtedly a defective law''.[766]

[765] Department for Transport, 'Airline Insolvency Review Final Report'(March 2019) https://assets.publishing.service.gov.uk/media/5cd1a8c940f0b6332070f283/airline-insolvency-review-report.pdf accessed on 12/12/2022
[766] Cork Report (n267)

There has been a long campaign to regulate the practice of shareholder loans.[767] However, as of now, the necessary reforms have not been scheduled into the legislative agendas. A number of arguments are often put forward in support of maintaining the current *status quo*. The argument goes that as the company faces financial troubles and possibly the impending fate of insolvency. One potential avenue to raise further funds for the purpose of easing cash flow and working capital difficulties is through the extension of loans by the shareholder(s) (or their family members or friends) to the company. Especially in closely-held companies, the shareholders with access to all of the relevant information are first to perceive the signs of financial distress, and there may well be the need to act swiftly to prevent further deterioration in company's viability. Generally, the shareholder provides this loan during times of financial distress, anticipating a strong possibility of a successful rescue attempt. This would ideally reverse the company's fortunes, ultimately preserving the company's value and safeguarding the interests of the creditors. This is to imply that shareholder loans may prevent the liquidation of the company and their prohibition may thwart even realistic and promising attempts to turn a failing business around.[768]

Moreover, the company may have limited options when looking for new financing, outside lenders might be unwilling to extend credit or loan money to distressed companies. Even where they are willing, their interest rates are likely to be high. The distressed business might not possess any unencumbered assets that could be used as collateral for an outside lender. Sourcing credit from outside lenders is potentially time-consuming as lenders tend to be cautious in their assessment of the company's financial and operational status and investigation of the possibility of implementing a sound rescue plan. This can be

[767] See for example Left Foot Forward campaign led by Member of the House of Lords Prem Sikka, https://leftfootforward.org/2018/03/revealed-how-private-equity-contributed-to-maplins-demise/ accessed on 22/11/2022
[768] Weijs (n744) 430

particularly problematic because of the urgency of the situation. Shareholders may swiftly step in and provide the needed financing for the debtor in distress.

5.8. Concluding remarks

Distressed debt investors as secured creditors are in a controlling position and can exercise great influence over how the administration procedure is conducted. They may align their interests with those of incumbent managers and administrators to achieve an outcome detrimental to those who are weaker/more vulnerable (i.e. unsecured creditors and shareholders). Unsecured creditors lack the ability to mount a challenge to actions undertaken by administrators. This is due to the long-established deference to the administrator's professional and commercial judgment. Although the utilisation of Pre-pack to conduct debt for equity swap raises serious concerns, they face little scrutiny and inquiry. Moreover, due to the under-developed mechanisms of valuation in the English law, unsecured creditors are often deemed to be 'out of the money', accordingly, they are deprived of their right to participate in the process, voice their concerns, or receive recovery/dividend rights. The fundamental principles contained within the Code of Ethics, SIP16, and the provisions in sections 391B-C of the Insolvency Act 1986 tend to be vague, and operate on a voluntary basis and lack specificity. And this as a result hampers the effectiveness in mollifying disenfranchised stakeholders.

Chapter Six: Corporate Insolvency and Governance Act 2020

6.1. Distressed Debt Investors as Primary Beneficiaries of Corporate Insolvency and Governance Act 2020

Corporate insolvency reforms have been scheduled into the UK legislative agendas for some time. Following consultations in 2016[769] and Spring 2018,[770] reform initiatives were announced in August 2018. The reforms were implemented for several reasons. Firstly, they aimed to enhance the UK's position in the World Bank rankings. Secondly, they sought to reinforce the country's corporate insolvency regime to remain competitive with the recently introduced European insolvency frameworks.[771] Lastly, the reforms were intended to maintain the UK's appeal as an international center for debt restructuring.[772] The implementation of the reforms was postponed due to the limitations on parliamentary time and capacity. However, the need to deal with the economic impact of COVID-19 further propelled the reforms. Ultimately, the reform realized through enactment of The Corporate Insolvency and Governance Act 2020.[773]

Central to these reforms is the implementation of certain provisions from Chapter 11 of the US Bankruptcy Code, chief of which include the introduction of a standalone moratorium

[769] Consultation Paper, May 2016(n48)

[770] Insolvency Service, Insolvency and Corporate Governance (August 2018)

[771] Directive (EU) 2019/1023 of the European Parliament and of the Council on preventive restructuring frameworks, insolvency and discharge of debt which was published and subsequently implemented by the member states. For example, the implementation was by Act 16/2022 in Spain and by order No. 2021-1193 of 15 September 2021 and Decree No 2021-1218 of 23 September 2021 in France

[772] Companies from across Europe moved their "centres of main interest" after the financial crises to restructure their debt in the UK. See for example Wind Hellas, the Greek mobile phone operator which moved funding vehicles to London to restructure through a pre-pack administration, London becomes bankruptcy capital of Europe' This is money (London, 6 March 2010) https://www.thisismoney.co.uk/money/article-1255940/London-bankruptcy-capital-Europe.html; Ayesha Javed, 'Firms pick UK as restructuring capital' Financial news(London, 27 June 2011) https://www.fnlondon.com/articles/firms-pick-uk-restructuring-capital-20110627

[773] John M. Wood, 'Creative destruction and the post COVID-19 economy: a critique of the (un)creative rescue value contained within the permanent CIGA 2020 reforms' (2023) Journal of Business Law,197,200.

and[774] a cross-creditor cram-down mechanism.[775] Chapter 11 has been held out as a success and as a model for the reform of restructuring laws worldwide. However, it is significant to recognise that the UK has not instinctively imitated Chapter 11. Instead, what had occurred was part of a selective process whereby the UK endorsed the Chapter 11 measures that it perceived would offer businesses greater protection against adverse economic conditions beyond what the existing insolvency laws afford. However, the importation of a new mechanism may have unintended consequences for a wide range of stakeholders. In essence, this chapter discusses how the new reforms strengthen the distressed debt investors' bargaining power to capture value from other weak stakeholders.

6.2. Relevance of the Scheme of Arrangement

The scheme of arrangement has been on the company law statute books since 1860s.[776] Such a procedure has demonstrated a considerable degree of flexibility and efficiency since then. It has been utilised in a wide variety of ways, primarily because its contents are not subject to any specific set of legal requirements. Consequently, a scheme can be a compromise or arrangement between a company and its creditors or members concerning any matter they can properly agree upon amongst themselves. This flexibility allows it to be adapted for various purposes within the bounds of what the parties deem acceptable and lawful. It has been used to effect internal organisational restructure, manage institutional change or to facilitate non-debt and debt distress mergers, takeovers and acquisitions.[777]

In recent years, schemes of arrangement have emerged as the preferred structure for renegotiating, refinancing, and rescuing companies confronting insolvency or aiming to mitigate that risk. Schemes of arrangements are of practical significance in this regard for

[774] Insolvency Act 1986, Part A1, Ch.2, s.A3.
[775] Companies Act 2006 Part 26A
[776] The Companies Act 1862 section 136
[777] Patrick A Gaughan, '*Mergers, Acquisitions, and Corporate Restructuring*' (Wiley and Sons 2018) 183-184

many reasons. First, the insolvency of the company is not a pre-condition to initiate the procedure, therefore, even solvent companies might use it.[778] This in turn, enables distressed companies to tackle difficulties at an early stage. Indeed, early intervention can help prevent insolvency and make the rescue process swifter and potentially more successful.[779] Secondly, given the fundamentally contractual nature of the procedure, the company may target specific stakeholders or a class of them. [780] In this sense, the scheme of arrangement allows the company to negotiate and reach an agreement with creditors who must be compromised to avoid default, while aiming to leave as many other creditors as possible unaffected or minimally affected by the plan. This contrasts with the collective and inclusive nature of insolvency proceedings, where all creditors may participate. Thirdly, the procedure can facilitate a cramdown, meaning that when the majority of the company's creditors or members support the proposed scheme, and the courts approve it, the new arrangement becomes legally binding on the minority of creditors or members who did not consent. This in turn prevents minority creditors from impeding the implementation of the agreed-upon arrangement.[781] Finally, since the scheme of arrangement is not an insolvency mechanism—its provisions form part of company law rather than insolvency law—it offers broader value to companies compared to insolvency procedures such as liquidation and administration, which are limited to corporate insolvency matters. This distinction likely decreases the stigma and negative effects typically associated with insolvency procedures, making schemes a more flexible and less damaging option for corporate restructuring.[782] Indeed, the insolvency stigma, especially in the UK,[783]can actually have a negative effect,

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[778] Jennifer Payne, 'Cross-border schemes of arrangement and forum shopping' (2013) 4 E.B.O.R, 563,568
[779] Cork Report (n267)
[780] Kanaga Dharmananda and Anthony Papamatheos, '*Schemes of Arrangement'* (Federation Press, 2011) 22
[781] Xie (n487) 54.
[782] Kevin J. Delaney, 'Power, Intercorporate Networks, and Strategic Bankruptcy' (1989) 23 Law & Soc'y Rev,643,644
[783] Qi (n345) 138

it may hinder potential rescues as well as having the ability to inflate the causes of the insolvency, making them appear more significant than they truly are.[784]

More importantly, in recent years, schemes of arrangement have become a means by which distressed debt investors affect debt for equity swaps in their target companies.[785] In substance, a debt for equity scheme usually involves the senior creditors agreeing to the cancellation of their debt in return of shares in the company while the interests of junior debtor are wiped out. This opens up the possibility abuse of control, oppression, coercive behaviour, and illegitimate wealth transfer. Therefore, it is crucial to ensure that the interests of all stakeholders are afforded equal protection throughout the process, not simply those who stand to gain the most from the procedure. This protection is provided through the requirement for class meetings,[786] voting requirements[787] and by court oversight.[788]

The first opportunity for the court to protect the interests of creditors arises from the requirement for the court to order the meetings of creditors and members to consider the scheme. During this stage, the court is not focused on assessing the merits of the scheme.[789] The court's role is supervisory, ensuring regulatory compliance. It will, for example, ensure that creditors receive sufficient notice before meetings and are provided with all relevant information and the motivations behind the scheme. The court will also ensure that the creditors' classes are constructed in accordance with its orders. Recent cases have highlighted that the court is not obligated to accept mere assertions in the evidence

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[784] Efrat (n594) 369

[785] Prominent examples include Apollo which swapped its debt for equity in Stemcor and Oaktree Capital which swapped its debt for equity in Countrywide through scheme of arrangement. Anousha Sakoui, "Vulture fund takeover of Countrywide was more than picking at the bones" Financial Times (London, 19/Feb/ 2010) https://www.ft.com/content/d9963e4e-14a9-11df-9ea1-00144feab49a; Troubled British steel trader Stemcor to split in two(Reuters, 15/ September/ 2015)https://www.reuters.com/article/idUSKCN0RF1GZ/

[786] Companies Act 2006 s 896(2)

[787] Companies Act 2006, s 899(1)

[788] Companies Act 2006, s 896.

[789] *Re Telewest Communications plc* (No.1) [2004] EWHC 924 (Ch),[2005] 1 BCLC 752

regarding class composition or any other matter. In *F Testament & Sons Pty Ltd*[790] Justice Lindgren emphasised the importance of procedural compliance in obtaining approval. In this context, ensuring complete and accurate disclosure to creditors is vital, as it enables them to make informed decisions regarding their participation in the scheme meetings and how to cast their votes effectively. Correctly classifying creditors at the earliest stage is fundamental to ensuring efficiency throughout the scheme of arrangement process. Correctly constituting classes at an early stage helps to prevent any unnecessary time and expenses incurred in a process that might later be deemed non-compliant with statutory provisions.

The requirement for creditors and members to convene in separate classes serves as one of the mechanisms aimed at protecting minority interests in a scheme. It allows like-minded creditors to examine and discuss the implications of the proposed scheme for their joint interests and voice any wealth transfer concerns and determine whether to oppose the scheme. Notably, the Companies Act 2006 does not mention how classes are to be divided, the matter has been left to be determined and developed by the courts. Under the case law as developed in the English courts, creditors are divided into classes according to the degree of similarity of their rights.[791] Where the company enters an insolvent state, for instance, classes will be determined according the creditors' rights on a winding up. The Court of Appeal In *Re Hawk Insurance Co Ltd* held that all of the unsecured creditors had the same rights in a winding up and it would be time-consuming and unnecessary to differentiate between them in the proposed scheme.[792]

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790 *F Testament & Sons Pty Ltd v Metal Roof Decking Supplies Pty Ltd* (1977) 3 ACLR 69, 72
791 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573, 583
792 *Hawk Insurance Co Ltd* [2001] EWCA Civ 241

At the sanctioning hearing, the court will ensure that all procedural requirements have been properly complied with, including confirming that the company's creditors have been accurately classified and that each class has approved the scheme by the requisite statutory majority. Additionally, the court will impartially consider the views of any dissenting creditors to ensure their concerns are appropriately addressed. It can be assumed that the strict wording of the provisions gives the court little choice but to respect the outcome of the majority. However, it should be emphasised that the sanctioning of a scheme is a not simply a "rubber-stamping" exercise by the court. Therefore, the procedural compliance and attainment of the relevant voting majorities does not guarantee the automatic approval of a particular plan.[793] In some cases, even where the majority approves the scheme, courts may refuse to sanction a scheme to uphold fairness and minimise prejudice, particularly to minority parties involved. The case of *Re Dee Valley* demonstrates how a court can refuse to lend its authority to manipulative practices by a shareholder in a majority-approved scheme, to ensure that the integrity of the court hearings and the interests of all stakeholders are protected.[794]

It can be assumed that the organisation of creditors with similar rights into classes, the requirement of approval of the scheme by the requisite statutory majority in each class, and the court oversight eliminate the possibility of tyranny of the majority during the process and in particular the potential wealth transfers from dissenters to consenters. However, it is noted the scheme of arrangement is defined as a court supervised and regulated new contractual arrangement between the company and its members/creditors or any class of them. Being contractual in nature, the company is free to choose which creditors to include in the scheme and which to exclude, and it is binding only on the included parties. Thus,

793 David Milman, 'Schemes of Arrangement: Their continuing Role' [2001] 4 Insolvency Law, 145,152.
794 *Dee Valley Group Plc* [2017] EWHC 184 (Ch)

only creditors within the scheme are empowered to argue against prejudice, unfairness or any significant irregularity in the process. In case of *Sea Assets v Perushaan Perseroan (Persoe) PT Perusahaan Penerhanagen Garuda Ltd*,[795] the interests of the procurement contract creditors and trade creditors were treated as unaltered and, therefore, were not brought into the scheme. Notwithstanding that, Gibson LJ ruled in a dicta that: ''If the creditors within the scheme think the proposal unfair to them and unduly favourable to those left outside the scheme, they can vote against the Scheme. If the majority vote in favour of the scheme, then a minority creditor has the opportunity to seek to persuade the court that the Scheme is unfair and should not be sanctioned''.

It also implies that once it becomes possible for a scheme to be implemented despite its rejection by one or more classes of dissenting creditors, the possibility of intra-creditor wealth transfers becomes a reality. In fact, this situation may occur where a scheme is twinned with a pre-packaged administration sale whereby the company's assets are sold to a newly incorporated company owned by the assenting creditors, leaving dissenting creditors stranded in the old empty shell company with their claims unaltered, but in reality, worthless.[796]

Distressed debt investors have utilised the strategy of twinning schemes with a pre-pack administration to effect debt for equity swaps in the face of whole classes of dissenting junior creditors. Recent examples include *WIND Hellas Telecommunications SA*,[797] *La*

[795] *Sea Assets* [2001] EWCA Civ 1696.
[796] *Re MyTravel Group* [2004] EWHC 2741 (Ch)
[797] Wind Hellas was taken by six specialist distressed debt investors -- Mount Kellett Capital Partners, Taconic Capital Advisers, Providence Equity Capital Markets, Anchorage Capital Group, Angelo Gordon and Eton Park International, See Sarah White, Sawiris loses Wind Hellas as bondholders take over, Reuters, (London 18, October 2010)

Seda de Barcelona SA,[798] and *Stemcor*.[799] Notably, in each of these cases, the proposed scheme was sanctioned without the consent of classes of junior creditors. In fact, the dissenters neither consulted nor offered to take part in the process. This is a departure from the stated goals of the company rescue,[800] amid at improving returns to unsecured and preferential creditors, collectivity, inclusion,[801] transparency and accountability[802] all of which underpin the EA 2002.

It has been argued that putting the fate of the rescue attempt into the hand of those who have little or no remaining economic interest in the company increases the risk of opportunistic hold-up behaviour and inhibits rescue attempts.[803] However, the amount of work of twinning schemes with administration to affect a scheme of arrangement without the consent of classes of creditors involves time and expense. In recent years, the government has been actively engaging in consultations,[804] emanating from Insolvency Service, meant, among other things, to enable the imposition a scheme of arrangement on unwilling creditors. The consultations were followed by proposals and ultimately, the mechanism introduced by the Corporate Insolvency and Governance Act 2020.

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[798] Alarna Carlsson-Sweeny, English scheme of arrangement: useful for a Spanish restructuring, Practical Law, 30-Jun-2010

[799] Stemcor was taken by distressed investment fund Apollo APO.N, See Maytaal Angel, Britain's Stemcor agrees deal with buyout firm Apollo, other creditors, Reuters, (London, 6 July 2015) https://www.reuters.com/article/idUSKCN0RF1GZ

[800] The 2002 reforms were clearly aimed at company rescue not just businesses, Mokal (n680) 1

[801] IA 1986, Sch B1, Para 3(2) as amended by the Enterprise Act 2002 requires the administrator to consider the interests of the creditors as a whole.

[802] For example, Insolvency Act 1986, s 176A requires require a meeting to be held by the administrators.

[803] Schillig(n153)

[804] Insolvency Service, Encouraging Company Rescue- A consultation, June 2009. and see Insolvency Service, Proposals for a Restructuring Moratorium-A Consultation, July 2010. Insolvency Service, Proposals for a Restructuring Moratorium- Summary of Responses, May 2011; Consultation Paper, May 2016(n34) and see Insolvency Service, Summary of Responses – A Review of the Corporate Insolvency framework, September 2016 ('Insolvency Service Summary of Responses, September 2016')

6.3. The Restructuring Plan Procedure

The new restructuring plan procedure, introduced under part 26A of the Companies Act 2006,[805] bears a close resemblance to the scheme of arrangement in terms of its overall structure and implementation. However, there are several distinctions, most notably is the introduction of the cross-class cram-down feature which enables restructuring proposals to be imposed on entire class(es) of dissenting creditors if it is shown, *inter alia*, that none of the dissenting class(es) of creditors would be worse off under the plan than they would have been upon the court deciding the most likely alternative for the company should the proposed plan were not sanctioned.[806]

6.4. The Introduction of the Powerful Cross-class Cramdown Feature

The introduction of this powerful feature raises concerns that companies might be inclined to utilise it as a means to write off liabilities, thereby benefiting the remaining creditors and equity holders to the detriment of other weak and vulnerable stakeholders. The approval of a majority of creditors of each class safeguard no longer exists. The restructuring plan also leaves the debtor in control of the distressed company; therefore, management is more likely to initiate the process, classify creditors into classes, and monitor the recovery plan. However, Restructuring plans are more likely to be driven by secured creditors, as they control all the cash flowing through the business via protective covenants in the loan agreement, possess extensive information about the debtor, and have the power to make an application to the court to initiate the procedure.[807] Where the interests of a debtor's secured creditors and its incumbent management align, the debtor may begin to act in ways that improve the positions of those parties at the expense of the debtor's other stakeholders. This

[805] Companies Act 2006, Part 26, ss 895-899
[806] Companies Act 2006, Part 26A, s 901G(4)
[807] Companies Act 2006 s.901A(3)

in turn, raises concerns of selective and differential treatment of creditors of the same rank in corporate insolvency law's distributional order of priority.

More importantly, the introduction of new feature may enable distressed debt investors to obtain excessive control at the expense of other stakeholders. It is well-known that distressed debt investors are sophisticated, aggressive and tend to exploit interstices in the insolvency procedures.[808] However, there is an expectation of additional scrutiny from the courts in the implementation of introduced restructuring plan under part 26A. Careful examination of the interests of excluded, impaired, and unimpaired creditors and increasing focus on questions of transparency and disclosure is emerging in restructuring plans under Pt 26A of the Companies Act 2006. In the first case of restructuring under the new procedure Trower J 'stated that: [809]

> ''A class right of veto is removed by cross-class cram down, justice may require the court to look at questions of horizontal comparability in the context of a cross-class cram down to see whether a restructuring plan provides for differences in treatment of creditors inter se, and if so whether those differences are justified''

The threat of serious inquiry and court review of the debtor's decision-making process can act as a deterrent to unfair prejudice or material irregularity in the process. The court will seek to ensure that the restructuring plan is just and equitable as the explanatory notes to the legislation indicate that 'an applicant company will have a fair wind behind it if it seeks an order sanctioning a restructuring plan notwithstanding a dissenting class'.[810] If a debtor chooses to create an impaired class comprising specific unsecured creditors while compromising others in the plan, and the plan fails to obtain the statutory majority of votes

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[808] Lipson (n111)1614.
[809] *Re DeepOcean 1 UK Ltd* [2020] EWHC 3549 (Ch); [2021] Bus LR 632
[810] Explanatory Notes to the Corporate Insolvency and Governance Bill 2019-21

in each voting class, the debtor will be obligated to provide justification for the selective and differential treatment. This requirement demonstrates that the treatment is not unfairly discriminatory and adheres to the principles of fair and equitable treatment can be a costly and unappealing undertaking for the debtor. The complexity and potential challenges associated with justifying such treatment may deter companies from pursuing this approach in their restructuring efforts.[811]

However, in practice, whether differential treatment of equal rank creditors constitute unfair prejudice has been primarily tested in CVAs[812] and the existing body of (CVA) case law suggests that a CVA which selects some voting creditors to bear the brunt of the losses and provides for differences in treatment of equal rank creditors of is not automatically unfairly prejudicial.[813] The courts adopt almost a similar approach when reviewing selective and differential treatment for unfair prejudice in Company Voluntary Arrangements (CVAs), Part 26 schemes of arrangement, and Part 26A restructuring plans. Therefore, there will only be court review of unfair prejudice if a challenge is mounted.

It is quite difficult for creditors to mount a challenge to differential treatment of the proposed scheme. The proposed scheme is likely to make the unsecured creditor-base more heterogeneous. For instance, one class of unsecured creditors may recover very little or nothing while other class may be paid in full. *The Virgin Active* case provides a good illustration. In that case, creditors were divided into seven classes; a class of secured creditors and unsecured landlords were divided into five classes based largely on the profitability of the relevant lease. However, each class was offered a different package of

[811] Sarah Paterson and Adrian Walters, 'Selective corporate restructuring strategy'(2023)86 Modern law review,436,445.
[812] Insolvency Act 1986, Part I
[813] See for example, *Discovery (Northampton) Ltd v Debenhams Retail Ltd* [2019] EWHC 2441 (Ch); *Re Debenhams Retail Limited* [2020] EWHC 921 (Ch); *Lazari Properties 2 Ltd et al v New Look Retailers Ltd et al* [2021] EWHC 1209

rights in the restructuring plan, ranging from full payment of contractual arrears, and amended payment terms, to compromised and deferred rent, or no rent at all and a small, one-off payment. The secured lenders class and only class A landlords voted overwhelmingly in favour. The majority in other classes voted against the proposed scheme. The court exercised its discretion to sanction the scheme, using the cross-class cram down mechanism. The commercial judgment which underpinned decision of differential treatment was not challenged by the dissenting class(s).[814]

Similarly, the restructuring plans of *DeepOcean Group Holding* provided for different treatment for the different classes of creditors and excluded 158 trade creditors owed about £2.2 million who were considered commercially necessary for the continuation of the Group's business from the scheme in order to be paid before the date on which the restructuring plans are implemented. However, no one had argued the absence of 'good commercial reasons' for excluding them.[815]

The costs of raising a challenge to the debtor behaviour in selecting and differentiating between creditors may be prohibitive. Walton and Jacobs observe, in a survey of the operation CIGA after three years of its commencement that a majority of respondents (76%) believe costs involved in challenging the approval of an RP which accumulate even before a creditor gets to court (i.e. accounting and valuation services) is excessive and a deterrent to dissenting creditors in their challenge of a restructuring plan.[816] The *House of Fraser* case, although it was under the CVA, is instructive as a recent example where the company initiated the closure of several stores in the UK and Ireland. While the Company Voluntary

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[814] *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2376 (Ch); [2020] BCC 997
[815] *Re DeepOcean 1 UK Ltd* [2020] EWHC 3549 (Ch); [2021] Bus LR 632
[816] Peter Walton and Dr Lézelle Jacobs "Corporate Insolvency and Governance Act 2020 - Final Evaluation Report" (University of Wolverhampton)https://www.gov.uk/government/publications/corporate-insolvency-and-governance-act-2020-evaluation-reports/corporate-insolvency-and-governance-act-2020-final-evaluation-report-november-2022

Arrangement (CVA) received approval from over 75% of the creditors, some landlords raised concerns about irregularities, and that as a result their interests were unfairly prejudiced. Despite challenging the CVA initially, the landlords later decided to withdraw their challenge and reached an agreement to settle the matter.[817]

In determining whether to 'cram down' a dissenting class(s), the court must ensure that at least one class who would receive a payment or have a genuine economic interest in the company in the event of the 'relevant alternative' votes to accept the plan. The purpose of the impaired class acceptance requirement is to show that there is adequate impaired claimant support for the plan. As UK courts have recognised at least since Lindley LJ 's judgment in *Re English, Scottish, and Australian Chartered Bank*,[818] The claimants, overall, possess superior judgment regarding their commercial advantage compared to any other entity, including courts. Consequently, the level of support the claimants show for a plan can be considered one of the most reliable indicators of the debtor's distress, viability, potential surplus creation, and the plan's credibility in preserving and distributing such surplus.[819]

The issue, however, lies in the fact that the support of a claimant class for a plan does not always accurately represent the support of the individual claimants themselves. The process of forming a class can be flexible and susceptible to significant manipulation, especially by the debtor who holds the power to propose classes. To trigger the cram down power in US courts, debtors attempt to create artificially impaired classes by strategically grouping claimants or proposing minor changes to the rights of friendly claimants. Relying on class

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[817] Caitlin Morrison, "House of Fraser to close 31 stores nationwide after reaching legal settlement with landlords" Independent (London 06 August 2018) https://www.independent.co.uk/news/business/news/house-of-fraser-store-closures-full-list-sales-cva-landlords-rent-agreement-a8479111.html

[818] *In re English, Scottish, and Australian Chartered Bank* [1893] 3 (Ch) .385

[819] Paterson and Walters (n817) 351

support as a proxy for claimant support is also vulnerable to abuse from creditors. For instance, a single creditor may purchase enough claims in all impaired classes to vote against the plan, deactivating the cram down power, even if the plan has broad support from other affected claimants.[820]

After a meticulous examination of these issues and a comprehensive review of evidence from diverse stakeholders and experts, the ABI Commission, comprised of distinguished judges, practitioners, and scholars, determined that the costs associated with detecting and preventing manipulation of the impaired class acceptance requirement outweighed its benefits. Consequently, they recommended its abolition. There are compelling reasons to anticipate that manipulation of the impaired class acceptance requirement in the UK may have analogous counterparts concerning condition B. Moreover, if UK courts interpret Condition B literally, as it does not necessitate anything akin to impairment in the assenting class, the likelihood and costs of such manipulation are likely to be higher.

The problem is not merely theoretical, as demonstrated in the case of *Re Virgin Atlantic Airways Limited*,[821] the first Pt 26A scheme, where Snowden J observed that three fully consenting classes of plan creditors might have been included in the restructuring plan to argue for the availability of the cram down power if the class of trade plan creditors had not voted in favor of the plan. However, a cram down was not required in that case. Snowden J emphasised that including fully consenting classes in a Part 26 scheme, where all relevant creditors are known to be willing to consent, is not typical practice. He clarified that his decision should not be regarded as establishing whether the inclusion of such classes would activate the cram down power as a jurisdictional matter or how it would impact the court's exercise of its discretion.

[820] Ibid 355
[821] *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2376 (Ch)

The concept of the 'relevant alternative' is also a key safeguard against abuse of the 'cram down' mechanism. The court must be satisfied that no claimants affected by the plan would be worse off under the plan than they would be in the event of the 'relevant alternative', which is whatever the court considers most likely to occur in relation to the company if the plan were no sanctioned.[822]Part 26A does not prescribe how relevant alternative be addressed by the courts. However, the idea has a long-standing history, dating back to the Court of Appeal's ruling in *Re English, Scottish, and Australian Chartered Bank*.[823] It has been endorsed in various similar forms and for related purposes, including in the Cork Report and concerning class formation by Lewison J in *Re British Aviation Insurance Co Ltd*.[824] It has also been applied to the 'vertical comparator' for an unfair prejudice challenge to a Company Voluntary Arrangement (CVA) by Norris J in *Discovery Ltd v Debenhams Ltd*.[825] All of this legal precedent provides an interpretive resource when considering Condition A.

The existing body case law indicates that the 'relevant alternative scenario' is expected to be relatively straightforward. If the restructuring plan fails to materialise and is not approved, the debtor is likely to face liquidation or administration. This would involve conducting a valuation of the debtor's assets, which could either be based on a piecemeal sale or, in specific situations, a sale of the debtor's assets as a going concern. The courts in general rely on market testing usually by public auction to determine the value of the debtor's assets and business. This usually result in undervaluing the debtor's assets and business for the reason discussed the previous chapter. The value would usually 'break' in

[822] Companies Act 2006, section 901A
[823] *Re English, Scottish, and Australian Chartered Bank* [1893] 3 (Ch) .385
[824] *Re British Aviation Insurance Co Ltd* [2006] 1 BCLC 665
[825] *Discovery (Northampton) Ltd v Debenhams Retail Ltd* [2019] EWHC 2441 (Ch); [2020] BCC 9

the secured debt and as such junior creditors will often no remaining economic interest in the company.

However, in certain scenarios, there may be a set of cases where liquidation is not a viable alternative to executing the proposed plan. The debtor could, for example, find itself in a financially robust state where the inability to engage in a restructuring plan does not necessarily pose a fatal threat to its prospects of rehabilitation or its ability to operate as a going concern in the short to medium term.

The procedure is not one triggered by the insolvency of the company.[826] A debtor which wishes to propose a restructuring plan must only prove that it 'has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern' and that the purpose of the proposed restructuring plan is to address these financial difficulties.[827] In conjunction with this very low threshold, the possibility of manipulation of the assenting class, heterogeneous objectives of the dissenting class(s). The fear that the new procedure will open the door to plans under which some of the value that should be flowing to members of the dissenting class would be expropriated for others is not overstated.

6.5. The Introduction of Moratorium

As the company slides into distress, each creditor has a strong incentive to recover his debt in full before any other creditor does so. If this individualistic race left unchecked, the company's assets will be unnecessarily depleted and high administrative costs will be incurred.[828] A well-designed insolvency law, therefore, should resolve these common-pool problems. To achieve this end, individualistic enforcement actions taken by self-interested

[826] Companies Act 2006, sections 901A-901L
[827] Companies Act 2006 s 901A(1), (2), (3)
[828] Jackson (n147)

creditors against the company should be stayed by the initiation of the insolvent procedure.[829] A stay of this kind can offer a distressed company a period of relief or a breathing space, allowing time to assess the situation and present a rescue plan to creditors.

A statutory moratorium to support rescue for companies through a CVA existed since 2000.[830] However, the moratorium triggered by a CVA is only available to the very small size of companies. A company is defined as small when its turnover less than £6.5 million per annum and its employees are fewer than 50, or when its balance sheet total is less than £3.26 million.[831]

A broader moratorium is attached to the administration procedure.[832] Initiation of the procedure triggers a moratorium that prevents the appointment of an administrative receiver,[833] enforcement of security interests over the company's property, the repossession of goods in the company's possession under retention of title or similar contractual clauses, peaceable re-entry into the company's premises by a landlord,[834] and the winding up of the company.[835] However, the effect of the moratorium is not absolute because parties with actions against the company are able to overcome the moratorium's restrictions by obtaining a leave of the court or the administrator's consent. Administrators will have strong incentives to grant the consent for the same reasons they would be strongly inclined to conform to the secured creditor's preferences (i.e., engendering future appointments).[836] Suppliers, subject to a few exceptions, are able to terminate 'essential goods or services' contracts on the

[829] INSOL, A statement of principles for a Global Approach to Multi-Creditor Workouts, available on the INSOL website <http://www.insol.org/page/57/statementof-principles
[830] Insolvency Act 1986, Sch A1
[831] Companies Act 2006, s 382(3)
[832] Insolvency Act 1986, Sch B1 paras 42-43
[833] Insolvency Act 1986, Sch B1 para 43(6A).
[834] Insolvency Act 1986, Sch B1 para 42(1)-(4).
[835] Insolvency Act 1986, Sch B1 para 42(1) and (2)
[836] Mokal (n459) 388

company's entry into insolvency proceedings.[837] landlord may also exercise re-entry right.[838] This in turn makes the protection of the administration's moratorium narrower than that available in US Chapter 11.

The strong automatic stay is a central feature of Chapter 11. In addition to its vital role of keeping the business and assets together while the rescue is negotiated and implemented. The tool of the automatic stay freezes the remedial rights of pre-petition creditors, particularly secured ones, to enforce their claims. The automatic stay prevents a secured creditor from exiting with its collateral or foreclosing on it. The claimant can lift the stay only if it can meet a high evidentiary burden of proofing that the property is not necessary to an effective reorganisation.[839] The stay prevents creditors from invoking *ipso facto* clauses.[840] As a result, an insolvent debtor that has entered insolvency may 'assume' an ongoing contract and thereby require the solvent firm to perform it.

The global financial crisis in 2007-08 made the consideration of insolvency reforms imperative and the government announced its intention to introduce a wider standalone moratorium (i.e., not attached or triggered by the commencement of insolvency proceedings). However, respondents to the consultation paper did not support the need for a moratorium and the Insolvency Service decided to shelve the reform plans.[841] The Service in 2016 again actively involved in reform initiatives. One of the central themes of these initiatives was the introduction of a wider freestanding moratorium. The advocation of enacting a court-ordered moratorium (initially for three months) was clear during the consultation process.[842] The question of how to strike a balance between the company's need

[837] Insolvency Act 1986 para 233A
[838] *Razzaq v. Pala* [1998] BCC 66
[839] 11 USC, section 362(d)(2)
[840] 11 USC, s 541(c)(1); s365(e)
[841] Insolvency Service(n619)
[842] Consultation Paper, May 2016(n48)

for a ‘breathing space' to negotiate a restructuring with its creditors and the protection of the interests of creditors was of significant importance. Directors who have little to lose may use the moratorium as a tactic to prolong the life of an inefficient company that exhausted all lines of potential recovery and economically failed.[843] Postponing the inevitable liquidation of an economically distressed company generates deadweight losses. It is an understanding that the longer economically distressed companies continue to trade, the more value that will be lost, and the more creditors’ recoveries will be impaired.[844]

There were eligibility requirements for companies seeking to make use of the proposed moratorium in the 2016 proposal.[845] The company would have to demonstrate that it is or is likely to become insolvent. The company must have sufficient funds to meet ‘current obligations as and when they fall due as well as any new obligations that are incurred’, whether to trade or financial creditors. The moratorium can be initiated not by an application for an order but by the filing of a notice of intention with the court (filing documents with the court). The proposal mandated that the notice must be accompanied by a statement from a monitor affirming that, in their opinion, there is a ‘reasonable prospect’ for the company to reach a compromise or arrangement with creditors, allowing it to continue operating as a going concern. Preserving the business as a going concern can be accomplished through a sale, either via standard administration or its expedited version, the pre-pack.

During the moratorium, the monitor will also ensure the qualifying conditions continue to be complied with, failing that, he is under a mandatory duty to bring the moratorium to an end. Finally, credit or finance provided to the company during the moratorium is afforded “priority repayment” in any subsequent administration or liquidation proceedings.[846]

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843 Payne (n386)288
844 Crystal and Mokal (n681) 128
845 Consultation Paper, May 2016(n48)
846 Ibid para 7.16

The Corporate Insolvency and Governance Act 2020 departed from the carefully considered proposal for a moratorium. In the proposal, as mentioned above, proving insolvency, risk of insolvency or any financial conditions was envisaged to be unnecessary, thus, both solvent and insolvent companies can access the proposed moratorium.[847] However, the Act made insolvency a pre-condition for access to the mechanism.[848] The test of a 'reasonable prospect' of achieving a compromise to save business as a going concern was tightened to require a company rescue to be 'more likely than not to succeed'.[849] Therefore, the moratorium cannot be used to stabilise a company's position in preparation for business rescue (i.e., selling the business as a going concern). The initial length of the moratorium was reduced from three months to 20 business days.[850]

Despite the Act does not require the company to have sufficient funds to carry on business, it requires the monitor to terminate the moratorium if they believe that the company is unable to pay either 'moratorium debts' (incurred during the moratorium) or 'pre-moratorium debts' (falling due during the moratorium but incurred before the moratorium) and for which the company does not have a payment holiday during the moratorium'.

Payments for new supplies under a post-commencement agreement would be a 'moratorium debt'. Rent for a post-commencement period under a pre-commencement lease would be a 'pre-moratorium debt' for which the company does not have a payment holiday'. More importantly, debts under financial contracts, including lending contracts are also a pre-moratorium debt for which the company does not have a payment holiday.[851] The end result is that if those debts are not paid, the moratorium will end. This means that the debtor enjoys no 'breathing space' from pre-commencement arrears owed to a lender or owed to a lender

[847] Ibid para 7.18
[848] Insolvency Act 1986 s A1, A2
[849] Insolvency Act 1986 A6
[850] Insolvency Act 1986 A9
[851] Insolvency Act 1986 A18

but transferred to a distressed debt investor. Moratorium introduced by the Corporate Insolvency and Governance Act 2020 seems to be at odds with the basic idea of a moratorium.

Insolvency bills usually suffer from interference during their legislative process. The Insolvency Act 1986 and the EA 2002 departed from the recommendations of the review committees. Sir Kenneth in his autobiography said about the implementation of his Committee Report that ‘‘they ended up by doing the very thing we asked them not to. They picked bits and pieces out of report so that they finished with a mish-mash of old and new’’.[852] Tribe argues that most interference occurs during the bills’ passage through the House of Lords and attributes it to the vested power interests:[853]

> Lobby groups also become more proactive as their interests are affected, all of which affects the carefully thought through policy intentions of the original policy framers.
>
> The banking lobby is an example of an interest group keen to raise the interests of banks, as compared with other stakeholders, and comment on substantial changes to legislation which obviously in turn affects the underlying policy intentions of the original framers.

In the same fashion, amendments to the Corporate Insolvency and Governance Act 2020 were made during its passage through the House of Lords. The House invoked the same argument that deference to the rights of financial creditors is necessary for ensuring the stability of the financial system and the availability of credit for companies at a lower cost.[854]

[852] Government white paper, ‘A Revised Framework for Insolvency Law (Cmnd 9175, 1984)
[853] John Tribe. ‘Policy Subversion” in Corporate Insolvency: Political science, marxism and the role of power interests during the passage of insolvency legislation’ (2019) 32 Insolvency Intelligence 59
[854] Kristin van Zwieten, ‘Mid-Crisis Restructuring Law Reform in the United Kingdom, (2023)24 European Business Organization Law Review, 287,293.

6.6. Concluding remarks

On the theoretical explanations as to why insolvency law exists, Warren argues that insolvency law should protect vulnerable groups in general.[855] The court involvement, the classification of creditors into classes on the basis of similarity of commonality of interests and rights are very important safeguards against the risk of a 'tyranny of the majority' and unfair and abusive practices. Distressed debt investors in particular often circumvent these procedural requirements by twinning a scheme of arrangement with a pre-pack sale of the business of to a newly incorporated NewCo. Dissentient class of claimants to the proposed plan are left in an empty/worthless shell company as it had been stripped bare. Unsecured creditors may apply to court to challenge this kind of reorganisation. However, a successful challenge hinges on an effective mechanism of valuation. Developing an effective mechanism was left to the courts. However, the courts are still at an early stage in tackling these questions. Distressed debt investors no longer need to twin a scheme with administration to enable a *de facto* cram-down of dissenting creditors. A plan can be imposed on dissenting class(s) pursuant to the new Part 26A. The Corporate Insolvency and Governance Act 2020 improved the positions of already powerful creditors at the expense of the debtor's other vulnerable stakeholders. Aside from the problems of lacking of uniformity, interest, sufficient information and legal knowledge to protect themselves. The under-developed valuation methods adopted by courts conform to the distressed debt investors' preferences for lower valuations. A lower valuation increases the proportion of equity that they are expected to receive and makes the junior creditors 'out of money' and therefore, unable scrutinise or challenge the terms of the proposed plan.

[855] Warren (n408) 356.

The ability of the moratorium which designed to provide debtor some breathing space from any action by creditors is debatable. The initial length of the moratorium is 20 business days. Loans owed to secured creditors are defined as a pre-moratorium debt and as a result the debtor company enjoys no ‘breathing space’. Loan arrears transferred to a distressed debt investors could be enforced and the debtor cannot prevent or stay such enforcement actions.

Chapter Seven: The Reliance on Market-led Contractual Solutions to Assimilate the New Challenges

Regulating the transfer of debt inside and outside insolvency decreases the liquidity in secondary loan markets.[856] However, debtor may contract to limit a lender's ability to transfer the loan to a third party, preventing the loan from ending up in the hands of investors with aggressive activism agendas. In short, assuming freedom of contract, the issue of predatory investor behaviour would be self-correcting. In the same fashion, market conventions may also shape distressed debt investors' incentives in ways that are similar to the formation of London Approach conventions which have shaped the banks' incentives.

7.1 Contractual Defensive Methods

A secondary market for loan assets exists as long as banks have originated loans. However, there has been profound shift in logic and practice in the market. Initially, the secondary market was largely interbank-oriented and was largely dominated by a few major banks, especially US-based ones.[857] This paradigm shifted during the early to mid-1990s, as institutional investors and non-bank financial institutions were progressively drawn to the senior secured, floating-rate, term loans that originated in the primary market. Currently, the spectrum of loans traded within the secondary market has expanded significantly, encompassing an even wider variety of loans, with leveraged finance loans taking a prominent role. These loans are now predominantly present and transacted by an array of entities, such as banks, hedge funds, pension funds, structured special purpose vehicles (including collateralised loan obligations or CLOs), and insurance companies.[858] The more

[856] Jennifer Albrecht, 'New Bankruptcy Rule 2019: Boon or Bane for Distressed debt investors' (2011) 2011 Colum Bus L Rev, 717,818.
[857] João A. C. Santos and Pei Shao, 'Investor Diversity and Liquidity in The Secondary Loan Market' (2022) 63 Journal of Financial Services Research,249,250.
[858] João A.C. Santos and Peter NigroIs, 'The secondary loan market valuable to borrowers?' (2009) 49 The Quarterly Review of Economics and Finance,1410,1412.

diverse group of investors has propelled a substantial surge in the trading volume of both par and distressed loans within the secondary market, a trend that has persisted up to the present day.[859]

The London-based Loan Market Association (LMA) was created by banks operating in the European loan market in December 1996. The primary objective of the LMA is to enhance liquidity in both the primary and secondary loan markets. To fulfil this objective, the association releases model form documents and corresponding guidance notes that have become extensively adopted in the origination and trading of loans. While parties have the freedom to craft customised contractual documents for their transactions, the overwhelming majority of loan trades are generally formalised using the secondary trading documentation established and upheld by the Loan Market Association (LMA).[860]

Within the LMA's standard facility documentation for leveraged and investment-grade deals, a lender is authorised (conditional upon any consent or consultation requirement) to assign or transfer its rights and obligations, either in full or part, to another bank or financial institution or to a trust, fund, or other entity that is consistently involved in or established for the objective of creating, procuring, or investing in loans, securities, or other financial assets.[861] This inclusive phrasing accommodates a comprehensive array of potential transferees, and should generally be expansive enough to facilitate transfers to most potential purchasers.

There is also a possibility that the facility agreement imposes restrictions on transfers to individuals not included on a pre-approved list of endorsed transferees, known as a 'white

[859] Loan Market Association, Guide to Secondary Loan Market Transactions (2018) https://www.lma.eu.com/news-publications/lma-guides
[860] Hannah Vanstone, 'Loan Market Association in Thomas Mellor (ed)Lending & Secured Finance Laws and Regulations 2023-2024(Legal Guides, Business Reports and Events,2023)
[861] Loan Market Association, Guide to Secondary Loan Market Transactions (2018) https://www.lma.eu.com/news-publications/lma-guides

list'. This white list provision enables a lender to transfer its stake in a loan to any entity listed on the pre-established, mutually agreed 'white list' without necessitating the borrower's consent. Borrowers frequently have the option to modify a white list by removing or potentially adding a specified number of names (typically up to five on an annual basis).[862] Similarly, borrows may also negotiate to restrict transfers to entities named on a black list. Therefore, a lender will be unable to transfer its loan participation to those entities during the life of the loan.[863]

Moreover, the facility agreement could incorporate extra transfer restrictions that are constructed based on the business undertakings of the potential transferee, which are perceived as conflicting with the interests of the borrowers. Among these restrictions, the most prevalent ones are restrictions that prohibit transfers to any entity considered a competitor to the borrower, a private equity sponsor; a supplier or sub-contractor of the borrower group; and a distressed debt investor. Finally, the credit agreement may include additional restrictions that prevent transfers if the seller's holdings in the underlying loan would drop below a specified threshold due to the transfer.[864]

7.1.1. Limitations of Loan Market Association Documents and Associated Guidance Notes

Concerns have been raised that the International Swaps and Derivatives Association, or ISDA[865] develops standardised documentation and approaches that benefit ISDA members at the expense of others, either because they redistribute resources among parties, create or take advantage of informational asymmetries, or create negative externalities, and at the

[862] Loan Market Association, Inhibitors to Liquidity in the Loan Market (July 2021) https://www.lma.eu.com/news-publications/lma-guides accessed12/01/2024
[863] Alan J. Davies and Michelle Lascelles Gilmore, 'Right or Wrong' (2018) 37 International Financial Law Review,51,53.
[864] Diane Roberts, 'Breaking Loose' (2017) 36 Int'l Fin L Rev, 67.
[865] The professional organization was established in 1985 and it provides to its members templates for swaps and derivatives contracts such as The ISDA Master Agreement, Credit Support Annex (CSA), Master Swap Agreement, and Liability Swap Agreement For more see https://www.isda.org/ accessed on 18/01/2024

same time demonstrate that legislative intervention is unnecessary.[866] In accordance with this argument, it could, be submitted that the secondary trading documentation created and maintained by the Loan Market Association (LMA) may also have been designed to benefit the banks at the expense of others.

The Cork Report provided a comprehensive and rational review of the law and practice relating to insolvency. In fact, the report aimed to implement the characteristics of a good modern insolvency law and, to this end, advocated for fundamental reforms across various important aspects of insolvency, including, among other things, the harmonisation and integration of existing procedures, increased transparency and accountability, cost-effectiveness, flexibility, a balanced distribution of power among the debtor's stakeholders, and the promotion of corporate rescue.[867]

The Cork Report took some time to find its way into legislation. However, not all of its recommendations were given legislative effect by the Insolvency Acts of 1985 and 1986. Sir Kenneth, moreover, was deeply concerned that the government was selective in its approach to his recommendations, saying in his autobiography:

> 'They ended up by doing the very thing we asked them not to. They picked bits and pieces out of it so that they finished with a mish-mash of old and new'.[868]

Political forces were inclined to advocate for a rescue model loosely based on that of the United States. In 1998, the then Secretary of State for Trade and Industry visited Silicon Valley on a trade mission and gained insights into the central policy concern of Chapter 11: that a senior class will have perverse incentives and thus opt to enforce and sell at a low point in the credit cycle, leading to losses for other stakeholders that might not have

[866] Partnoy and Skeel Jr (n285) 1120
[867] Cork Report (n267)
[868] Finch (n168)18.

occurred if the company had continued to operate. The English insolvency law's model of secured creditor control did not align well with this theoretical framework. Subsequently, there was an extensive and sustained period of consultation. The White Paper preceding the EA 2002 reforms highlighted concerns that had arisen since 1986, indicating that receivership was considered a destructive mechanism that ''caused companies to fail unnecessarily''. At the same time, the fact that the receiver was primarily accountable only to the chargee raised concerns that receiverships could not provide adequate transparency and accountability for all stakeholders of distressed companies. Secured creditors may lack incentives to maximise recoveries and minimise costs in cases where the company's assets are valued higher than the face value of the senior debt. The prevailing belief was that secured creditor control tended to diminish recoveries for junior claimants. To address this, the solution involved tilting the balance firmly in favour of collective insolvency proceedings by introducing a new and more robust administration regime.[869] Government ministers echoed these sentiments when the EA 2002 was introduced in Parliament:[870]

> ''Company rescue is at the heart of the revised administration procedure. We want to make sure that viable companies do not go to 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 good for the companies themselves; it is also good for their suppliers, customers and employees''.

The motivation behind the EA 2002 reforms was to further enhance the importance of rescue, transparency, fairness, inclusivity, flexibility, and cost-efficiency. To this end, administrative receivership was effectively, but not completely, eradicated and replaced with a more collective administration procedure. Some power also was shifted from secured

[869] Insolvency Service, Productivity and Enterprise: Insolvency – A Second Chance (HMSO 2001)2.5
[870] HL Deb 22 July 2002, vol 638, col 766.

to unsecured creditors. However, McCormack noted that the current situation seems to incorporate elements from both administration and receivership procedures.[871] What is even more concerning according to McCormack is that the resulting form of administration resembles a 'receivership plus' involving a fusion or integration of administrative receivership and administration procedures.[872] This dynamic does not signify the end of administrative receivership, but rather a transformation or amalgamation of the two procedures.[873] Armour, Hsu and Walters argue that the transfer of control to unsecured creditors is incomplete.[874] This is because lenders can still appoint administrators of their choice. While administrators are recognised as professionals and are expected to maintain a neutral stance, there is a possibility that their actions might be influenced by their appointers' interests, aiming to secure future appointments and uphold a reputation of being favourable to banks. Additionally, they have presented data indicating that although administration yielded higher overall returns to creditors compared to receivership, the associated costs of administration were also higher. These findings imply that administration might not necessarily be more advantageous than administrative receivership.[875]

The primary reason for the change in the original vision of the insolvency bills has been attributed to the interference and influence of vested power interests involved, particularly secured creditor interests. Paterson argues that the banking industry holds substantial political power, influencing the designing of insolvency laws which serve to protect its interests, deference, dominance, and control over rescue/insolvency process at the expense of others, and which also gives the system a sense of unfairness.[876] Similarly, Tribe strongly

[871] McCormack(n482)536
[872] Tribe (n853)66
[873] McCormack (n482) 521
[874] Armour, Hsu, and Walters (n472)10
[875] Ibid 10
[876] Paterson(n422) 607

points at the role of the powerful lobbying group in subverting the carefully thought through policy intentions of the original policy makers during different stages of the legislative process.[877] He argues that the banking community represented by the British Bankers' Association (BBA) interfered in the making of the Insolvency Act 1986 and the EA 2002 to eliminate the need to balance the interests of different groupings and raise the profile of the rescue culture on grounds that deference to rights of senior secured creditors ensures the availability of cheap credit for healthy companies.[878] The severity of the influence of the banking community is exacerbated in the design of the LMA's standard facility documentation. This section will explore this into detail.

7.1.2. Vague Wording and the Lack of Clarity

It can be assumed that market and freedom of contract are adequate factors to protect companies against predatory investors behaviour. However, the LMA standard terms and conditions are far from perfect, the typical LMA wording is simplified to encompass only another bank or financial institution. However, the LMA Agreement does not define the expression of the "bank or other financial institution" leaving its meaning, at best, vague and imprecise.[879] The courts support a permissive reading of transfer rights in LMA agreement and in syndicated loan agreements generally. The court has established that an entity can be categorised as a 'financial institution' even if it is not a bank but shares similarities with a bank or undertakes bank-like operations (like lending money). The court in *Argo Fund Ltd v Essar Steel Ltd* recognised a hedge fund with a portfolio of debt purchased mainly on the secondary market with a view to realising more by enforcing the security as a 'financial institution'.[880] In *Re Olympia Securities Commercial plc (in*

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[877] Tribe (n853)66
[878] Ibid
[879] Matthew Dunn, and others, The new breed of transfer restrictions in leveraged lending transactions: a new paradigm or just a sign of the times? (2018) Butterworths Journal of International Banking and Financial Law.
[880] *The Argo Fund Ltd v Essar Steel Ltd* [2006] EWCA Civ 241)

administration); Grant and others as Joint Administrators of Olympia Securities Commercial Plc (in administration)) v WDW 3 Investments Ltd and another[881] the court held that funds, which include a recently incorporated company with a share capital of just £1 and no trading history, formed with the intention of acquiring a defaulted loan with the goal of realising greater returns through enforcement than the amount invested in acquiring the debt, can be classified as a 'financial institution' under the transfer clauses of a loan agreement. Therefore, distressed investment funds still fall within this definition and be permitted transferees under the LMA documentation.

Moreover, in cases where consent is required, it is customary for the facility agreement to specify that such consent should not be unreasonably withheld or delayed. Additionally, consent is often deemed to have been granted if no rejection is made within a stipulated timeframe, typically around five business days. The LMA cautions also that the presence of an approved list of transferees is not meant to provide borrowers with grounds to contend that they can reasonably withhold consent for transfer requests solely because the potential transferee is not listed. The question of when it is reasonable for a borrower to withhold consent in the context of a loan transfer has not been directly tested before an English court.[882] The absence of legal precedents defining what qualifies as 'unreasonable' conduct within a commercial context leaves borrower uncertain about whether they possess valid reasons to withhold consent.[883]

Drafting transfer restrictions based on the categories of entities involved in specific activities introduces a high level of uncertainty. There is limited legal precedent to offer

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[881] *Re Olympia Securities Commercial plc (in administration) and ors v WDW 3 Investments Ltd and anor* ([2017] EWCH 2807)
[882] Loan Market Association, Inhibitors to Liquidity in the Loan Market July 2021
[883] David J. Karp and Anthony Lombardi, 'Transfer restrictions may create additional counterparty risk for distressed debt investors' (2014) Corporate Rescue and Insolvency https://www.srz.com/images/content/6/8/v2/68983/Corporate-Rescue-and-Insolvency-Transfer-Restrictions-May-Create.pdf accessed 12/09/2023

direction regarding their interpretation and the specific entities aimed to be encompassed by such restrictions. For example, there is no standard definition for 'competitors'. Similarly, defining hedge funds is challenging due to the diverse array of investment strategies they utilise, alongside the multitude of markets in which they operate.[884]

7.1.3. Major Events of Default

Transfer restrictions typically cease to apply following the occurrence of an event of default, eliminating the need for obtaining prior borrower consent. The fundamental reasoning behind this is to ensure that lenders are not dependent on obtaining borrower consent for a transfer when the borrower has either misperformed or neglected to execute an action as outlined in the terms of the loan agreement. However, the 'Event of Default' definition in this context is broad enough to encompass both technical and credit-related matters (i.e. breach of a financial covenant, on-payment of the principal loan amount and/or interest, or insolvency). More importantly, borrowers might not be concerned by the identity of their lenders or their incentives, for so long as the loan commitments are undrawn. In an actual sense, transfer restrictions fall away when they are needed most. Indeed, the company, upon default, initially approach their creditors to seek forbearance, a waiver, amendment or more advanced negotiations. However, determining who is really at the negotiating table would be difficult,[885] and upon determining, they find themselves exposed to the whim of sophisticated, aggressive and speculative investors.

7.1.4. The Problem of Sub-participation

Restrictions outlined in the LMA standard facility documentation frequently centre on transfers conducted through novation and assignment. To circumvent these restrictions or for reasons related to reputation, the original lender, typically the bank, may establish an

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[884] Kahan and Rock(n195)1023

[885] James M. Shea Jr, 'Who Is at the Table - Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors under Federal Rule of Bankruptcy Procedure 2019' (2008) 76 Fordham L Rev, 2561.

interest in the underlying loan, or at least its proceeds and associated risks, in favour of a sub-participant. To accomplish this, the bank, known as the lender of record, and the sub-participant enter into a separate agreement. Although linked to the underlying loan, this agreement remains legally distinct and independent from it. This independent and purely contractual agreement does not entail the transfer of any legal or beneficial stake in the underlying loan or its proceeds to the sub-participant. Consequently, the sub-participant lacks the ability to assert any rights against the underlying borrower. The sub-participant's rights are solely against the lender of record and the nature of that relationship is one of creditor and debtor respectively. The obligation of the lender of record to pay the sub-participant is triggered only in the event the borrower makes a payment of principal and/or interest to the lender of record. However, that payment to the sub-participant originates from the Lender of Record's own funds. The lender of record does not retain payments received from the borrower on behalf of the participant, nor is there an assignment of any interest in the loan or its proceeds.[886]

In this context, the bank preserves its relationship with the borrower by ensuring that no rights in the loan are transferred to the sub-participant that could negatively impact, or otherwise affect, its relationship with the borrower. Simultaneously, the bank can achieve full regulatory relief by removing the loan from its regulatory balance sheet and circumventing any restrictions present in the underlying loan agreement.[887]

Penn argues that the arrival of new sub-participants in the market demonstrates a notable change in the practice, specialist debt traders have emerged as active purchasers with the intention to exert more influence over the daily management and oversight of the underlying

[886] Graham Penn, 'Promoting liquidity in the secondary loan market: is sub-participation still fit for purpose? The development of transfer restrictions and their potential impact on sub-participation' (2022) 3 Journal of International Banking Law and Regulation,85,88.
[887] Ibid 89

loan.[888] This especially pertains to the execution of enforcement rights. Given the absence of a direct contractual link between distressed debt investors and the ultimate borrower, this influence is exerted through the lender of record acting behind the scenes, so, the borrower has no knowledge of it. A typical example will be the current LMA master funded participation agreement which states that, 'where voting rights are granted to the sub-participant, the lender of record is not able to exercise or refrain from exercising any of its rights under the [underlying loan agreement]' agree to any variation or waiver of the [terms of the underlying loan agreement] or perform any acts thereunder without the consent of the [sub-participant].[889] Distressed debt investors may also include provision in the sub-participation agreement stating that any unapproved changes will not be binding on the sub-participant. Neglecting to adhere to the binding instructions could lead to an immediate obligation for the lender of record to repay the remaining sum of the sub-participation, along with the potential for a claim seeking damages for any further loss incurred by the sub-participant.[890]

The contract between the lender of record and the distressed debt investor may incorporate a provision referred to as 'elevation'. As the name implies, this mechanism grants the sub-participant the right to demand its position to be elevated to that of the 'lender' as defined in the underlying loan agreement.[891] Alternatively, if the sub-participant is unable to act in that capacity due to reasons such as transfer restrictions affecting the sub-participant as well, the clause allows the sub-participant to request the transfer of the sub-participated portion of the underlying loan to another party unaffected by the restrictions. This new party

[888] Ibid 90
[889] LMA Secondary Debt Trading Documentation (Par and Distressed) Users Guide (1 January 2021)
[890] LMA Standard Terms and Conditions (29 October 2018)
[891] Adam Blakemore and Oliver Iliffe, 'Sub-participations, taxation and the mitigation of lender credit risk' Butterworths Journal of International Banking and Financial Law ' (2011) https://www.cadwalader.com/uploads/books/5d5dbe40bd5c3e92c782230f85bd51ea.pdf accessed 9/12/2023

will subsequently become a lender, and the sub-participant intends to establish a new sub-participation arrangement with this entity to maintain its economic interest.[892]

The existing LMA (Loan Market Association) master funder participation agreement[893] includes an elevation mechanism that can be triggered ‘on request’ from either the sub-participant or the lender of record.[894] The pertinent clause outlines that ‘‘subject to the terms of the underlying loan agreement’’ either party can ask for the sub-participant’s position to be elevated to that of the ‘lender’ under the underlying loan. Upon such a request, both the lender of record and the sub-participant are obliged to make commercially reasonable efforts to promptly execute any necessary documents, as reasonably requested by the other party. This process ensures that the sub-participant assumes the role of the lender of record concerning the specific portion of the underlying loan that is the subject of the sub-participation. The provision restricting elevation based on the terms of the underlying loan agreement acknowledges, in part, that one of the reasons sub-participations are often used as a transfer method is to circumvent the transfer restrictions commonly present in primary loan agreements, which usually mandate borrower consent. [895]

Critically, given that there is no necessity for borrower to seek the consent for transfers to existing ‘lenders’ a status the sub-participant attains upon its elevation to the position of ‘lender’ as outlined in the ‘changes to the lenders’ clause commonly found in LMA-style primary loan agreements. As a result, one or more relatively minor (in terms of value) sub-participations, after being elevated, could expose a borrower to unregulated transfers

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[892] Penn (n886) 90

[893] Market Loan Association, ‘Documents and guidelines' LMA Master Funded Participation Agreement (PAR/DISTRESSED) Revised 04/01/2022 available at https://www.lma.eu.com/documents-guidelines/documents accessed on 03/12/2022

[894] Loan Market Association, 'Documents & Guidelines'' LMA Master Funded Participation Agreement (PAR/DISTRESSED) Revised 04/01/2022 available at https://www.lma.eu.com/documents-guidelines/documents accessed on 12/12/2023

[895] LMA Master Funded Participation Agreement (PAR/DISTRESSED) (29 October 2018)

through novation or assignment to those sub-participants. This might potentially allow them to acquire a 'blocking' position with negative control or direct voting influence over the entire underlying loan.

Borrowers' attempts to tighten the transferability language and extension of their consent right to include sub-participations are usually met with significant resistance from the banks. They insist on retaining maximum flexibility on how to manage their financial asset in particular, nonperforming loans.[896]

7.1.5. The Problem of Unsecured Debt

Despite bank debt is particularly attractive to distressed debt investors, it is not the only debt traded in the market. Distressed debt investors may buy up existing unsecured creditors' debt. Unsecured trade debt poses even more challenges to the debtor company than bank debt. Unsecured creditors are dispersed and tend to include involuntary creditors, The nature of the relationship between the latter and the company is not contractual.[897] For example, there is a little possibility for the debtor company to either negotiate or impose restrictions on tort claimant's ability to transfer its claims against the company. The distressed debt investor may buy the unsecured debt quietly in private transactions. In essence, the distressed debt investor may engage in a secret accumulation of the unsecured debt in which the company is unaware of it until the distressed debt investor has a foothold in the company's debt in ways which are reminiscent to hostile equity-based takeover.[898]

7.2. The Imperfection of the UK's rescue Finance and Secondary loan markets

Assuming competition in the distressed lending market, the new issues created by distressed debt investors would be self-correcting. If the market is sufficiently robust, with a large

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[896] Sarah Paterson, *'Corporate Reorganization Law and Forces of Change'*(1st edn, Oxford University Press 2020) 101
[897] Gullifer and Payne (n259) 60.
[898] Harner(n103) 159

number of suppliers, the debtor can secure competitive rates for the fresh funding needed to avoid insolvent liquidation or to implement a restructuring plan. This, in turn, increases the chances of a successful recovery strategy. The debtor can also replace distressed debt investors pursuing value-destructive strategies with new investors whose interests are more closely aligned with the debtor's business.[899]

> 'If financial markets have achieved that level of perfection, there is less reason for full-scale traditional bankruptcy decision-making'.

The US, where the distressed debt investors have long been praised for creating efficiencies in the Chapter 11 process, has a broad and long-established market in post-petition financing.[900] Bankruptcy claims (bank secured debt, unsecured trade debt, consumer claims, bond debt, tort debt trade freely in the secondary market. In this sense, distressed debt investors may purchase company's debt off the books of the banks. The existence of a readily available exit strategy helps banks to free up their cash resource and facilitate their liquidity preservation and stability. Subsequently, banks can play their traditional role of financing healthy companies. While distressed debt investors in the course of making profit can help liquidating fundamentally unviable and unprofitable companies to be redeployed in the economy. If the company's business remains viable, and in expectation of a successful turnaround, the distressed debt investor is likely to remain invested in the distress company in order to continue receiving the economic interests (i.e. the interest rates and fees chargeable on the loan). The company can refinance the loan to pay off the existing investors.[901]

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[899] Mark J Roe, 'Three Ages of Bankruptcy' (2017) 7 Harv Bus L Rev,187,195
[900] Payne and Sarra (n69) 188
[901] Adam J. Levitin, 'Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron'(2007) 1Columbia Business Law Review 83,89; Levitin (n29) 85

Chapter 11 empowers the courts to furnish a prospective financer, providing money to a company undergoing formal restructuring or intends to make use of the Chapter 11 to implement a workable restructuring plan, with a super-priority status over existing creditors in any subsequent restructuring plan or liquidation outcome.[902] This advantageous treatment increased the risk appetite and interest of various investors in participating in Chapter 11 situations.

Under Prior Rule 2019, creditors' statutory committees in Chapter 11 cases were required to disclose details of their members' investments in the debtor.[903] In essence, a verified statement disclosing must be filed to disclosing: ''(1) the name and address of the creditor or equity security holder; and (2) the nature and amount of the claim or interest and the time of acquisition thereof' unless acquired more than one year prior to filing of the petition. (3) the amounts of claims and interests owned by the members of the committee (4) the amounts paid for such claims or interests; and (5) any sales or other disposition thereof''. The intention behind the requirements was to address the coercive and exploitative behaviour of distressed debt investors and ensure creditors on the committee remain committed in their fiduciary duties to the rest of creditors.[904]

Investors may avoid the disclosure requirements of the Prior Rule 2019 and form an unofficial committee with other similarly situated claimholders.[905] Member of an unofficial or ad hoc committee are not required to publicly disclose their economic interest in the debtor and owe no fiduciary duties to other creditors. There was much debates as to whether the Rule should be extended to cover unofficial or ad hoc committees.[906] At one end of the

[902] See 11 U.S.C. § 364; Paul M. Baisier and David G. Epstein, 'Postpetition Lending under Section 364: Issues Regarding the Gap Period and Financing for Prepackaged Plans'(1992) 27 Wake Forest L. Re 103
[903] US Federal Rule of Bankruptcy Rule 3001(e)
[904] Federal Rules of Bankruptcy Procedure 3001(e)
[905] Thomas(n33) 220
[906] This controversy started when the court agreed to the debtor's request in case of *In re Northwest Airlines Corp* requiring each equity holders sitting on the hoc committee, pursuant to Prior Rule 2019, to disclose "the

spectrum, it was advocated that Rule 2019 should be applicable to members on ad hoc committee and thus they should file verified statements disclosing (1) investments in claims against, and securities issued by, the debtor (2) its trading history in such claims and securities; (3) the amount paid for such claims and securities; and (4) any sales or dispositions of such claims or securities during the course of the insolvency proceeding.[907]

Differential treatment i.e. the application of the rules on official committees and not on ad hoc committees is virtually meaningless and lacks normative appeal. It has also been argued that Rule 2019 serves as the latest tool in the toolkit of debtors confronting aggressive distressed debt investors and traders engaged in speculating on the debt and equity of bankrupt companies.[908]

At opposite ends of the spectrum, there is an argument that extending the scope of rule to *ad hoc* committee create sufficient incentives for distressed debt investors to shy away from investing in distressed market. In such situation, distressed debt investors are compelled to choose between several unattractive alternatives: (1) bear the substantial costs of individual actions; (2) join an ad hoc committee, divulging intricate trading information and risking exposure of proprietary valuation models and trading strategies;(3) take no active role in the company restructuring efforts and observe passively from the sidelines. This in turn harms the liquidity in the distressed claims and chill the market.[909]

The Committee on rules of practice and procedure of the judicial conference of the United States clarified and amended Rule 2019 by expanding its scope to cover unofficial

entirety of their holdings in the debtor, the times of the purchases, the amounts paid therefor and any sales or other disposition thereof *In re Nw. Airlines Corp*., 363 B.R. 701 (Bankr. S.D.N.Y. 2007). However, the court in *In re Premier International Holdings*, held that Prior Rule 2019's disclosure requirements are not applicable to an ad hoc committee." *In re Premier Int'l Holdings, Inc*., 423 B.R. 58, 76 (Bankr. D. Del. 2010)

[907] Federal Rules of Bankruptcy Procedure 3001(e)

[908] Coco(n46) 614; W. Andrew P. Logan III, Note, Claims Trading: The Need For Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2) (1994) 2 American Bankruptcy Institute Law Review 495

[909] Albrecht (n856) 720

committees that represent creditors or equity security acting in concert to promote their common interests.[910] The new rules require committee members to disclose the nature and amount of each 'disclosable economic interest' (e.g. short positions, derivative positions (including credit default swaps and total return swaps).[911] Since the distressed debt investors' positions become more transparent, courts and debtors can decipher and evaluate their motivations and intentions.[912] However, creditors on both official and unofficial are no longer required to disclose the price and timing of debt acquisition. The new rules play into the hands of distressed debt investors who seek to keep the prices paid for claims, valuation models, trading strategies, and the work of their skilled investment analysts confidential to maximise total returns on their overall investment. The market was effectively deregulated and this subsequently increased both distressed debt investors' participation in Chapter 11 bankruptcy proceedings as well as liquidity in the secondary market for distressed claims.[913]

> Bankruptcy Procedure Rule 3001(e)(2), which allows for the relatively free trading of bankruptcy claims, leaves open a regulatory gap because it does not effectively mandate any disclosure regarding the details of an investor's claims or interests.[914]

The substantive expansion in distressed debt investing is also related to the parallel growth in the issuance of high-yield bonds and highly leveraged bank loans, as well as the increased ease with which they have been traded in the secondary loan market. Along with the huge increase in distressed firms in the aftermath of 1989-1991 recession, 2000-2002 stock market downturn, and the 2008-2009 great financial crisis.[915] The high probability of investment returns and investment opportunities captured the interest of increasing numbers of investors

[910] Coco(n46) 614
[911] Federal Rules of Bankruptcy Procedure 3001(e)
[912] Ibid
[913] Edward J. Janger, 'The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration, and Coordination Problems' (2009) 4 Brooklyn Journal of Corporate, Financial & Commercial Law 40
[914] Coco(n46) 620
[915] Goldschmid (n235)195

and analysts. In 2013, it was estimated that 200 investors operating in the US market.[916] It is fair to expect a reduction in cost of credit including post-petition financing as the competition in the market increases.

In the UK, rules are lacking on distressed financing. The Insolvency Act of 1986 provides no formal mechanism to facilitate such financing. In the build up to the passage of the EA 2002, policy makers extensively considered a number of initiatives to introduce a form of rescue financing but such initiatives did not eventually find their way into the legislation. The subject was revived in the subsequent consultations in 2009[917] and more recently in 2016.[918] However, it seems that there is limited enthusiasm for implementing legislative changes in this regard. Respondents to the Insolvency Service's Consultation advocated the reliance on a market-based mechanisms on the assumption that market participants are able to identify and fund viable companies.[919]

It is not possible for distressed debt investors to enjoy a level of priority to the financing they may provide to a company with no prior relationship. With no such priority, the consent of existing lenders will be required to give such financing a priority, which may be particularly difficult to obtain. Indeed, fully pre-insolvency secured creditors are unlikely to encumber their debtors' company assets with more security interests in favour of a new lender. Doing so means ceding the powers they have to enforce their debt and sharing rateably with a new lender in the proceeds of the sale enforcement.[920]

As a result, providing distressed financing has become highly concentrated among a small number of providers. In a market only supplied by a few investors and without any

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[916] Altman(n167)80
[917] Insolvency Service (n619)
[918] Consultation Paper, May 2016(n48)
[919] Insolvency Service, A Review of the Corporate Insolvency Framework: a consultation on options for reform, May 2016
[920] Payne and Sarra (n69) 189

competition, these investors are the price makers.[921] The price of credit (i.e. the interest rate against which the new credit will be extended) will be higher to reflect risk of possibility of participating into an insolvency situation. High interest rates could make a distressed company more prone to insolvency.[922] This may also decrease the chances of a successful recovery strategy for an insolvent company as it will turn it into "zombie"[923] company and eventually exacerbate insolvency recidivism rates.

Obtaining new financing can send a positive signal to the market, indicating that lenders have confidence in the company's viability. This, in turn, can encourage other lenders, suppliers, and employees to maintain their relationships with the company, thereby enhancing the chances of accomplishing a successful reorganisation.[924] However, obtaining new financing from distressed debt investors can also send a negative signal to the market. companies approach distressed debt investors as 'lenders of last resort'.[925] Other lenders, suppliers, and employees can safely infer that companies resort to distressed debt investors only where traditional banks reject them, signalling the company's potential unviability. Distressed debt investors extend credit not based on the assumption of the company's viability, strong operating performance, or a well-thought-out restructuring proposal. Instead, they provide finance in exchange for a high interest rate to compensate for the increased risk of default.[926] A situation of high borrowing costs could make the debtor company more prone to insolvency.[927] The decision to put a company into insolvency, often

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[921] Wyn Morgan, Michael L. Katz, and Harvey S. Rosen, *'Microeconomics'*(2nd edn, McGraw-Hill Education,2009)537

[922] Lucia Cusmano, 'New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments' Unpublished Working Paper [2015] OECD Centre for Entrepreneurship, SMEs and Local Development available at hhttps://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf (accessed on 02 /11/2022).

[923] A "zombie" company is a corporation that uses its cash resources to service interest payments with no capital to pursue or fund valuable projects.

[924] Aurelio Gurrea-Martinez, 'Debtor-in-Possession Financing in Reorganisation Procedures: Regulatory Models and Proposals for Reform' Review(2023) 24European Business Organization Law Review 555,559

[925] Li and Wang(n87) 130.

[926] Baird and Rasmussen (n61) 679

[927] Cusmano (n922) para 36

means extinguishing the rights of others, such as unsecured creditor.[928] Distressed debt investors may provide finance with the intention of pursuing a debt-for-equity swap through a pre-pack administration, in which the claims of unsecured creditors, including suppliers and employees, are extinguished. In both situations, such financing is likely to discourage other lenders, suppliers, and employees to keep dealing with the company. The example of Wilko illustrates how resourcing credit from distressed debt investors contributes or may even accelerate the debtor's decline and ultimately precipitates its insolvency.[929] After facing financial troubles and a significant reduction in consumer demand, the discount retailer turned to a distressed debt investor for additional funding to be able to continue to trade.[930] However, credit insurers had ceased to provide insurance coverage for the retailer, leading to certain suppliers suspending their deliveries, and the company collapsed into administration a few months later.[931]

Companies in the UK are largely dependent on bank loans to finance their operations. Banks usually offload distressed loans in one shot through auctions. Conducting an auction is not without concerns or limitations. A rational investor would not incur huge legal fees and time needed to conduct the requisite due diligence where only the winning bidder is able to recoup fees. This usually results in the disposal of distressed loans at a steep discount to their face value. There would be little reason for the new creditor to steer the firm into a value-maximising sale. The investor will in most cases bid the amount of its claim as currency to buy the company in a quick auction and before any other bidder can get

[928] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 UCLR 775
[929] Sarah Butler and Joe Middleton, 'Meet Hilco, the firm behind the scenes at Wilko failure and other high street collapses' The Guardian (London,4 Sep2023)https://www.theguardian.com/business/2023/sep/04/hilco-wilko-high-street
retailers#:~:text=However%2C%20Hilco%20has%20a%20dual,the%20debt%20is%20paid%20off 3
[930] Aoife Morgan, 'As Wilko secures emergency funding, what options do retailers in distress have?' retailgazette (London,05/01/2023)
[931] Sarah Butler, 'Wilko secures £40m funding from Hilco as it faces cash squeeze' retail gazette (London,04/01/2023)

involved. The new investor's strategy is to make profit through recoveries on the debt in a sale to a third party. If the investor recovers enough value to make its targeted profit, it is unlikely for the investor to push for higher prices or look after the unsecured creditors.

7.3. Can a Market-led Solution Similar to The London Approach be Developed Within the market?

The emphasis has always been on market-led solutions in the UK's corporate rescue model. The London Approach has played a vital role in the restructuring of large corporates in the UK.[932] The threat of regulatory sanctions from the Bank of England was critical in "seeding" the approach principles. In fact, the threat of sanctions was theoretically and empirically proved credible for the banks to make them comply to overcome their coordination problems and reach an agreement on how a distressed company should be dealt with.[933] When the responsibility for workout management being devolved to market participants themselves, the banks contributed to the ability of the London Approach to maintain its normative force and remain an effective mechanism for reducing the incentives to engage in strategic creditor actions such as hold-out creditor problem, free-rider problems, and "ransom" demands. This is because the finance market in the UK was dominated by a few banks and those who did not abide by the established principles or created impediments to solutions to distress would be excluded from the ability to participate in future syndicated loans.[934]

The emergence and the subsequent stability of market conventions requires the availability of strong state institutions and relatively coherent and homogenous group of market participants often with similar types of credit policy and objectives for holding particular loans or bonds.

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[932] Flood, Abbey, Skordaki and Aber (n9)
[933] For details on how London Approach became a normative force see Armour and Deakin (n12)
[934] Paterson(n179) 338

7.3.1. The Absence of the State Institutions

Distressed debt investors are typically hedge funds[935]and private equity funds. Funds are often referred to as unregulated or lightly regulated and unsupervised investment vehicles. Jaeger points out that 'hedge funds are generally structured to qualify for various exemptions, exclusions, and 'safe harbours' that are explicitly provided within the regulatory framework'.[936] While the United Kingdom serves as a significant centre for hedge fund managers, the funds themselves are frequently situated offshore due to tax considerations.[937] Hedge funds generally do not require regulatory approval or registration with a regulatory body in order to operate. Hedge fund regulation focuses on the regulation of hedge fund managers who must seek the authorisation of the Financial Services Authority (FSA) pursuant to section 19 of the Financial Services and Markets Act of 2000.[938] Therefore, hedge fund managers possess a relatively high degree of freedom to employ a wide array of strategies, as there are no specific limitations on their investment choices.

Hedge funds are not subject to extensive state or local influence, or political control and are often located offshore and nimble enough to move their operations elsewhere. Therefore, the threat of dire sanctions, such as adjusting the terms of the bank's licence, meeting behind firmly closed doors with officials of the Bank of England, which played a critical role in the formation of the London approach principles, are likely to be ineffective for the lightly regulated hedge funds.[939]

[935] Macey(n188) 247
[936] Robert A. Jaeger, '*All about Hedge Funds: The Easy Way to Get Started*' (1st edn, 2002, McGraw-Hill)181
[937] international financial services London (IFSL) research, Hedge funds 2010 (http://www.thecityuk.com/media/2358/HedgeFunds 2010.pdf
[938] Financial Services and Markets Act 2000
[939] Armour and Deakin (n12) 22

Hedge funds also provide positive benefits, such as more efficient and liquid markets. Therefore, some form of state intervention to enable a market-led solution becoming a normative force is more likely destroy the positive benefits. The Bank of England highlighted the growing importance of debt trading since 1990s. Trading corporate debt can introduce liquidity into banks' loan portfolios and be used as a tool for sound portfolio management.[940] Additionally, a sufficiently deep and liquid market might provide a useful guide to the extent of provisioning which might be appropriate in individual cases. Trading can also provide a useful exit route for lenders unwilling to participate in what could be a painful restructuring. For these reasons, the suggestion of prohibiting trading in the debt of a company which is the subject of a workout or inhibiting the growth of the distressed debt market was rejected.[941]

7.3.2. The Diversity of Distressed Debt Investors Community

In addition to the prominent participants in the distressed debt market (i.e. hedge funds and private equity funds) the list also includes investment banks, pension funds, mutual funds, 'bad bank' often backed by the government, states through their central banks and sovereign wealth funds. Distressed debt investors may morph into hedge funds, and hedge funds may become distressed debt investors.[942] Hedge funds may even establish a separate, ambiguously named entity for the sole purpose of buying up claims while concealing their identities.[943] Distressed debt investors may have heterogeneous priorities. They buy the debt of troubled companies including subordinated debt, junk bonds, bank loans, and obligations of suppliers.[944] Some seek long-term control of the business, while others are

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[940] Bank of England, 'The London Approach and trading in distressed debt' [1993] Bank of England Quarterly Bulletin 1996 Q2. Available at https://www.bankofengland.co.uk/quarterly-bulletin/1996/q2/the-london-approach-and-trading-in-distressed-debt

[941] Michael Smith, 'The London Approach and trading in distressed debt' Business Finance Division, Bank of England 01 /06/1996

[942] Miller and Waisman (n242) 380

[943] See Logan III A (n908) 496

[944] Anson (n169) 9

passive, short-term investors. Others may hold a basket of both long and short positions in multiple tranches and complicated hedges involving other businesses.[945] They may also purchase several companies in the same industrial segment. The involvement of distressed debt investors in distressed situations increases creditor conflict and litigation. They frequently pursue litigation strategies or the threat of litigation as leverage to improve their plan treatment.[946]

Hedging techniques are frequently employed to safeguard against significant shifts in positions that could negatively impact the investor. These techniques might involve short-selling the underlying equity of a company after acquiring a distressed bond or loan, which is believed to have the potential for improvement but could also default. Another approach is to secure a hedge by purchasing credit insurance, often through the credit default swap market. In this scenario, if the distressed company defaults, the investor will receive the principal amount along with interest. Therefore, in contrast to the homogenous lending community of banks which led to the formation and stability of the London Approach principles, the lending community of distressed debt investors is more diverse and heterogenous. This in turn makes the formation of new market conventions practically impossible.[947]

The number of distressed debt investors grows year on year. This is compounded by technological advances and the globalisation of the distressed debt market. This means that distressed debt investors are not repeat players at the negotiating table.[948] New and also existing distressed debt investors move across various distressed debt markets to exploit

[945] Baird and Rasmussen (n61) 672
[946] Harner, Griffin and Ivey-Crickenberger(n354) 175
[947] Janger and Levitin (n46) 1866
[948] Harner (n28) 709

investing opportunities.[949] This increases the likelihood that one or more such parties may incorrectly observe the conventions of the market, making the stability of the market conventions challenging.

7.4. The Reliance on Reputation to Combat the Disincentive Problem

A creditor would be indifferent to whether the company survives, except to the extent constrained by reputational or other concerns. Key lenders, commonly the banks, would not wish to link their reputations with a corporate collapse and therefore, and seek to protect their reputation by offering their support to ailing companies.[950] Strategic creditor actions, (i.e. holdout and hold-up behaviour) could gain a bank a reputation as a 'bad actor', likely excluding it from participation in future syndicated credits.[951] The liquidation of an ailing company is likely to impose switching costs on employees, managers, and suppliers. Indeed, the costs associated with finding new customers or seeking alternative employment, often with the possibility of lower salaries, incentivise trade creditors and employees to support and assist in the rescue efforts undertaken by the distressed company.[952]

Likewise, The desire to develop and maintain a reputation as 'professional and careful' provides strong incentives for managers and directors to ensure that the company remains viable and profitable, and to steer it back to healthy operations during troubled times. It is highly unlikely that managers and directors linked to, or perceived as responsible for, corporate collapses would gain future appointments; conversely, a successful track record enhances their prospects.[953] This is different for distressed debt investors, they seek to develop and maintain a reputation of barging toughness in restructuring negotiations and a

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949 Edward I. Altman and Robert Benhenni, 'The Anatomy of Distressed Debt Markets (2019) 11Annual Review of Financial Economics, 21,23

950 Viktar Fedaseyeu and Robert Hunt, 'The Economics of Debt Collection: Enforcement of Consumer Credit Contracts 8 (Fed. Reserve Bank of Phila' Working Paper No. 15-43, 2015)

951 Mark J. Roe, 'The Voting Prohibition in Bond Workouts'(1987) 97 The Yale Law Journal 232

952 Franks and Nyborg (n563)1166

953 Paterson (n264)507

reputation of high performance. Private equity and hedge fund managers put more weight on paying large dividends that support future fundraising.

7.4.1. Reputation of Toughness in Restructuring Negotiations

Distressed debt investors place significant emphasis on building a reputation for adopting tough policies in restructuring negotiations, aiming to shift control rights in their favour and extract concessions from other stakeholders. The importance of such toughness has already been noted in academic and practitioner literature. Coffee and Klein argue that distressed debt investors generate profits by cultivating a reputation for toughness, which enables them to commit to negotiation strategies that compel other claimholders to limit their demands on the company's cash flows.[954] To maintain and exploit their reputations for toughness, the investor must sustain a tough stance in a series of debt restructurings and consistently adopts tough negotiating positions.[955]

> ''For tough policies to be rational, vulture has to believe that if he fails to reduce stockholder concessions restructuring, he will lose face, and, thus, fail to extract concessions in future restructurings''

Distressed debt investors' profits depend on the amounts they can obtain from debtors, incentivising them to even use unethical methods to increase collection.[956] Moreover, it is unlikely for distressed debt investors to maintain ongoing relationships with the companies they attempt to collect from. Unlike traditional banks, which need to maintain good standing in the community so that customers will choose to obtain loans from them in the future, distressed debt investors' behaviour is not constrained by a desire to maintain goodwill or a good reputation.[957]

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[954] John C. Coffee Jr and William A. Klein, 'Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations' (1991) 58 The University of Chicago Law Review,1207,1209.
[955] Thomas H. Noe and Michael J. Rebello, 'Reputation and the Market for Distressed Firm Debt' (2003) 38 The Journal of Financial and Quantitative Analysis,503,506.
[956] Deitch(n161) 410
[957] Ibid 411

Distressed debt investors use the inherent risks of distressed debt market argument to sort out the reputation concerns. In the case of the *Monarch Airline ltd*, distressed debt investors argue that

> ‘‘Turnaround investing is risky and challenging. It is important to us, and the health of the broader economy, that when such turnaround attempts fail, investors who were willing to take on these difficult situations are not unduly criticised or assumed to be guilty until proven innocent, our involvement with Monarch, as shareholders and investors, has been to provide vital capital to a company when no other investor, bank or financial institution was willing to assist’’[958]

Similarly, in the case of *Bernard Matthews ltd*, the distressed debt investors argued that

> ‘‘despite our substantial involvement and investment, we were not able to return Bernard Matthews to a sustainable profit-making business"[959]

7.4.2. A Reputation of High Performance and High Returns to Their Stakeholders

Private equity firms and hedge funds act as financial intermediaries. Private equity funds are organised as limited partnerships where investors, as limited partners (LPs), provide capital to a private equity fund that is managed by a private equity firm, acting as a general partner (GP). To achieve this purpose, LPs provide *ex ante* equity financing, providing the GP with significant leeway over when and what to invest in, while deals employ significant amount of leverage.[960]

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[958] Press release, Marc Meyohas, ‘Response from Greybull Capital LLP to Chair re Monarch Airlines collapse’ 24th October 2017, available at https://www.parliament.uk/documents/commons-committees/transport/Response-from-Greybull-Capital-LLP-to-Chair-re-Monarch-Airlines-collapse-24-10-2017.pdf accessed 09/08/2023

[959] Rutland Partner, 'Response re: Press comment on Bernard Matthews"(2017)https://rutlandpartners.com/wp-content/uploads/2020/07/Response-re-Press-Comment-on-Bernard-Matthews.pdf accessed 09/08/2023

[960] Hotchkiss, Smith, and Strömberg (n130) 701.

The goal is to manage pools of capital and invest them in companies that generate a high rate of return. This is often done by injecting capital into underperforming businesses to increase their operational efficiencies and subsequent earnings and profitability.[961]

The pay of managers is closely tied to performance to align the incentives of limited partners (LPs) and general partners (GPs). GP compensation typically consists of three components: a management fee, a carried interest provision that grants GPs a share of the fund's profits, and various fees charged directly to portfolio companies.[962] The management fee can be viewed as the fixed part of compensation. It is usually 2%, with the basis being committed capital during the investment period, and invested capital in the later part of a fund's life. Carried interest typically gives GPs 20% of fund profits, conditional on fund performance exceeding a hurdle rate (normally 8%).[963] There is more variation in other types of fees, and various rebates offered to LPs. Therefore, the compensation package provides GPs with a strong pay-for-performance component of pay, aligning incentives of LPs and GPs.[964]

Private equity funds have finite lifespans, usually 10–12 years, the finite fund life provides a natural indirect component as GPs regularly have to raise new funds in the market. As documented by Chung et al,[965] Barber and Yasuda,[966] and Brown et al,[967] high current fund performance increases the likelihood that a GP raises a new fund and, conditional on successful fundraising, the fund is larger. Typically, new funds are raised between the third

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[961] Ibid
[962] Andrew Metrick, Ayako Yasuda, 'Venture Capital and Other Private Equity: a Survey' [2011] 17 European Financial Management, 619,621.
[963] Ludovic Phalippou a, Christian Rauch b, and Marc Umber, 'Private equity portfolio company fees' [2018] 129 Journal of Financial Economics 559
[964] Ibid at 561
[965] Ji-Woong Chung, Berk A. Sensoy, Léa Stern, and Michael S. Weisbach, 'Pay for Performance from Future Fund Flows: The Case of Private Equity'(2012) 25 The Review of Financial Studies, 3259, 3260.
[966] Brad M. Barber and Ayako Yasuda, 'Interim fund performance and fundraising in private equity'(2017) 124Journal of Financial Economics 172
[967] Gregory W. Brown, Oleg Gredil, and Steven N. Kaplan, 'Do Private Equity Funds Manipulate Reported Returns?'(2019) 132 Journal of Financial Economics, 267,270.

and sixth year of the existing fund. This ensures that the private equity firm has capital to deploy when promising investment opportunities are found.

Limited Partners (LPs), or simply investors, are institutions and wealthy individuals responsible for providing the capital for the private equity fund. LPs typically play no role in the day-to-day control and management of the fund and only have limited liability. However, their exposure cannot be limited if they decide to involve in the management or the operation of the funds. Liquidity-seeking partners may depart if they are not rewarded a fair share of profits. Such departures negatively impact the ability of GPs to raise more capital.[968]

PE fund managers may be compelled to employ excessive leverage, borrowed money, employee layoffs, cost cutting or even extracting wealth from other stakeholders to pay large dividends to the LPs. Actions that boost the short-term returns to PE owners at the expense of long-term investments could drain liquidity, putting PE-owned firms at higher risk of default.[969]

Hedge funds and private equity funds tend to overlap, the main difference being the regulatory requirements. However, hedge funds also invest for the benefit of their own investors. They also regularly use leverage. They obtain most of their capital from a limited range of “accredited” or “qualified” wealthy individuals and institutions such as foundations and pension funds. Hedge fund managers are highly incentivised to maximise the returns to fund investors. The standard hedge fund charges a base fee equal to 1-2% of the assets under management and a significant incentive fee, typically 20% of the profits

[968] Sharon P. Katz, ‘Earnings Quality and Ownership Structure: The Role of Private Equity Sponsors’(2009) 3The Accounting Review 623,626.
[969] Hotchkiss, Smith, and Strömberg (n130) 700

earned. The resulting profits can be extraordinarily high for hedge fund managers. Hedge funds have a limited life, the average life of a hedge fund is 7 years.[970]

Hedge fund investors could make withdrawals usually after an initial lock-up period of six months. Therefore, hedge fund managers, like private equity managers, also care about retaining existing investors and attracting new ones through their performance. Hedge fund managers are highly incentivised to use their knowledge and expertise to generate a high return for the benefit of their investors. In fact, the focus might be on returns in the short run to satisfy liquidity-seeking investors. This may lead solvent companies to default and newly restructured insolvent companies to relapse into insolvency a second or a third time.[971]

There is no reason to expect distressed debt investors to be concerned with the negative media coverage, social backlash or the accusation of pushing companies under, degrading product quality, creating job losses, cutting costs, and enriching themselves by focusing on short-term profits at the expense of the long-term investments or by extracting wealth from other stakeholders. They are constrained by reputational concerns with investors. In fact, they are dependent on reputation for their ability to achieve high returns to their investors.

7.5. Concluding remarks

Based on Coase's theory, in a cost-free transaction environment, the negotiation process would seamlessly relocate rights to the most efficient use and destination. Without transaction costs, there would be fewer barriers to exchanges, promoting optimal resource allocation and economic efficiency. Therefore, the role played by the law would be marginal since it would not provide any surplus in terms of economic efficiency. The risk

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[970] Jón Daníelsson, Ashley Taylor, and Jean-Pierre Zigrand, 'Highwaymen or heroes: Should hedge funds be regulated?: A survey' (2005) 1 Journal of Financial Stability,522,524.
[971] Ibid 525

lies in the possibility that regulations, intended to ensure fair and ethical practices, could inadvertently raise transaction costs. This increase in costs might lead to inefficient outcomes, as resources may be hindered from being used most effectively due to the burden of heightened transaction costs.[972]

An economy with perfect capital markets does not, in reality, exist. The imperfections in capital markets are highly diverse. In contrast to the ideal scenario suggested by Coase, capital markets themselves are allocatively inefficient. This justifies the need for a certain set of rules, whether mandatory or procedural, to ensure minimum levels of fairness, efficiency, and competitiveness in business contracting. This principle has been intentionally established as one of the foundations of modern company law in many legal systems, including the EU at large and the UK in particular.

The distressed debt market is not an exception. Debt is traded in over-the-counter markets. It is understanding that transactions in over-the-counter markets occur in private; thus, they are largely opaque. It is conceivable that opaqueness may create informational asymmetries, information asymmetries in turn can lead to bargaining problems.[973]

It has been proved that a variant of empty governance problem can occur in UK Insolvency system. Some distressed debt investors have taken insolvency proceedings which were developed as mechanisms of last resort to facilitate an efficient realisation of the assets in the collective interest of the creditors to distort the distributional principles (i.e. achieving short-term fixes to write off liabilities, value extraction from other claims). However, it would be a mistake to assume that market-led contractual solutions would be the panacea. Such solutions do not (sufficiently) address the interests of some weak stakeholders such

[972] Robert D. Cooter and Thomas Ulen, *'Law& Economics'* (6th edn, Pearson 2014) 71
[973] Ronald M. Giammarino, 'The Resolution of Financial Distress' (1989) 2 Review of Financial Studies, 25,27.

as unsecured creditors who lack sufficient information and bargaining power to exercise control or improve their protection.[974] The debtor company itself lack the bargaining power to negotiate transfer restrictions in their loan agreements so as in a distressed scenario an existing lender cannot transfer its control rights to an investor whose agenda are not aligned with the company.

[974] In the form of adjustment to the price of the contract or a security interest to reflect the risk of a debtor's default.

Chapter Eight: Proposals for Reforms

8.1 Introduction

The advent of distressed debt investors, the re-examination of efficiency of the current safeguards, and the exploration of the market-led solutions reveal the underlying weaknesses of the insolvency system to assimilate the new challenges and underscores the need for reform.

Such a reality raised the need to protect the interests of the weak stakeholders in insolvency, namely preferential and unsecured creditors and the need to enhance public confidence in the integrity of the insolvency system. The transfer or diverting of wealth from vulnerable to sophisticated creditors in insolvency cases is comparable to illegitimate unfair wealth transfers from creditors to shareholders in solvent companies, a practice that has long been disapproved of and deliberately proposed as one of the foundations of modern company law.[975] When purchasing debt for control purposes in insolvency cases, distressed debt investors adopt tactics used by investors known as 'corporate raiders' to initiate takeovers of solvent companies. Paradoxically, significantly greater protection is put in place for minority shareholders in the target company by takeover regulations than those exists for vulnerable unsecured creditors in the context of debt-based takeovers.[976] In fact, the protection provided for vulnerable unsecured creditors in a debt-based takeovers pursued through the administration process is relatively modest. However, reforms should not inhibit the distressed debt market operation. Any reforms should not frustrate the ability of creditors to sell their claims by imposing requirements that would restrict trading in claims.

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[975] Directive 2004/25/EC

[976] See for example the protection provided by The City Code on Takeovers and Mergers and Directive 2004/25/EC

A balance between the facilitating a ready market for claims trading and protecting the interests of weak stakeholders is achievable.

8.2 Introducing Additional Rigorous Safeguards in Lender-led Prepacks.

Critics have always questioned the on the legality of the pre-pack administration and raised doubts on its benefits.[977] However, courts have long accepted the legitimacy of the practice[978] and the government appears committed to keep it within the corporate insolvency law toolbox.[979] However, to improve the reputation of practice and assuage the concerns of disenfranchised creditors, several reports into the use of pre-packs were commissioned over the last decade and after each report a set of reforms were introduced. The sale of distressed businesses to connected persons was at the centre of these rounds of reports and regulatory responses. This is because the lack of competitive marketing of connected pre-pack sales exacerbates the plight of unsecured creditors, combined with evidence that businesses emerging from connected-party pre-packs perform poorly and relapse in insolvency again at a higher rate than those purchased by third parties.[980] To alleviate the double whammy usually felt by disfranchised creditors, a series of measures were introduced within the Small Business, Enterprise and Employment Act ('SBEEA') 2015.[981]

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[977] Jon Moulton, 'The Uncomfortable Edge of Propriety - Pre-packs or Just Stitch-ups?' (Spring 2005) Recovery 2; Martin Ellis, 'The Thin Line in the Sand Pre-Packs and Phoenixes', Recovery, (Spring 2006),3; Peter Walton, 'Pre-packaged Administration – Trick or Treat?' (2006)113 Insolvency Intelligence, 114.

[978] See *T&D Industries Plc* [2001] 1 WLR 646; *Transbus International Ltd* [2004] EWHC 932 (Ch), [2004] All ER 911; *DKLL Solicitors* [2007] EWHC 2067 (Ch)

[979] Despite the widespread concerns about the propriety of pre-packs, Theresa Graham emphasized the value of retaining pre-packs within the UK's insolvency landscape, for more on the justifications for this see Graham Report (n548)

[980] Ibid

[981] Small Business Enterprise and Employment Act 2015

8.2.1 The establishment of the pre-pack pool: The flaws of relying on voluntary compliance

The creation of a body of independent professionals with relevant experience to review and opine upon the reasonableness of the decision to pre-pack, called the Pre-pack Pool was one of these measures introduced under the SBEEA 2015. The referral to the Pool, was only for sales to connected parties. This is because connected sales in prepacks as mentioned above were correlated with significantly lower returns to unsecured creditors and lower post-rescue survival rates than sales to non-connected parties.[982] However, the referral to the Pool was merely voluntary and imposed prohibitive costs on parties. For these reasons, the referral rate was low even with evidence on the increasing frequency of connected party pre-packs.[983]

Criticism towards the practice has become even more intense and the Pool clearly failed to refute negative perceptions about it or improve its transparency to mollify disaffected creditors.[984]A new report was later commissioned by the Insolvency Service to address these shortcomings.[985] Following this, new regulatory reforms have been introduced in the law.[986]

8.2.2 From Voluntary to Mandatory Compliance

The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 were introduced. Accordingly, it prohibits administrators from disposing all or a substantial

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[982] Graham Report (n548) [7.53] – [7.56] and [7.88] – [7.90]
[983] PrePack Pool, 'Annual Review 2017' (May 2018) 6 <https://www.prepackpool.co.uk/uploads/files/documents/Prepack-Pool-Annual-Review-2017.pdf> accessed 22 November 2022
[984] Vaccari(n659)617; Max Goldbart, 'The Pool is struggling to sell the idea of 'good' pre-packs' Printweek (London,24 April 2017) https://www.printweek.com/content/briefing/the-pool-is-struggling-to-sell-the-idea-of-good-pre-packs/ accessed 12/01/2024.
[985] The Insolvency Service, "Prepack Sales in Administration Report 2020 (Pre-pack Report 2020)" <www.gov.uk/government/publications/pre-pack-sales-in-administration/pre-pack-sales-in-administration-report> accessed 22Novmber 2022.
[986] The Administration (Restrictions on Disposal etc to Connected Persons) Regulations 2021 (Administration Regulations 2021)

part of a company's business or assets to a person with previous connections to the company within the first eight weeks of the administration's commencement unless they have obtained either pre-disposal approval from creditors or a qualifying report from an independent third-party evaluator.[987] The reasoning behind the eight-week period appears to be based on the idea that this timeframe allows other potential buyers to become aware of the administration process. During this window, these parties can submit alternative and competitive offers for the business and its assets. This, in turn, creates competitive tension, potentially helping administrators achieve the maximum possible value for the distressed business.

It is important to note that despite the proposals were initially brought in with the aim of addressing the lack of transparency and improving public perceptions and confidence in the connected party pre-pack administration sales, the regulations went further to cover all connected party administration sales. Moreover, to obtain creditor approval, an administrator has to prepare and put a proposal, detailing the grounds for the substantial disposal of the company's assets to the creditors who then vote whether to accept, reject or recommend modifications to the proposal.[988] This must be also accompanied by an invitation for a meeting to be held at least 14 days after the proposals are sent.[989]

The administrator is bound by the decision of the creditors and faces the risk of a hold-up problem, which could lead to adverse publicity, delays in completing the transaction, or a reduction in the value of the company's assets. This, in turn, would undermine and run contrary to the underlying purpose of a pre-pack. The popularity of the pre-pack sale is attributed to its benefits of reducing the circle of cooperation of parties involved in the

[987] Administration Regulations 2021, r 1
[988] Administration Regulations 2021, r 4(2)(a).
[989] Administration Regulations 2021, r 4(2)(a).

insolvency scenario and the subsequent difficulties in reaching an agreement, speediness, certainty, the confidential nature, business efficiency in the sense of keeping legal and professional costs at low levels, preserving their going concern value and goodwill.[990]

The only viable and realistic option is to obtain a qualifying report from an independent, third-party evaluator. In this sense, the new regulations effectively replace the existing voluntary referral mechanism of the pre-pack pool with a mandatory one. As a result, the number of referrals to new the mechanism has increased dramatically.[991]

Under the previous regime the Pool can issue one of three opinions: (1) The pre-pack is not unreasonable; (2) The case for a pre-pack is not unreasonable but there are minor limitations in the evidence provided; or (3) The case for a pre-pack hasn't been made. The Pool had no power to block a pre-pack sale from going forward, even in situations where the Pool's report indicated that a case was not made.[992] Unlike referrals to the Pre-pack Pool, which focused solely on providing an explanation and justifications of the reasons why the applicants considered the pre-pack to be the best outcome, the Administration Regulations 2021 require the evaluator to determine whether the decision to pre-pack and the consideration paid for the business are reasonable.[993] This approach would require a consideration of the deal, including, most importantly, the valuation question, which is at the heart of pre-pack disquiet.

However, similar to the previous regime, the administrators can still proceed with the disposal even where the evaluator makes a statement that he is not satisfied that the

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[990] Frisby (n106)
[991] Pre Pack Pool, "Annual Review 2016" [2017] https://www.prepackpool.co.uk/uploads/files/documents/Prepack%20Pool%20Annual%20Review%202016-17.pdf [Accessed 11 July 2022] ; Pre-Pack Pool, "Annual Review 2017" [2018] https://www.prepackpool.co.uk/uploads/files/documents/Prepack-Pool-Annual-Review-2017.pdf [Accessed 11 Julu 2022]
[992] Vaccari (n492)177
[993] Administration Regulations 2021, r 7(h)(i); Insolvency Service Guidance 2021, s 8

consideration to be provided for the company's assets and the grounds for the substantial disposal are reasonable.[994] All what required is that the administrator explains his rationale for ignoring a negative opinion in a statement to the creditors. This further incentivises practitioners to use the qualifying report route and avoid the publicly transparent creditor approval route which provides more time for disaffected creditors to scrutinise and challenge the reasons for, and the terms of the proposed deal. This can be seen as a reflection of the long-established deference, which has always been demonstrated by UK insolvency law, to the professional and commercial judgment of insolvency practitioners.[995]

There is no appeal mechanism against the evaluator's decision and this system can encourage parties to find a more favourable report, leaving the process open to opinion forum shopping. More importantly, the scope of the definition of connected parties includes any person entitled to exercise control over the distressed company such as directors and managers of and their relatives, and companies associated with the pre-administration company. Secured creditors favour such sales because they are assured of a high-level control and low-cost route to a swift and full recovery. Secured creditors may prefer pre-packs to ensure minimisation of prejudice and costs to unsecured creditors even if the receiverships or standard administrations would enhance their own returns.[996]

> ''It is submitted that secured creditors have a vested interest to prevent an abuse of process, as they can significantly benefit from successful pre-pack proceedings. Pre-packs appear to be a 'controlled way forward' for secured creditors and one could argue that banks in particular, are very well placed, due to their experience and vast range of resources, to provide advice on the

[994] Bolanle Adebola, 'Transforming Perceptions: The Development of Pre-pack Regulations in England and Wales'(2023)43 Oxford Journal of Legal Studies 150

[995] The Insolvency Service, 'Report on the First Six Months' Operation of Statement of Insolvency Practice 16' http://webarchive.nationalarchives.gov.uk/+/http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/policychange/sip16-final.pdf, accessed on 22/08/2023

[996] Insolvency Service, Productivity and Enterprise: Insolvency – A Second Chance (HMSO 2001) 2.5

> viability of a rescue business plan and to positively influence the outcomes of a pre-pack administration proceeding''

Much of the debate on pre-pack sales focused on manager and previous owners led-ones. The attention accorded could have varying reasons but can majorly be seen to the high incidence of such tactic. However, pre-pack sales to secured lenders or lender-led pre-packs which are utilised to pursue debt for equity swap have attracted comparably less attention and therefore, are not caught by the Regulations. Pre-pack sales to secured lenders – despite being relatively small in number – pose more significant problems than sales to directors and managers and their relatives. Secured distressed debt investors with ownership agenda are not motivated by a desire to ensure a swift and full recovery for their claims or minimise the prejudice. They have a strong incentive to utilise the pre-pack sale to chill bidding and depress the value of the assets, to end up with eventual ownership of business, leading to a problem of 'undervalue transactions'.

Recidivism is a matter of concern in pre-pack sales to previous owners and management.[997]The causes of corporate failure are diverse, and some can be attributed to the manager-owners of the company.[998] However, manager-owners cannot control external economic forces that may contribute to a company's failure, such as a general economic downturn, an industry-specific downturn, or prolonged strikes. But management may have the ability to deal with such issues and their implementation of a rescue strategy with the best chance for the company to trade successfully again may depend on their specific skills. Thay may have, financially speaking, skin in the game. In essence, they are likely to ensure the continuity of business which they built from the scratch and on which their livelihood

[997] Wolverhampton report (n505), Figure 21

[998] Evidence from surveys completed by insolvency practitioners showing poor management as one of the primary causes of financial hardship of companies proposing CVAs to restructure their debt. Naresh Pandit, Garry Cook, David Milman and Francis Chittenden, 'Corporate Rescue: Empirical Evidence On Company Voluntary Arrangements And Small Firms' (2000) 7 Journal of Small Business and Enterprise Development 241

depends on.[999] However, owners may be deterred by the risk of (potentially) losing their means of livelihood and prefer to continue trading without making use of informal insolvency proceedings (e.g. seeking help from outside internal management). When the company is given a second chance, they might put in place an overly optimistic rescue plan and accept the challenge of returning the company to health even when the company is economically distressed and its business is unviable.[1000] Empirical evidence provides support for the argument that businesses sold to connected parties are much more likely to fail within the subsequent few years in contrast to those sold to non-connected parties - a failure rate documented by recent study 30% compared to 18.4% within the subsequent 36 months.[1001] closely similar to a previous rate of 48.6% compared to 28.5% within the subsequent 36 months.[1002]

Pre-pack sales to secured creditors (e.g. distressed debt investors) raise similar concerns. Customers, essential suppliers, and employees may be reluctant to continue trading with or working for a business once it is taken over by distressed debt investors. This hesitation arises from the concern that these investors may prioritise short-term financial gains over the long-term stability of the business. They may, for instance, burden the newly acquired company with excessive debt to extract dividends, potentially compromising the company's future viability.[1003] The debt incurred to finance the acquisition may weigh heavily on the company's balance sheet. The end result is that the company will collapse again into insolvency with employee's job termination, underfunded pensions, and further losses to suppliers and customers. There is so far limited empirical evidence of the subsequent failure rate of businesses sold through pre-packs to secured creditors. The reason for this is that

[999] Hahn(n506) 123.
[1000] Adebola (n109) 138
[1001] Walton and Umfreville (n548)
[1002] Frisby (n106)
[1003] Kaplan and Strömberg (n205)130.

distressed debt investors with ownership strategies are more likely to target large companies and the number of such transactions is relatively small. However, the impact and implications for a wide range of stakeholders is significant. It is worth nothing that large companies often employ a large number of employees and along with a substantial number of customer and supplier relationships.[1004] Interestingly, anecdotal evidence supports the foregoing argument.

Transform Hospital Group was one of the UK leading providers of medical aesthetic and cosmetic surgery. It commenced human health business activities in 1974 and operated 26 clinics and two hospitals across the UK with 355 staff in 2012. By 2014, the company's fortunes deteriorated due to a controversy surrounding defective cheap, non-medical silicone used in enlargement procedures and accusations of acting negligently and faced significant claims from former patients.[1005] Transform's financial difficulties presented an opportunity for distressed debt investors that purchased the company's secured debt and pursued a debt for equity swap through a pre-pack administration on 30 June 2015. However, the company continued to lose customers' confidence under the new owners, eventually collapsing into administration on October 18, 2022.[1006] It was subsequently sold again through a pre-pack arrangement. Such cases often attract negative media attention,[1007] undermining public

[1004] large companies employed over nine 9.3 million people in 202339% of the U.K.'s workforce and contributed about 48% of the country's GDP, Department for Business, Energy & Industrial Strategy, "Business population estimates for the UK and regions 2023: statistical release", 11 October 2023. Online:https://www.gov.uk/government/statistics/business-population-estimates-2023/business-population-estimates-for-the-uk-and-regions-2023-statistical-release accessed 21 January 2024.

[1005] TRANSFORM MEDICAL GROUP (CS) LIMITED, Statement of administrator's proposal. available https://find-and-update.company-information.service.gov.uk/company/03228476/filing-history?page=2 accessed on 13/12/2022

[1006] THGL REALISATIONS LIMITED, Statement of administrator's proposal (Companies House, 26 Oct 2022) Available at https://find-and-update.company-information.service.gov.uk/company/11932035/filing-history accessed on 12/12/2022

[1007] See for example, Adam Lusher, 'Women left in pain by 'botched cosmetic surgery' fear losing compensation as firms fold' The Independent, (London,05 November 2016) https://www.independent.co.uk/life-style/health-and-families/health-news/cosmetic-surgery-gone-wrong-plastic-surgery-disasters-the-hospital-group-in-administration-compensation-battles-bankrupt-transform-dawn-knight-kevan-jones-a7388646.html accessed on 14/10/2022 confidence in the integrity of the insolvency system and damaging the reputations of its practitioners.

This thesis argues for the strengthening the of evaluators' powers and the extension of their role to cover lender-led prepacks. To achieve this end, the administrator should be bound by the evaluator's decisions. The evaluator should be given the power to request additional information from the administrator, debtor and purchaser and to consult with all interested parties, if and when it is deemed appropriate to do so. Given that distressed debt investors are sophisticated, repeat players, and are likely to have influence regarding the identity of the evaluator. An evaluator may have to act in favour of their interests to gain future appointments (e.g. supporting a low valuation for the company's business). Parties who feel disenfranchised should be able to demand full transparency from evaluators regarding reasons for coming to their opinion and the parties and the evaluator should be further empowered to refer cases of any suspected abusive and opportunistic behaviour or misconduct to the Insolvency Service. Parties should be allowed to challenge the evaluator's opinion on a proposed pre-pack administration in court.

Evaluators should be empowered to assess the commercial viability of the business. To achieve this end, the suggestion is that he may engage in wide consultations with the wider market and all interested parties. Having acquired a set of valuable information, he will be in a position to make a final evaluation as to the financial viability of the business. If a distressed business shows fundamental signs of distress with no possibility of returning back to health. For example, the unwillingness of suppliers and customer to continue dealing with company or the absence of a suitably motivated workforce, or worthwhile products to survive in a competitive environment or when the business suffered a loss of confidence and it is impossible to restore it. Evaluator may take into consideration what measures might be taken by the purchasers to address the problems (e.g. the merits and demerits of the rescue plan). The pre-pack sale may just delay the inevitable process of liquidation and liquidation would be the best course of action to avoid to further loss of value. The evaluator may argue for a rapid conversion to liquidation proceedings. This in turn, would improve outcomes for stakeholders, enhance public confidence in the integrity of the insolvency system.

8.2.3 Further Justifications for the Imposition of Additional Safeguards in the Lender-led pre-packs

Introducing additional rigorous safeguards in pre-packs and in the lender-prepacks to provide a strong response to a serious problem does not undermine the primary advantages of prepacks including the speed and costs. Support for this stems from the premise that in the US, prepacks have long been praised by both practitioners and researchers as a superior, fast, efficient, and reasonably inexpensive alternative to the conventional route of Chapter 11 and other purely contractual arrangements.[1008] However, the sale process is subject to a great level of court scrutiny. Although the bankruptcy code's requirements of sale pursuant to section 363 does not explicitly impose a court approval or an auction. In practice, pre-pack sales typically involve court approval.

It is true that courts often approve sales upon a showing that the sale is justified by either a 'good business reason', the creditors' Committee's favour for the sale, [1009] the need to curtail the deterioration of the company's viability and its going concern value, or even the liquidation value of its assets.[1010] However, the likelihood of judicial approval increases in cases where the sale is negotiated and consensually agreed by senior secured creditor and the official committee of unsecured creditors and no or limited objection to the sale is raised

[1008] Bebchuk(n155)780; Robert G. Hansen and Randall S. Thomas, 'Auctions in bankruptcy: theoretical analysis and practical guidance'(1998) 18International Review of Law and Economics, Elsevier,159,161
[1009] *In re Lionel Corp*., 722 F2d 1063 (C.A.N.Y.,1983)
[1010] *Re On-Site Sourcing*, Inc., 412 BR 817 (Bankr ED Va 2009); *re Chrysler LLC*, 576 F.3d 108 (2d Cir 2009)

by other involved parties. To limit appellate review of the sale, a buyer would attempt to obtain the consent of major creditors and assuage the concerns of other constituencies before presenting the sale to the court.

It is a common practice for the creditors' committee to request a formal role in the process, and the purchase sale agreement often accommodate this demand. Conversely, the court is unlikely to lend its authority to a sale where the benefits primarily flow to the powerful secured creditors, while less powerful creditors bear the brunt of the losses resulting from the debtor's insolvency.[1011] The court must also ensure that interested parties, including all creditors, the unsecured creditors' committee and all contractual claimants are given the necessary notices of the debtor company's intention to conduct the auction process. Essentially, the notice must indicate the applicable deadlines and procedures. Consequently, the stakeholders can conduct a review of the purchase deal and scrutinise and challenge its terms if and when they think it is appropriate to do so.[1012]

The court cannot approve the sale unless all objections lodged to the proposed sale are resolved consensually by the parties or overruled by the court. A debtor may use Chapter 11 plan of reorganisation as a *façade* to disguise 363 sales. The courts have long refused to recognise the validity of such transactions because the requirements of stakeholder participation and their fair treatment for confirmation of a plan reflect the fundamental values and principles underlying Chapter 11. A sale of assets pursuant to section 363, which is specially designed for exceptional circumstances, does not impose such procedural protections, and therefore, cannot serve as a substitute for a Chapter 11 plan.[1013]

[1011] *In re Gulf Coast Oil Corp.*, 404 B.R. 407, 428 (Bankr. S.D. Tex. 2009)
[1012] Alla Raykin, 'Section 363 Sales: Mooting Due Process' (2012) 29 Emory Bankr Dev J 91
[1013] *In re Braniff Airways*, 700 F.2d 935 (5th Cir. 1983)

The business being sold is usually exposed to the market for an appropriate period of time under the court's supervision. In this way, the debtor and its creditors can test the market and ensure the sale price reflects the 'highest and best offer'. To achieve this end, auctions are organised in two phases. First, a competitive auction outside of bankruptcy is held to obtain a stalking-horse bid. It is also typical for the company to negotiate a form of asset purchase agreement that specifies an expense reimbursement provision in the event of the staking horse is outbid, a bid minimum, and a break-up fee with the stalking-horse bidder. This means that the company enters into Chapter 11 with a predetermined stalking-horse bid and a defined set of bidding procedures. The second auction, where topping bids are solicited, takes place after the insolvency filing and is therefore conducted under court supervision with the involvement of creditors. The court may approve the sale without conducting a formal auction. Nonetheless, in such a situation, the court may conduct a fact- and circumstance-intensive inquiry into the sale instead.[1014]

More importantly, transactions in which a proposed purchaser is an insider or a person with a fiduciary relationship to a company (connected sales) attract a greater level of court scrutiny. The prevailing attitude of the courts is to decline approval of section 363 sales to an affiliate, fiduciary, or insider with evidence of conflicts of interest and self-dealing between the proposed purchaser and the debtor's management,[1015] or lack of proof and the inability to demonstrate good faith on the part of the prospective purchaser. Although the Bankruptcy Code does not clearly define what constitutes as 'good faith' or 'bad faith'. Reported case law provides substantive guidance. For example, arrangements between a prospective buyer and the debtor's directors, where the directors are granted equity and assured continued employment in the new company after the sale, in return for manipulating

[1014] *In re Sears Holdings Corp*., No. 18-23538-rdd
[1015] *In re Bidermann Industries U.S.A*., Inc 203 B.R. 547 (Bankr. S.D.N.Y. 1997)

the timing of the insolvency filing to hinder genuine competitive bidding, create a clear conflict of interest. Such actions favour the directors' gain and breach the principle of good faith.[1016] Similarly, a collusive agreement inferred from the circumstances—among potential bidders to control the asset price or diminish the value of the estate that could be generated through competitive bidding—constitutes bad faith. This may warrant the disapproval of a sale, the avoidance of an approved sale, or the pursuit of damages from the bidder.[1017]

In a 363 sale, the debtor's assets are transferred to the purchaser 'free and clear' of any interest with such interests to attach to the proceeds of the sale instead. This means that the debtor ceases to exist and the rights of stakeholders against it are terminated and their only recourse would be a satisfaction of their claims from the sale proceeds. However, the purchaser may voluntarily agree to assume some of the seller's liabilities. A purchaser might be also held liable -by operation of law- for certain claims arising from the operation of the purchased assets prior to the sale. The court may apply 'the successor liability doctrine' according to which a purchaser's liability for certain claims such as post-sale injuries caused by defects in products manufactured and sold before the 363 sales will not be extinguished.[1018] For instance, In *re Motors Liquidation*, the court held that customers whose interests were harmed by defective General Motors cars sold prior to the closing of the 363 sale should have access to an equitable remedy via the successor liability doctrine because the insolvency case was a 'sleight-of-hand' transaction that allowed the company to shed pre-sale liabilities and buy back the business.[1019] Similarly, in In *re Grumman Olson Industries Inc*, the court held that the victims' claims caused by defective products that had been manufactured and sold before the insolvency cannot be extinguished by the sale. This

[1016] *In re Abbotts Dairies of Pennsylvania* 788 F.2d 143 (3d Cir. 1986)
[1017] *In re Sunnyside Timber*, LLC), 413 B.R. 352, 363 (Bankr. W.D. La. 2009)
[1018] *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003).
[1019] *In re Motors Liquidation* 829 F.3d 135 (2d Cir. 2016), cert. denied, 137 S. Ct. 1813 (2017)

is because it would have been impossible to *ex ante* anticipate the existence of the plaintiffs' claim. Striping them of the right to seek redress would violate their due process rights. The court emphasised that the victims lacked notice or an opportunity to participate in the proceedings leading to the sale order. Consequently, the court ruled that the sale order did not extinguish the victims' claims for post-sale injuries, even though these injuries were linked to defective products produced and sold before the bankruptcy proceedings.[1020]

Sales under Section 363 cannot be done quietly and this makes it less susceptible to manipulation and increases the likelihood of an arm's-length fair value transaction. Courts have over the years developed means of and deterring abusive and value-destructive behaviours, and unfair dealing. Attempts to circumvent the protections enshrined in law for the benefit of vulnerable stakeholders are therefore, detected and thwarted.

Section 363 sales to secured creditors are of particular importance to courts. Courts apply a heightened standard of review to transactions in which a proposed purchaser is the secured creditor[s]. The greater level of scrutiny and inquiry reflect the risk of various forms of abuse and the possible value extraction or destructive tendencies that may be orchestrated by distress- investors. Secured creditors can exert great influence over troubled borrowers both inside and outside of insolvency. Secured creditors using debt-based takeover strategies have a strong incentive to exert considerable influence over the insolvency process. They may seek to expedite the process, conceal information from other stakeholders, and exclude other bidders. These tactics allow them to convert their debt into ownership of the company at a favourable price, without having to share ownership with other stakeholders. In the *Sears bankruptcy*, the only bid for the assets was a credit bid from an insider, holding 49% of Sears' equity and much of its secured debt. The court approved the credit bid, but only after

[1020] *In re Grumman Olson Industries Inc* 467 B.R. 694 (S.D.N.Y. 2012) an extensive investigation conducted by the debtors and the creditors' committee, and a multi-day hearing.[1021]

In *re Fisker Automotive Holdings*, the holder of a secured loan who acquired the debt at a steep discount took action with the intention to conduct a 'hurried sale process' through use of a credit bid, the court was satisfied that the intention behind this problematic conduct was to freeze out other bidders. As a result, the court capped the credit bid at the price the holder had paid for the loan, and ordered a competitive auction; Fisker was ultimately sold to another bidder.[1022] In *Free Lance-Star Publishing*, the right of a potential acquiror to credit bid using a claim that it had acquired at a discount as part of a loan-to-own strategy was limited by the court to restore enthusiasm for the sale and foster a robust bidding process.[1023] In both cases, the disappointed credit bidder was refused leave to take an immediate appeal.

It is clear why this research believes that the pre-pack pool's functions should be strengthed further and extended to include exercising oversight over lender-led pre-packs.

8.3. The Need to Regulate the Shareholder Loans Phenomenon

Distressed debt investors with the goal of influencing the insolvency process to emerge as an owner of the target company may identify and purchase a concentrated position, often in a 'fulcrum' security or provide the most needed fresh capital. Such involvement may occur during the insolvency process or before the commencement of insolvency proceedings. In this sense, distressed debt investors force a change of control on the company's owners or management. However, some takeovers of distressed businesses launched via the (friendly) bids with the consent of the current owners. Distressed debt investors may also buy

[1021] *In re Sears Holdings Corporation* (Bankr. S.D.N.Y. 2019)
[1022] *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 61 (Bankr. D. Del. 2014)
[1023] *In re The Free Lance-Star Publ'g Co.*, 512 B.R. 798, 814 (Bankr. E.D. Va. 2014)

distressed business out of administration without exerting influence during the insolvency process.

Regardless the hostility or friendliness characteristic of the takeover, distressed debt investors will identify the cause of distress and depends on the extent of and the source of distress, a recovery plan is designed. Fundamental changes in governance and capital structure, the employment of a suitably motivated workforce, skilfull marketing, cost cutting measures are extremely common elements of a sound recovery plan. However, critical to this turnaround strategy and this business model is the availability of new financing.[1024] The company may re-enter the debt markets and raise debt again. However, distressed debt investors are characterised by their vast resources and significant cash reserves; therefore, it is very likely that they would provide their newly owned company with the needed financing. New funds provided by the new shareholders enters the capital structure as equity and return on such contribution, in the form of dividends or an increase in the share value, is dependent on the success of the company. However, there is a growing trend towards dressing such contribution of capital in the form of a loan rather than an equity. Return on such loans is a periodic payment of principal and interest, which usually secured by a floating charge. Principal and interest must be paid regardless the company's profitability or financial status (e.g. solvent, distressed) and failure to keep up or make a significant payment of principal or interest to the creditor is a breach of a covenant and therefore, an insolvency event, which triggers an insolvency procedure.

A problem of perverse incentives and behavioural distortions can arise in rescue attempts, where distressed debt investors may recklessly undertake risky investments, overestimate the chances of success, or overinvest in non-viable undertakings. Despite having access to

[1024] Adebola (n109)139

accurate and updated information, they may conceal the plan's unviability and delay the initiation of the insolvency process to maximise interest payments, thereby diverting value from other vulnerable creditors. The investor is entitled by operation of his security, to recall their loans in full, ahead of other creditors. As Weijs put it 'if the shareholder is really fully secured, he can make an investment from which he can only profit and as to which the downside is fully borne by other parties'. This clearly runs contrary to the longstanding principle of 'equity is wiped out first'.[1025]

Protection of the creditors' entitlements is at the heart of insolvency law. In fact, all insolvency scholars have generally agreed with insolvency law's function in maximising the collective return to creditors.[1026] If the company is financed by means of shareholder loans, this means that insolvency law exists to serve the interest of shareholders. This clearly undermines the fundamental values and the normative aims of insolvency law, and provides the justifications for the desirability of the imposition of regulatory – and often mandatory- mechanisms to restore the insolvency law's role. In the US,[1027] Germany,[1028] and several other countries, there are legal mechanisms in place aimed either for the subordination of shareholder loans to the debt provided by external creditors. Thus, security rights for such loans are not enforceable and payment on these loans will only be made after the satisfaction of all claims submitted by creditors, or recharacterization of such loans into equity.

An acute version of this problem exists in the UK. In insolvency scenarios, such investors, as secured creditors, are given significant control over the insolvency process, allowing them to appoint an administrator of their choice, [1029] decide the procedure (i.e., administration or

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[1025] Weijs (n744) 420
[1026] Jackson (n147) 64
[1027] The Doctrine of Equitable Subordination *In re Mobile Steel Co*., 563 F.2d 692, 701 (5th Cir. 1977); *Diasonics, Inc. v. Ingalls*,121 B.R. 626 (Bankr. N.D. Fla. 1990); *In re Vietri Homes, Inc*., 58 B.R. 663, 665 (Bankr. D. Del. 1986) and the Doctrine of Recharacterization 11 USC s 510(c)
[1028] Insolvenzordnung (InsO – German Insolvency Code) s 39
[1029] IA 1986, Sch B1, Para 2.

pre-pack), choose the buyer, and determine the valuation method and purchase price. However, the legislation is silent as to how shareholder loans are treated.

There is a need to introduce a mechanism that restore the insolvency law's conventional role, address the threat of insider manipulation, and protect the weakest stakeholders in insolvency scenarios and out of court debt restructuring. Such mechanism can be closely modelled on the discretionary subordination rules or automatic subordination rules.

8.3.1. Selective Subordination: The Case of US

US law provides rules on subordination, with two basic doctrines. Equitable subordination and recharacterization. Equitable subordination is a consequence of inequitable conduct of a controlling shareholder towards his corporation. Because the shareholder has treated his corporation unfairly, usually by causing it to transfer an unjustified benefit, all of his outstanding claims against the corporation may be subordinated to the claims of other creditors, regardless of whether these claims are the result of the inequitable conduct. The remedy has been developed by the Court of Appeals of the 5th Circuit in *re Mobile Steel Co*[1030] and later codified by the bankruptcy law 1978.[1031]

One of the most important considerations in applying the above-mentioned factors is the debtor's capitalisation. If the shareholder has financed a generally undercapitalised company only by means of loans, this is an important element in coming to the conclusion that the shareholder acted inequitably towards the creditors. The burden of proof for inequitable conduct is lower than the burden of proof for tortious liability.[1032]

[1030] *Matter of Mobile Steel Co*., 563 F.2d 692 (5th Cir. 1977)
[1031] James H.M. Sprayregen and others, "Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine" (2004) 2 Annual Survey of Bankruptcy Law 1
[1032] R.J. de Weijs and Michael Good, 'Shareholders' and creditors' entitlements on insolvency: who wins where?'(2015) 30 Butterworths Journal of International Banking and Financial Law 642

Recharacterisation differs from ordinary subordination in two respects: it does not require a showing that the shareholder acted inequitably; and rather than simply being subordinated to other creditor claims, the shareholder's contribution is treated as equity. The court in the implementation of the rules may consider, among other things, the names given to the instruments, presence or absence of a fixed maturity date and payment schedule, presence or absence of fixed interest payments, adequacy or inadequacy of capitalization, security (or not) for the advances, the corporation's ability to obtain financing from outside lenders, the extent to which the advances were used to acquire capital assets.[1033]

8.3.2. Blanket Subordination: The Case of Germany

Austria provides for subordination, initially modelled on the old pre-2009 German law. This means that shareholder loans that would not have been granted by an outside arm's length creditor under the same conditions are subordinated.[1034] According to the now-abolished rules, only loans provided by a shareholder at the 'point of no return' are subordinated. The company is assumed to has reached that point and thus became financially distressed if it has satisfied either the cash flow test (no longer capable of paying their debts as they fall due) or balance sheet test (has total liabilities that exceed the value of its assets). Financially distressed company lacks creditworthiness and therefore, a third party would not have granted a loan to such a company. Although the creditworthiness criterion seems to be quite straightforward and easily applicable at first sight, in practice, it may create some unwanted difficulties. One of the problems with this criterion is that determining the 'point of no return' is fraught with difficulties. In fact, the meanings and content of the both the cash flow and the balance sheets tests of insolvency, and the way that they are applied is highly disputable and could lead to extensive judicial litigation. A company's financial status is not always a

[1033] Skeel Jr and Krause-Vilmar(n745) 205.
[1034] See Eigenkapitalersatz-Gesetz (Austrian Act on Capital Replacing Financing) s 1

good barometer that could be relied upon to reach a decision of whether to provide a loan the company.[1035]

A heavily indebted business may choose to purse or undertake new positive net value projects that would increase earnings and create value for the benefit of the creditors' claims and shareholder value. While such loans should be encouraged, the threat of recharacterisation of shareholders loans may act as a powerful deterrent for some shareholders who may willing to provide finance to their failing businesses when non-insiders are unwilling to do so. Besides the fact that willingness of an outside creditor to make a loan is also often very hard to determine or prove. This willingness is itself is a somewhat vague benchmark to measure against it whether a loan would enhance or destroy value. Outside creditors might be motivated by individual benefits (e.g. high interest rate that may be received from lending to a company 'unworthy' of credit.[1036]

In light of these flaws and concerns outlined above, Austria replaced the creditworthiness criterion with undercapitalization one.[1037] Instead of asking whether or not a well-informed external creditor would supply the company with a loan under the same conditions. A company is regarded as financially distressed and thus debt can be recharacterized into equity once its solvency ratio falls below 8%.[1038] The statutory thresholds prevent complex and lengthy analysis as to what third parties might or might not have done, which might cause a gridlock in court litigation. The limited use of judicial discretion also promotes legal uniformity and commercial predictability. However, the undercapitalization criterion is not free from criticism. The statutory thresholds in Austria can be considered significantly lower than the typical solvency requirements set by banks when extending credit to their debtors.

[1035] Gelter(n263) 481
[1036] Weijs and Good (n1038) 645
[1037] The Austrian Equity Repayment Act S 1
[1038] the Austrian Equity Repayment Act s 5,14

In essence, if the goal is to subordinate loans that would not have been approved by third parties, the Austrian rules should be seen as being more lenient rather than overly restrictive. Therefore, the 8% threshold in Austria can be characterized as favoring shareholders. In other words, the 8% threshold would usually result in decisions that the finance advanced by the shareholders are loans.

In 2009, German corporate law was extensively overhauled, in part, to encourage investment and economic growth. However, the overhaul included a revision of the shareholder loans rules and introduced an automatic subordination rule within insolvency law which, subject to few exceptions, will apply to all shareholder loans, regardless of their timing and whether or not the company was in distress.[1039] The subordination also applies to all companies irrespective of the legal form of the company and to all claims resulting from legal transactions which are comparable to a shareholder loan in economic terms. As a result, subordination will apply not only to companies incorporated under German law but also to foreign companies operating mainly or exclusively in Germany and to all claims resulting from circumstances in which a shareholder gave credit to its company in any form.[1040]

Since shareholder may prioritise the repayment of its loans prior to the initiation of the insolvency proceedings in a way that circumvent the blanket subordination rule, the insolvency administrator is empowered to claw-back payments made in satisfaction of a shareholder loan (or comparable claim) that were made within one year prior to the insolvency filing. Similarly, a shareholder may decide to induce a third party (e.g., related entity) to make the loan or the shareholder may make the loan and then assign it to a third party in order to circumvent the subordination rules. A shareholder may also transfer the

[1039] German Insolvency Code, sec. 39

[1040] Lars Weber, 'Treatment of shareholder loans under German Insolvency law'(April 2013) https://www.gvw.com/en/news/blog/detail/treatment-of-shareholder-loans-under-german-insolvency-law#:~:text=Under%20the%20new%20law%2C%20any,a%20financial%20crisis%20or%20not. accessed 08/01/2023 shares to a third party and keep the loan that he previously granted to the company. In response to these circumventing attempts, the German Federal Court of broadened the definition of a shareholder and on this basis subordinated loans, given by an affiliated companies that (directly and indirectly) controlled by the shareholder, to other creditor claims.[1041] The Court found that a loan given by a former shareholder is subordinated if the lender had been a shareholder of the company at any point within the one-year prior to the filing of insolvency.[1042] The Court also held that a loan assigned within one year prior to the filing for insolvency[1043] to a third party with no previous connection or control to the shareholder remains subordinated.[1044] In this case, because the company repaid the loan to the assignee within the one-year period, the court determined that the insolvency administrator had the right to claw back the repayment from both the assignee and the shareholder. As a result, the court held the assignee and the shareholder jointly and severally liable. This means that a shareholder could be held responsible for repaying a loan to an assignee, even if the shareholder did not participate in the repayment and didn't directly or indirectly benefit from it.

One can reasonably infer that the rule of subordination applies to almost every kind of shareholder loan (or comparable claim) in the event of insolvency. However, the German Insolvency Code, as mentioned above, formulated two exceptions, which also existed under the old rules. The first exception to the subordination rule applies to shareholders who are not directors of the company and do not hold more than 10% of the registered capital.[1045] This means that subordination typically applies to shareholders with significant influence on the company's management. The purpose is to facilitate financial support for companies in

[1041] BGH 21.2.2013 IX ZR 32/12; BGH 18.7.2013 IX ZR 219/11
[1042] BGH 15.11.2011 II ZR 6/11
[1043] German Insolvency Code, sec. 135
[1044] BGH 21.2.2013 IX ZR 32/12
[1045] German Insolvency Code, sec. 39

cases where a lender, such as a bank, holds a small stake in the company. The second exception comes into play during a rescue attempt by an investor who previously did not own shares in the company (or only held a small number falling under the first exception). If this investor acquires shares to rescue the company from a crisis, any loans granted before or in connection with acquiring the shares will not be subordinated. This exception serves as an incentive for rescue efforts by external investors.

8.3.3. What is the Best Option for the UK?

Having examined legal solutions to the hazards posed by shareholder loans, it is safe to recommend a legal framework modelled on the German automatic subordination of any kind of shareholder loans to fill in the legislative gaps. The introduction of the subordination rules will restore the insolvency law's functions as a law existing to protect creditor's interests and preserve the insolvency law core principles (absolute priority rule, collectivity and *pari passu* distribution). Blanket subordination rules will incentivise distressed debt investors to diagnose the cause of the failure, make a careful assessment of the chances for a company's recovery, draw up a viable business plan and monitor it until the distressed business is transformed into a profitable venture. Vice versa, in the absence of such rules, distressed debt investors have a strong incentive to gamble at the expense of the creditors and to delay the inevitable process of insolvency, and this of course is at odds or incompatible with the Insolvency law goal of incentivising parties to timely initiate the insolvency process.

The rationale behind the introduction of a blanket subordination rules, not only discretionary is the fact that dangers posed by shareholder loans tend to be more acute in the management displacing insolvency model employed in the traditional administration procedure and the extent of the secured creditors' power in pre-pack administration, to wit: shareholders-directors may postpone insolvency filing for fear that they will lose their job once administration proceedings are initiated. While in pre-pack administration, distressed debt investors shareholders stand on both sides of the transaction. Occupying conflicting positions is indeed a cause for concern. As the primary organisers of the transaction, they are not only lack incentives to maximise value, they have a strong incentive to depress sale prices by depriving competing bidders of information, carrying out limited marketing, and forcing speedy fire sales.

8.4. Addressing the Valuation Question

The barrier to the opening of formal insolvency procedures is low. An administration case is opened upon showing insolvency or likelihood of insolvency.[1046] Insolvency statutes do not define insolvency. However, as a guideline, two tests that if satisfied amounts to sufficient evidence for insolvency proceedings to be initiated. These tests are known as "cash flow" insolvency (unable to pay debt as they fall due) and 'balance sheet' (or asset) test insolvency. Of interest, a company is a balance sheet insolvent if it its total liabilities exceed the value of its assets. Contingent and prospective liabilities may be included in assessing whether the liabilities outweigh the amount of assets the company possesses. However, contingent and prospective assets cannot be taken into account.[1047] The statutory notion of 'liability' has a broader meaning than the notion of 'debt'.[1048] The lack of guidance on the time period considered for future liabilities is due to the case-specific nature of such assessments. The determination depends on the circumstances of each case. Similarly, when it comes to contingent liabilities, there is no specified level of probability required to

[1046] Insolvency Act 1986 ('IA 1986'), Sch. B1, para 11(a), as amended by the Enterprise Act 2002 ('EA 2002')

[1047] *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2011] EWCA Civ 227, [2011] 1 WLR 2524

[1048] *Re a Debtor* (No. 17 of 1966) [1967] Ch. 590, Pursuant to r.14.1(6) Insolvency Rules 2016 ('IR 2016'), the notion of "liability" includes 'any liability under an enactment, any liability for breach of trust, any liability in contract, tort or bailment, and any liability arising out of an obligation to make restitution'. According to r.14.1(5) IR 2016, it is immaterial whether the liability is present or future, certain or contingent, fixed, liquidated or subject to determination.

establish the existence of the debt arising from a future event. The degree of probability needed is not explicitly defined, leaving it open to interpretation based on the particulars of each situation.

The onus of proof of whether a company is insolvent or on the verge of becoming insolvent might be quite easy to establish. A company may be classified as insolvent and thus put into administration even if it is cash flow solvent (i.e. can pay its debts as they fall due).

The logic behind this is to ensure that a looming threat of insolvency is detected, diagnosed and treated at an early, rather than a late stage.[1049] Early intervention is paramount to the implementation of a successful recovery plan by which a viable company is returned to health(saved).[1050] Likewise, it increases the chance of preventing a raid on an unviable company's assets by the claimants and the consequences that follow in bankruptcy (e.g. the unnecessary depletion of the debtor's estate, strategic and administrative costs, and the 'free-rider risk'.[1051] Therefore, the value received on the sale of such companies is maximised for the benefit of all stakeholders.

However, the emphasis on the early intervention to the imminent insolvency has resulted in the approval of insolvency petitions in cases where there was no 'true' (i.e. cash flow or even balance sheet) insolvency.[1052] More importantly, once a company has entered administration,

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[1049] Cork Report (n267)
[1050] It is recognised by the R3 that the success of a rescue procedure largely hinges on elasticity and responsiveness for a company during the early stages of its distress. Therefore, enabling the company to take the decision of rescue before insolvency reduces the extent the company's exposure to failure and aids the rescue procedure to be swifter and potentially more successful. R3 – Association of Business Recovery Professional, 'Understanding Insolvency', October 2008, p.3 https://insolvency-online.co.uk/files/2018/12/understanding-insolvency-guide-r3-1.pdf accessed 12 December 2023
[1051] This is the basic problem that most bankruptcy laws are designed to handle, it has various names (e,g the chaotic race to the court problem, the common pool problem, the collective action problem, the problem of strategic actions of stakeholders, and the creditor coordination problem) Jackson(n78)
857.
[1052] Cases include *Re Casa Estates (UK) Ltd* (in liquidation.) [2013] EWHC 2371 (Ch) (where a company was declared insolvent because it used short-term loans to re-finance its debt); *Re Douglas Griggs Engineering Ltd* [1963] Ch. 19 (where a company was found insolvent on the basis of the absence of assets on which execution could be levied); *Re Lyric Club* [1892] 36 Sol. Jo. 801 (where insolvency was declared because the receivers for the debenture-holders had taken possession of all of the assets)

the question of valuation comes to the fore. Crucially, a valuation of the debtor's assets discerns whether a creditor or group of creditors have a remaining economic interest in the company and therefore, entitled to receive a distribution (e.g. equity in the newly organised company or a portion of the proceeds arising from the sale of the debtor's estate)

The market price of the assets is frequently used by courts and insolvency practitioners to assess the value of the debtor.[1053] If reorganisation is possible, creditors will swap their claims into new debt or equity. However, the allocation of equity is determined by reference to the amounts that creditors would have received if no reorganisation had been agreed. A failure to agree on the allocation of equity is likely to result in the debtor being sold to a third party on either a piecemeal or going concern basis. (i.e. the 'relevant alternative scenario'). Some evidence of exposure of the business and assets to the market have to be submitted to identify the value which would be achieved in this alternative scenario. Administration may also involve a real sale of assets to the highest bidder(s) followed by a distribution of the proceeds among the creditors according to their entitlements.

The price that a party is willing to pay does not necessarily reflect the actual price of the business. There is a consensus that a viable business has greater value as a going concern.[1054] However, markets may be sufficiently illiquid due to a general economic downturn, an industrial downturn, potential bidders may face difficulties in raise financing for the transaction, debtor/management may restrict information and lower the marketing quality to depress the price. Hence, there is always a risk of auctions at 'fire sale' prices, or, worse, on a break-up basis, which are equivalent to the liquidation value for companies which are not even insolvent or able to continue as a going concern in the short- to medium-term. Reliance

[1053] Vaccari(n119) 140

[1054] This objective capturing this going concern surplus is equivalent to the 'maximisation of value' objective which many scholars say insolvency law is essentially designed to achieve. Baird and Rasmussen(n377); Alan Schwartz, 'A Normative Theory of Business Bankruptcy' (2005) 91 Virginia Law Review 1199 on expert valuation evidence seems more appropriate in administration cases that imitated to affect a debt for-equity exchange or functionally equivalent sale transaction. Valuation experts apply one of three standard valuation methodologies to assess the value of the debtor. Namely, the DCF analysis, the comparable companies analysis and the comparable transactions analysis.[1055]

The DCF analysis starts by projecting future cash flows and subsequently applies a discount rate to these flows, resulting in the present value and providing an assessment of an asset's worth. The discount rate attempts to measure the opportunity cost of the capital from the investor's perspective, signifying the rate of return anticipated on alternative investments with comparable risk to the evaluated asset.[1056]

While the DCF method is theoretically sound, its practical implementation poses challenges due to the need for numerous assumptions that are intricate to assess. Forecasting future cash flows for an operational company involves intricate predictions about aspects such as sales growth, profit margins, capital expenditures, and working capital requirements. These projections are subject to debate, yet historical data can serve as a reasonable starting point for determining whether future projections are aggressive or conservative. For instance, if a company has consistently maintained gross margins at 30%, a model predicting future gross margins of 40% would necessitate an explanation from the expert regarding the anticipated changes in future circumstances.[1057]

The CCM and TM methods follow the same fundamentals of healthy businesses and are conducted in two steps. First, a group of comparable companies (or projects) that have size or form, assets, size of the workforce, failure risks, and growth and productivity comparable

[1055] Ayotte and Morrison (n146) 1829
[1056] Ibid 1830
[1057] Ibid 1831

to those of the target company are identified. In the CCM method, the enterprise value is determined by utilizing the market values of comparable publicly traded companies. Conversely, in the TM method, the valuation is based on the actual prices paid in acquisitions of comparable companies. In both approaches, the enterprise value of each comparable company is divided by a readily calculable metric of the company's size or profitability, such as revenues or EBITDA. This resulting ratio, known as a multiple, is then applied to the relevant data of the target company to derive an estimated enterprise value for the target.[1058]

CCM and TM as compared to DCF are often considered more straightforward to understand and give rise to fewer difficulties in application. These methods are similarly reliant on assumptions about the future success and the cash flow that it would be eventually generated, leverage, operational expenses and cost of finance of both the target and the comparable companies. Therefore, the slight difference is in the way in which these assumptions are constructed, they are made explicit in DCF but implicit in CCA and TM through the choice of comparable companies.

The validity of a CCM or TM estimate often are subject to different disputes. One area of dispute is whether the comparison group employed to derive the multiples is suitable. The appropriate denominator in the multiple is a matter of opinion, which there could be disagreement, whether a multiple of sales or EBITDA should be used to estimate enterprise value or whether the data from the comparable should be trailing (historical) values or forward (estimated future) value. There is a possibility of ex-post adjustments and revisions to the final valuation to correct differences between the target company and the comparable in terms of market risk, company-specific risks, firm size and industry. Therefore, deciding

[1058] Gilson, Hotchkiss, and Ruback(n702)46 what the company is worth through professional valuation opinions tend to involve large costs, delay, and complexities.[1059]

Moreover, the outcome of valuation remains uncertain and is difficult to predict. Valuation testimonies produced by experts are based on complicated forecasts and techniques and their implementation is a discretionary matter to be exercised by the court according to the individual merits of each case. Courts often approve ex-post adjustments even when an expert opposes them. Valuation testimonies can be subject to manipulations and bias as experts could be tempted to propose valuations, despite lacking reliable basis or evidence, in favour of their clients to engender future appointments. However, judges may fail to detect such manipulation attempts or as Ayotte and Morrison put it 'experts recommend, and judges approve'.[1060]

To avoid inconsistency, unpredictability, uncertainty and prolonged litigation. Parties often negotiate an out of court restructuring and settle their valuation disputes in the shadow of a judicial valuation.

> ''Where the parties bargain in the shadow of the law they seek to achieve an agreement by reference to what will happen if they fail to achieve agreement and they are forced to go to court''

Due to the uncertainty of predicting the valuation outcome, and the fear of extensive litigation, senior claimants will be willing to ignore the absolute priority rule and give a part of their share to junior claimants. This may also be preferable for junior claimants. They have obvious incentives to accept a settlement agreement and receive that part of share rather

[1059] Ibid 47
[1060] Ayotte and Morrison (n146) 1822

than run the risk of a valuation battle which could result in a determination that they are entitled to a lower distribution or nothing at all.[1061]

The administrator may conclude that a sale of business to its pre-distress stakeholders (e.g. shareholders or secured creditors) or to a third party would achieve a better result for creditors. In this situation, creditors' participation in the sales proceeds hinges upon the highest value bid received for the business. This means that the value of a debtor is not determined by some evidence of exposure of the debtor to the market (e.g auctions functioning as a 'staging post' to put a value on the debtor), but by an actual auction or a similar sales process.

There is an argument that the behaviour of the marketplace is the best indicator of enterprise value.[1062] Auctions are also procedurally fair and ensure predictability and replicability and a competitive auction strongly indicates that a purchaser has paid appropriate value for estate assets. However, the manner in which a sale process is structured and conducted typically has a significant impact on the final price. Parties may conduct fictitious or hasty auctions to chill bidding and depress the value of debtor.[1063]

More importantly, a sale may coincide with a general or industrial illiquidity. Notwithstanding that the administrator's duty to consider the interests of the creditors as a whole does not extend to postpone a sale in the hope of obtaining a higher price in the future. This brings the risk of the company's assets or business being sold cheaply and may lead to over-compensation of secured creditors at the expense of unsecured ones.[1064] A distressed debt investor with senior secured debt bought on the cheap have an incentive to sell the debtor's assets as quickly as possible because even if assets are sold at 'fire sale' prices

[1061] *In re Calpine*, No. 05-60200 (Bankr. S.D.N.Y. Dec. 20, 2005); Bebchuk(n155) 775
[1062] *Re Bluebrook ltd (aka IMO Carwash)* [2009] EWHC 2114 (Ch) [2010] B.C.C. 209
[1063] Vaccari (n119) 145
[1064] Shleifer and Vishny (n697) 1347

during economic or industrial downturn, they still can make a profit. Such sale will also ensure cheap ownership for distressed debt investors who use their full amount of claim as consideration for the purchase of the debtor's assets.

In addition to the great level of scrutiny that can be imposed by the pre-pack pool on the sale procedures and the price. The adoption of expert valuations in the reorganisation and restructuring cases or what referred to as the hypothetical sale of a distressed company to its pre-distress stakeholders, combined with empowering the administrator to delay a sale in real business sales to secure the best price possible. In this system of robust process, the perverse incentives of creditors are addressed and thus the position of unsecured creditors will be protected and improved and more importantly corporate rescue is promoted.

Support for this suggestion stems from the premise that the EA 2002 weakened the rights of secured creditor to enforce his security irrespective of the consequences to others. The new administration procedure was designed to be a collective procedure at which all the company's creditors can make their voices heard. The administrator has been assigned a duty of care to the general body of creditors and not only to his or her duty to the appointing creditor.[1065] In light of such complexity and uncertainty, the focus rested on the belief that the outcome of any insolvency case would become less predictable. This, in turn, stressed the need for early intervention, the need for incorporating warning signs of distress into lending contracts and the establishment of 'Business Support Teams', 'Specialised Lending Service Divisions' and other units within the banks at which corporate troubles is monitored, arising business issues are diagnosed, If the business is viable, a rescue strategy for turning the business around is proposed and an external expert is requested for its monitoring and implementation and upon the completion of the rescue strategy the business is transferred

[1065] Armour and Mokal (n6) 30

back to the branch.[1066] Similarly, there is a good reason to believe that in light of valuation uncertainty, and a greater level of scrutiny on the sale procedures and the price, distressed debt investors would also be incentivised to reach an agreement (e.g. restructuring, reorganisation) which accommodates the conflicting interests of all parties.

8.5. Improving the regulatory position of unsecured creditors.

Administrators are entrusted with wide discretionary power. So, they can conduct the affairs of the company as they please. This discretionary power extends not only to how the fate of the distressed company is being determined (e.g business sale, restructuring), but to how the interests of the creditors as a whole are being considered, and how the various insolvency legislation, rules and codes are being interpreted. Creditors are kept informed of by way of detailed reports along with justifications of why certain decisions and actions are made.[1067]

However, discretion gives rise to the possibility of power abuse,[1068] reinterpretation of aspects of the law beyond what was initially intended by parliament, and the creation of techniques that have no specific basis in insolvency legislation.[1069] Moreover, justifications are not always clear and concise. Administrators may favour strong/controlling parties at the expense of weak parties. Notwithstanding that it may sometimes be difficult if not impossible to mount a challenge on the actions or conduct of an administrator. Courts[1070] and the administrators' respective Recognised Professional Body[1071] are reluctant to interfere in the 'commercial decisions' made by administrators. The relevant codes of ethics contain their own flaws (i.e. fundamental lacking specificity and compliance). Unsecured

[1066] Finch(n87)
[1067] Gerard McCormack, Andrew Keay, and Sarah Brown, ' *European Insolvency Law Reform and Harmonization'*(1stedn, ElgarOnline,2017) 73-80
[1068] Jim Cousins and others(n596)
[1069] For example, pre-pack is not a creature of statute, the practice has been invented and developed by practitioners. Adebola(n994)
[1070] *Re T&D Industries Plc* [2000] 1 WLR 646
[1071] Wood (n591) 109.

creditors also lack financial resources, information, evidence, knowledge about insolvency process, and understanding of their rights. and their claims tend to be small so they have few voting rights and the costs often outweigh the benefits if they decide to initiate and pursue a claim against the administrator.

Insurance and trust mechanisms have been explored as part of the then Government's consultation on measures to provide additional protection for consumers. Insurance is often perceived as expensive. Considering that the majority of consumer claims are relatively low, there is a doubt about whether consumers would see it as advantageous to insure their claims. Moreover, even if consumers are not obligated to insure their claims, proposing that businesses offer insurance to unsecured would be economically burdensome. This is because businesses would be expected to pass the extra costs, incurred in providing insurance to their customers, to those same customers through higher prices. As a result, while the intention may be to assist vulnerable creditors, this could inadvertently worsen the problem. It has the potential to cause broader market repercussions by diminishing consumer confidence and possibly contributing to more business failures.[1072]

Trust-schemes are based on the notion that a certain amount of money is ring-fenced for unsecured creditors. A distinction should be drawn between the establishment of trust accounts by the debtor company and the creation of a trust financed by public funds. Regardless of the nature of the trust, setting up these trusts would increase the costs and legal complexity of administering insolvencies. In fact, they trigger some practical questions as how those trusts can be governed. leaving the governance of such trusts to businesses/debtors themselves poses problems of accountability.

[1072] See Department for Business, Energy and Industrial Strategy, Law Commission Report on Consumer Prepayments on Retailer Insolvency: Government Response (December 2018) 5 available at https://s3-eu-west-2.amazonaws.com/lawcom-prod storage11jsxou24uy7q/uploads/2016/07/law-commission-report-government-response.pdf.

The reliance on public trusts creates perverse incentives for opportunistic behaviour. Indeed, if the manager knows that the public will bear the consequences of failure and the disfranchised creditor will be repaid by the public funds, they will engage in enormous risks, speculate or gamble at the expense of the public purse, delay taking proactive steps to address causes of distress, postpone the inevitable insolvency of inefficient companies. This, of course, could reduce business standards and the public confidence in the integrity of the insolvency system.

Against the above disadvantages, public trusts can still deliver benefits for disfranchised creditors. In essence, they can be useful in helping disfranchised creditors, who lack sufficient financial resources, to finance insolvency litigation (e.g. hiring professional advisors, solicitors, valuers) This will indeed improve their engagement and ability to challenge IPs' decisions, and initiate claw-back procedures and and/or liability procedures.

Nonetheless, despite the merits of the suggestion, setting up public trusts to help unsecured creditors standing up to the value destructive tendencies that might be orchestrated by distressed debt investors have their own limitations, including the assertion that they give rise to the problem of perverse incentives. In essence, depending on public funds, unsecured creditors with nothing to lose may commence reckless procedures with no evidence or reasonable grounds of malpractice or abuse, and engage in opportunistic behaviour (e.g. inflicting huge costs on other investors and directors, and derailing the restructuring).

Creditor committees are widely regarded as one of the most iconic and innovative features of the American Chapter 11. The Code specifically provides for the appointment of an official or ‘statutory’ committee(s) to represent unsecured creditors. The creditors’ committee typically consists of seven or more of the debtor’s largest unsecured creditors, and it acts as a fiduciary for all of the debtor's unsecured creditors[1073]. In order to fulfil its fiduciary responsibility and make an informed judgment it must receive material inside information about the debtor's financial status and the proposed business plans. Committees do not typically make such information public. This is essentially a balance between the creditors' need for disclosure and the debtor's need for confidentiality. Because they may lack expertise and financial/legal knowledge to perform their tasks. It can hire accountants to investigate the books of the company. It can hire investment bankers to assess what options the company has. It enjoys the broad power to 'investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case. It can also engage attorneys to help guide it through the bankruptcy proceeding'.

The creditors on the committee have an economic interest to fight for the group of unsecured creditors as a whole, because distributions are made *pari passu*. Moreover, the general creditors as a group bear the expenses of the committee as committee members will be reimbursed and compensated from the estate for expenses they incurred in connection with their representation of the group. The appointment of unsecured creditors, therefore, reduces the risk of free-rider and enhances creditor coordination to reach a requisite level of support for the business plan.

The committee is a key player in the reorganisation process. It acts as a principal vehicle for mediating the interests of the general unsecured creditors as a group through committee meetings and deliberations. It acts also as a watchdog on behalf of unsecured creditors during the case. It may also start recovery procedures against the former management of the

[1073] The fiduciary obligation extends to all unsecured creditors and it requires that creditors' committee 's actions to be guided solely by the interest of the all-unsecured creditors. See, e.g., *In re Fas Mart Convenience Stores*, 265 B.R. 427, 432 (Bankr. E.D. Va. 2001) and *In re ABC Auto. Prods. Corp.,* 210 B.R. 437, 441 (Bankr. E.D. Pa. 1997) debtor[1074]and fraudulent transfer actions[1075]against other creditors for the benefit of unsecured creditors as a whole. However, a conflict of interests among committee members and potential misuse of insider information may materialise and this may engender delay and additional expense.

A member may be acting opportunistically and trade on sensitive information he obtained while serving on the bankruptcy committees to gain private benefits or advantages to the detriment of other creditors. Case law provides guidance on how courts have consistently refused to allow creditors to serve on the committee if they have a conflict of interest that would give rise to a breach of their fiduciary duties. any creditor that executes a prepetition restructuring support agreement (i.e. pre-negotiated Chapter 11 plans and prepackaged plans) is ineligible to serve on a creditors' committee.[1076] Committee members are restricted from engaging in the trading of a debtor's securities or the purchase or sale of claims against the debtor. Such fiduciary duties are also likely to restrict the ability of a committee member to acquire claims or to purchase assets in a Section 363 sale. The bankruptcy court may order appointment of additional committees, whose members will be appointed by the U.S. Trustee, to ensure adequate representation of creditors or equity holders. The division of creditors into committee is done according to those whose rights are 'substantially similar' to ensure they are well represented.[1077] Federal Rule of Bankruptcy Procedure 2019 requires compliance with certain formalities for a creditor wishing to serve on a committee, whether official or unofficial, including the need to file a disclosure statement setting forth the nature and amount of the claim or interest in the debtor and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition.[1078]

[1074] *In re Midway Games, Inc.*), 428 B.R. 303 (Bankr. D. Del. 2010)
[1075] *In re ATP Oil & Gas Corp Bankr.* S.D. Tex. Jan. 6, 2014
[1076] See Roberta A DeAngelis and Nan Roberts Eite, 'Committee formation and Reformation: Considerations and Best Practices (2011) American Bankruptcy Institute Journal
[1077] *In re Dow Corning Corp.,* 244 B.R. 634, 644 (Bankr. E.D. Mich. 1999
[1078] FED. R. BANKR. P. 2019 and see also In re Nw. Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007)

Violating fiduciary duties triggers criminal penalties. In the *Neiman Marcus* bankruptcy, a distressed debt investor serving on the unsecured creditors' committee was sentenced to six months in prison for committing bankruptcy fraud and violating his fiduciary duties.[1079]

Conversely, in the UK, the creditors have the option to form an official committee but the administrator is under no direct obligation to appoint one.[1080] Administrators may take the views of an official committee into consideration when deciding the fate of the distressed company but are not obliged to act on them.[1081] The committee appointed by unsecured creditors may appoint professionals in law and finance to thoroughly investigate the financial affairs of the company and the course of action (e.g. liquidation, restructuring of the company, and rescue of the business or sale of its assets or entities) the administrator has decided for the company and whether a different the one or a different timing for the sale) is likely to result in a better outcome. However, professional fees will not be paid by the estate. Such fees might be divided among the unsecured creditors but this is unlikely to happen because of free rider problems. It therefore should come as no surprise that empirical studies reveal that no creditors committee was established in the majority of the cases and where appointed, they play very limited roles.[1082]

Committees in administrations could be further empowered to have a material influence on the outcome of process, to such an extent that behoves the administrator to consider unsecured creditors' concerns as part of its commercial judgement. To achieve this end, they should be enabled to look behind the decisions made by the administrator and review and opine upon them. It would be necessary to provide them with the relevant information to do

[1079] United States Attorney's Office, Southern District of New York, New York Hedge Fund Founder Pleads Guilty To Bankruptcy Fraud In Connection With Neiman Marcus Bankruptcy, Press Releases Feb 3, 2021/ https://www.justice.gov/usao-sdny/pr/new-york-hedge-fund-founder-pleads-guilty-bankruptcy-fraud-connection-neiman-marcus
[1080] Insolvency Act 1986, Schedule B1, para. 57(1)
[1081] Statement of Insolvency Practice 15 (England and Wales)
[1082] Frisby (n14).

so. If administrators refuse to act on their opinions, a full explanation should be given for their reasons why it is not possible to do so. The expenses incurred by members of the creditors' committee should be reimbursed by the debtor to overcome the free-rider problems. This will ensure that unsecured creditors are provided with a voice in the process, therefore, they can raise objections with the intention to produce a higher level of recoveries for creditors overall.

8.6. Conclusion

Distressed debt investors have significant resources and are willing to engage in substantial activism in troubled situations, where traditional lenders are increasingly reluctant to play this role.

An active distressed debt market can generate broad economic benefits. By injecting essential capital, distressed debt investors help facilitate the efficient restructuring and recovery of struggling companies. In essence, their funding plays a crucial role in reducing the debt overhang and supporting the implementation of effective turnaround strategies.

Distressed debt investors may purchase the company's debt off the books of the banks. The existence of a readily available exit strategy helps banks to free up their cash resource and facilitate their liquidity preservation and stability. Subsequently, banks can play their traditional role of financing healthy companies while distressed debt investors in the course of making a profit can help liquidating companies to be redeployed in the economy.

These common arguments are often made on the assumption of a perfectly competitive distressed debt market. In the United States, the market for post-petition lending has expanded significantly since its inception, with a corresponding growth in the number of participants. Given that the market is sufficiently robust, with a large number of suppliers, distressed debtor companies can borrow at competitive rates and terms. This, in turn, increases the chances of a successful recovery strategy. The debtor can also replace distressed debt investors pursuing value-destructive strategies with new investors whose interests are more closely aligned with the debtor's business.

The UK lacks a long-established and robust market for rescue finance, with the market currently supplied by only a few investors. This limited supply leads to an increase in the cost of such lending. A company with few alternatives may have no choice but to accept high interest rates, a situation that could push a distressed but otherwise solvent company closer to insolvency, or even accelerate its decline. Moreover, the availability of post-petition financing for companies undergoing formal insolvency proceedings may increase their burden of crippling debt, rather than supporting the successful implementation of a restructuring plan.

In the US, market forces are complemented by extensive judicial scrutiny and inquiry throughout the bankruptcy process. However, in the secured creditor-controlled administration procedure, the involvement of distressed debt investors reintroduces the problem of perverse incentives and raises serious concerns about abuse, value extraction from other stakeholders, and value destruction. Many of these concerns are supported by data. It is not uncommon for distressed debt investors pursuing an ownership agenda to orchestrate a debt-for-equity swap through a pre-pack sale of the company's business to a company they control. Pre-packs, in general, suffer from systemic issues in marketing practices. The structure of distressed debt investor-led pre-packs creates a situation where the investor in the auction holds an informational advantage over other bidders. Furthermore, the investor acts as both the seller and the buyer of the business. Instead of maximising the debtor's economic value or prioritising creditors' recoveries, the investor has a strong incentive to chill the bidding process and depress the asset value, to the detriment of other stakeholders.

The investor may seek to make a profit on debt purchased at a discount to par value, primarily through recoveries on the debt. If the investor recovers enough value to generate a profit, it is unlikely to assess the viability and economic prospects of the debtor company. Furthermore, it is unlikely to prefer certain forms of restructuring and reorganization over liquidation, even though the total value of the assets might be maximised through restructuring.

In a liquidation scenario, investors are unlikely to favour selling the business as a going concern over a break-up sale, even if the former would yield greater overall value for creditors. They are also unlikely to postpone the sale in hopes of securing a higher future price. The problem of perverse incentives and ex-post non-optimal outcomes also arise in the case of fully secured banks. A bank whose debt is fully secured does not share in the upside should a restructuring improves the debtor's fortunes. The bank may see no need to risk a form of restructuring and reorganisation that could only reduce its recovery. The bank may also lack the incentive of incurring the costs of looking for alternatives that best suit the interests of other stakeholders.

The costs and complexity of insolvency procedures as opposed to the cost savings conferred by the informal restructuring may not deter the bank from forcing an immediate liquidation. However, the banks are constrained by reputational and relationship concerns with their debtors and with other borrowers and therefore the emphasis has always been on market-led solutions such as the London Approach and 'Business Support Unit' (BSU). However, distressed debt investors have "one-off" relationships with the debtor company and it is unlikely to be concerned about maintaining customer relationships. The risk of negative perceptions by the general public, and losses of reputations matters less for the general partner (GPs) of distressed debt funds. GPs are highly motivated by concerns for their reputation of being able to generate value for the distressed debt fund in the form of large dividends. More value for the limited partners increases the likelihood that a GP raises a new fund. Thus, they are likely to have a strong incentive to take decisions such reducing the insolvency case to a fire-sale of the business even though longer-term efforts to preserve the company as a going concern would generate more value for creditors.

Distressed debt investor may not only purchase undervalued debt to engage in acquisition strategies. Alternatively, the target may be a distressed company, put up for sale by its existing owners. Upon completing this friendly takeover, the new owner takes the necessary measures to turn around the business's fortunes. These could include a contingency plan, employee layoffs, the appointment of turnaround directors, and top management turnover. However, of great importance to this business model is the availability of new financing to strengthen the liquidity position of the company so it can continue in its operations. It is not uncommon for distressed debt investors who have substantive financial resources to inject much-needed money into the capital structure of the company.

The money channelled into the capital structure of the company is usually dressed in form of secured loans instead of a capital contribution. Loans of this kind limit the distress's downside risk and pass it on to other parties, such as unsecured creditors. For example, in case of insolvency, the investor can invoke security rights and receive back in full its investment, ahead of other creditors. The investor would be over-optimistic in his formulation of the rescue strategy plan and the prospects of business recovery. Even more problematic, the investor may seek to push the company toward insolvency to orchestrate pre-packs in which he can buy back the business in consideration for a release of his secured loans.

Empty crediting is, therefore, a cause for concern. Secured distressed debt investors are unlikely to make objective decisions, such as pursuing the most value-maximising option.

They may be indifferent to, or even overly eager to push companies into insolvency proceedings, which are traditionally regarded as mechanisms of last resort. In such proceedings, they have little incentive to maximise the value of the business. In fact, they may have strong incentives to suppress bidding and depress asset values in order to acquire ownership of their target at a reduced cost.

There are considerable reasons to doubt that safeguards, previously built to combat perverse incentives, abuse, minority oppression, and wealth transfers, can deal with empty crediting problem and the aggressive behaviour of distressed debt investors. Management of the insolvency case is entrusted to insolvency practitioners who have a duty to act in accordance with open-character specificity-lacking ethics codes. Unsecured creditors lack the ability to block a harmful outcome as it is extremely difficult to challenge commercial judgement of the administrators who may skew their decisions in the interest of distressed debt investors.

Pre-pack sales to the secured creditors are subject to limited standards of transparency, scrutiny and accountability. Rules are also lacking on finance contributed by owners in the form of loans. The market testing approach adopted by administrators and courts entails determining the value of debtor by reference to the highest value bid received and without taking its future earning capacity into account. This would merely reflect the distressed debt investors' preferences for a lower valuation for the debtor to make junior creditors out of money and therefore, unable to participate in recoveries or to have a say over the insolvency process. The use of claw-back and liability procedures comes with several challenges, including the heavy burden of proof, difficulties in accessing relevant information and gathering necessary evidence, and the reluctance of administrators and courts to engage in such litigation.

Real-world businesses and markets are both imperfect and allocatively inefficient. Absent perfectly functioning markets, governments regulate almost every sphere of economic activity to ensure minimum levels of fairness, efficiency and competitiveness. However, distressed debt market is not an exception. Distressed debt investors may engage in strategies to enrich themselves at the expense of other stakeholders. This creates the need to mitigate their perverse incentives, improve the regulatory position of vulnerable stakeholders, take proactive steps to enhance public confidence in the integrity of the insolvency system. To this end, this research advances some regulatory suggestions including the introduction of additional rigorous safeguards in lender-led prepacks, full subordination of shareholder loans, and the adoption of income-based valuation techniques which take into account the intrinsic value of debtor and its future earning capacity.

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APPENDIX

Companies used to generate data

company number, name

NI035748/CASTLEBAWN LIMITED

04403284/METHOD INVESTMENTS LIMITED

03797066/NORTHANTS ROCKINGHAM SPEEDWAY LIMITED

09094163/SANDS HERITAGE LTD

03655355/SPECIALISED MACHINE SERVICES LIMITED

NI017934/MAYDOWN PRECISION ENGINEERING LIMITED

03816617/CLAMONTA LIMITED

NI019991/SLEMISH HOMES LIMITED

01836890/FACTORY OUTLETS LIMITED

06361658/CLEARWATER (OVERCLIFF) LIMITED

NI064067/DERMONT DEVELOPMENTS LIMITED

SC304407/CALLANDER RESIDENTIAL LIMITED

06259685/ZOG BROWNFIELD VENTURES LIMITED

NI018169/DIME PROPERTY MANAGEMENT COMPANY LIMITED

04610110/HAWKSTONE PROPERTIES (BRIDGEND) LIMITED

04327279/ETHEL AUSTIN PROPERTIES (KENDAL) LIMITED

05364187/T @ K PUBS LIMITED

SC315258/DEALTEE LIMITED

NI017617/S. & R. ELECTRIC LIMITED

SC228589/BELL'S MILLS LIMITED

03455325/NORTHERN OFFICE INVESTMENTS LIMITED

03504068/WCPC REALISATIONS LIMITED

NI020350/PRENTICE ESTATES LIMITED

03899696/KINGSLAND ESTATES (LEICESTER) LIMITED

SC334107/MMV LTD

SC213090/IHUB UK LIMITED

SC250775/R.F. CHATTELLE (DEVELOPMENTS) LIMITED

SC151138/CROFTSHORE LIMITED

02268772/BOWESFIELD INVESTMENTS LIMITED

SC323802/ABERDEEN LEISURE INVESTMENTS LIMITED

01006648/E PEARSON (REMOVALS) LIMITED

SC160480/ALEXANDER SHORT PROPERTIES LIMITED

7673072/LEYTON HEALTHCARE (NO 10) LIMITED

07306744/PMG LEISURE LIMITED

03530112/BLUCHIE LIMITED

SC247601/BALI PROPERTIES LTD.

06264099/THE FULL MOON AT RUDGE LIMITED

00347046/MHW REALISATIONS LIMITED

05891724/QUADRANT ENTERPRISES LIMITED

SC286972/PALACECRAIG STREET COATBRIDGE LIMITED

04032322/WYCAR LEYS LIMITED

05407119/RETAIL DEVELOPMENT PARTNERSHIP GENERAL PARTNER LTD

02389054/HARTLEPOOL RENAISSANCE LIMITED

03261090/MMC DEVELOPMENTS LIMITED

05439353/STARCOURT DEVELOPMENTS LIMITED

00907593/MONARCH AIRLINES LIMITED'

05336990/ARGENT RISK MANAGEMENT SOLUTIONS LIMITED

04928463/ATH RESOURCES PLC

03228476/TRANSFORM MEDICAL GROUP (CS) LIMITED

04201151/GRAINGER GAMES LIMITED

06205093/T.I.S. ACQUISITIONS LIMITED

03978855/O.W. BUNKERS (UK) LIMITED

04216917/GHH HOLDINGS LIMITED

09055443/INK (GLOBAL) LIMITED

02811932/DIVISIONS OPERABLE WALL SYSTEMS LIMITED

01529898/ARCS REALISATIONS 2016 LIMITED

06587828/JAEGER LONDON LIMITED

06663910/TCG PUBS LIMITED

04520457/TRAVELZEST PLC

04390406/COURTMINT LTD

NI037093/NACK FOODS LTD

SC057687/THOMAS MITCHELL HOMES LIMITED

05750995/ST ANNES ROAD PROPERTIES LIMITED

04850002/BR REALISATIONS LIMITED

03472784/BUK (REALISATIONS) LIMITED

09988846/BRANTANO RETAIL LIMITED

09953318/JB REALISATIONS LIMITED

01264385/MAPLIN ELECTRONICS LIMITED

05552480/VELTI LIMITED

02039233/ES REALISATIONS 2017 PLC

03406335/WHYTE CHEMICALS LIMITED

00945174/H THORNTON ESF LIMITED

01720832/GDC REALISATIONS LIMITED

09911854/MALBEC BIDCO LIMITED

SC015382/JOHNSTON PRESS PLC

06933936/SHUROPODY FOOTCARE LIMITED

03154198/PHONES 4U LIMITED

04160038/DEBT FREE DIRECT LIMITED

01955534/TFL REALISATIONS LIMITED

SC221832/QUESTWAY LIMITED

07738701/UNIPART AUTOMOTIVE LIMITED

07081054 /CALECORE LTD.

06355404/SHUROPODY LIMITED

08050525/SHOON (TRADING) LIMITED

01038435/MOORGATE INDUSTRIES LIMITED

07496824/CHROMOGENEX HOLDINGS LIMITED

SC335305/TAILWIND ENERGY CHINOOK LTD

05674948/PUPL REALISATION LTD

00805812/RECORD SHOP 1 LIMITED

04069894/CAV AEROSPACE LIMITED

09493445/NESS (HOLDINGS) LIMITED

00288766/JTB REALISATIONS LIMITED

03271008/BASLER (UK) LIMITED

01809223/TOYS "R" US LIMITED

02215564/POUNDWORLD RETAIL LIMITED

01455007/WXYZ CORPORATION LIMITED

00625299/BML REALISATIONS 2016 LIMITED

07022896/CORNISH MINERALS LIMITED

01080872/CITY LINK LIMITED

05755897/SILVERDELL PLC

02924874/GROSVENOR CHEMICALS LIMITED

06020013/PHF REALISATIONS LIMITED

08462233/TOP GUN REALISATIONS LIMITED

01529849/MAMAS & PAPAS (RETAIL) LIMITED

07966612/HAWK PLANT (UK) LTD

03325255/MORTIMER MANAGEMENT GROUP LIMITED

07393181/SPIRAL HEALTH C.I.C.

08600176/AH REALISATIONS LIMITED

08829596/NORVIK NEW BUILD LIMITED

00088456/INTERSERVE PLC

05448421/DEBENHAMS PLC

04586150/ADMIN PAYMENTS LTD

10769092/THE RAPHAEL HOSPITAL DEVELOPMENT LIMITED

02240475/BSCL REALISATIONS LIMITED

04261294/NOSS LAND COMPANY HOLDINGS LIMITED

08136193/DOLAN PARK LIMITED

02102901/FRESHFIELD CONTRACTING LIMITED

SC315531/LOCH ORCHY LTD.

03652670/NEW CENTURY GROUP HOLDINGS LIMITED