INSOLVENCY STATUTORY RULES AND CONTRACTUAL FREEDOM:
A STUDY ON THE LIMITS OF CORPORATE INSOLVENCY LAW IN THE
ANGLO/AMERICAN TRADITION

Eugenio Vaccari*
PhD Candidate

City, University of London
Law School
September/October 2018

# Table of Contents

**Table of Cases** ................................................................................................................................. 7

**List of Abbreviations** .......................................................................................................................... 21

**Chapter 1 - Foundations** .................................................................................................................... 33

1.1 **Preamble** ........................................................................................................................................ 33
   1.1(a) Justification for the Research ........................................................................................................ 35
   1.1(b) Outline of the Thesis ..................................................................................................................... 38

1.2 **State of the Art** ............................................................................................................................... 42

1.3 **Key Concepts and Evaluative Criteria** ............................................................................................ 46
   1.3(a) The “Common Pool” Narrative (Revised) .................................................................................... 46
   1.3(b) “Rescue” and “Restructuring” ...................................................................................................... 52
   1.3(c) A Pragmatic, Value-Bereft Framework of Insolvency Law ......................................................... 55

1.4 **Rationale of the Thesis** .................................................................................................................. 61
   1.4(a) Main Research Questions ............................................................................................................ 64
   1.4(b) Research’s Findings ..................................................................................................................... 65

1.5 **Methodology** .................................................................................................................................... 66

1.6 **Concluding Remarks** .................................................................................................................... 70

**Chapter 2 - The Limits of Insolvency Law in Autonomy-Based Frameworks** .................................... 71

2.1 **Introduction** ...................................................................................................................................... 71
   Late Sixties: England and France ........................................................................................................... 72

2.2 **Autonomy-Based Solutions to Insolvency Law** ............................................................................. 75
   2.2(a) Autonomy-Based Remedies in Domestic Cases .......................................................................... 84
      2.2(a)(i) Pro-Debtor Laws and Carve-Outs: The Case of the United States ........................................ 92
      2.2(a)(ii) Pro-Creditor Laws and Carve-Outs: The Cases of England, Australia and Singapore .......... 96
      2.2(a)(iii) Carve-Outs and the Role of the Judiciary ............................................................................ 107
   2.2(b) Autonomy-Based Remedies in Cross-Border Cases .................................................................... 112

2.3 **Marketization of Insolvency Law in Asset-Segregated Industries** .................................................. 121
   2.3(a) The Nature of Autonomy-Based Mechanisms ............................................................................ 123
   2.3(b) The Lack of a TCP Problem ....................................................................................................... 127
2.4 NORMATIVE, EFFICIENCY AND FAIRNESS CONSIDERATIONS........................................................................ 129

2.5 CONCLUDING REMARKS.............................................................................................................................. 133

CHAPTER 3 - THE LIMITS OF INSOLVENCY LAW IN PROCEDURALIST FRAMEWORKS......................................... 137

3.1 INTRODUCTION ............................................................................................................................................. 137

2012: Detroit, Michigan. ...................................................................................................................................... 138

3.2 PROCEDURALIST SOLUTIONS IN INSOLVENCY LAW.................................................................................. 140

3.2(a) Procedure-Based Insolvencies ................................................................................................................. 147

3.2(a)(i) Auction-Based Insolvencies without (Re)Distributive Implications .................................................. 151

3.2(a)(ii) Auction-Based Insolvencies with (Re)Distributive Implications ....................................................... 155

3.2(a)(iii) More on Proceduralist Insolvencies .................................................................................................. 160

3.2(b) Procedural Coordination in Cross-Border Insolvencies ........................................................................... 164

3.3 NORMATIVE, EFFICIENCY AND FAIRNESS CONSIDERATIONS................................................................. 168

3.4 CONCLUDING REMARKS .............................................................................................................................. 172

CHAPTER 4 - THE LIMITS OF INSOLVENCY LAW IN PRINCIPLE-BASED FRAMEWORKS.................................. 175

4.1 INTRODUCTION ............................................................................................................................................. 175

20 April 2010: U.S. Exclusive Economic Zone, Gulf of Mexico. ........................................................................ 176

4.2 PRINCIPLE-BASED SOLUTIONS IN INSOLVENCY LAW............................................................................. 178

4.2(a) Could a Principle-Based Approach Shape Insolvency Law? ................................................................ 189

4.2(b) Preliminary Findings .................................................................................................................................. 192

4.3 THE PROBLEM OF WEIGHTING PRINCIPLES............................................................................................ 193

4.3(a) Personal, Proprietary and Risk bearer Interests ....................................................................................... 197

4.3(b) What Interests Are Relevant in Corporate and Insolvency Practice? .................................................... 204

4.3(b)(i) Directors’ Duties in Solvent Times ........................................................................................................ 204

4.3(b)(ii) Office- HOLDERS’ Duties in Insolvent and Near-Insolvent Times ....................................................... 214

4.3(b)(iii) Half-way Findings ............................................................................................................................. 221

4.3(c) A Normative Argument to Consider the Interests of All Controlling Stakeholders .................................. 223

4.3(d) Should Controlling Interests Be Relevant under Insolvency Law? A Theory of Wealth-Maximisation of Stakeholders’ Interests (“WMSI”) .................................................................................... 228

4.3(e) Concluding Remarks .................................................................................................................................. 234

4.4 FINDINGS AND OPEN PROBLEMS .............................................................................................................. 235

CHAPTER 5 - A NORMATIVE ANALYSIS OF ELIGIBILITY REQUIREMENTS....................................................... 241
6.3(a) Corporations are NOT Controlled by Either Shareholders or Creditors (Only)........ 320

Proprietary vs. Controlling Rights ............................................................................. 321
Controlling Powers in Times of Distress.................................................................. 322
6.3(b) The “Corporate Distress” Threshold ................................................................. 328
6.3(c) A Normative Criticism of the Revised Common Pool Standard ......................... 331
6.3(d) Testing the Theory of “Wealth Maximisation of Stakeholders’ Interests” ............ 334
6.3(e) Findings ........................................................................................................... 339

6.4 "WEALTH MAXIMISATION OF SHAREHOLDERS’ INTERESTS": PROCEDURAL ASPECTS........ 339
6.4(a) Application from the Debtor ............................................................................. 340
6.4(b) Application from a Stakeholder ....................................................................... 341
6.4(c) Right to Appeal ............................................................................................... 342
6.4(d) The Eligibility Panel ....................................................................................... 344
6.4(e) Alitalia (2017) Recast ..................................................................................... 347

6.5 "WEALTH MAXIMISATION OF STAKEHOLDERS’ INTERESTS": A CRITICAL ASSESSMENT........ 354

6.6 "WEALTH MAXIMISATION OF STAKEHOLDERS’ INTERESTS": IMPACT AND LIMITS............. 363
6.6(a) Promoting Success: Addressing Behavioural Biases in the Decision-Making Process 364
6.6(a)(i) Biases in Real-World Decision-Making .......................................................... 365
6.6(a)(ii) Addressing Behavioural Biases .................................................................... 371
6.6(b) Avoiding Failure: Limits, Limitations and Delimitations of this Study ............... 375
6.6(b)(i) Limits .......................................................................................................... 375
6.6(b)(ii) Limitations .................................................................................................. 376
6.6(b)(iii) Delimitations ............................................................................................. 378

6.7 CONCLUDING REMARKS ..................................................................................... 381

CHAPTER 7 - THE WAY FORWARD: CONTRIBUTION AND RECOMMENDATIONS .................. 383

7.1 SUGGESTIONS FOR FURTHER RESEARCH ................................................................ 389

BIBLIOGRAPHY ........................................................................................................ 391

Books and Chapters .................................................................................................... 391
Journal Articles .......................................................................................................... 401
Reports, Working and Consultancy Papers ................................................................. 427
Newsclips and Articles ............................................................................................... 430
Miscellaneous ............................................................................................................ 433
ACKNOWLEDGMENTS

A short mention in the opening paragraphs of this thesis does not do justice to all those who supported me throughout this journey and who have been instrumental in making it possible. Nevertheless, it would have caused me great shame if I did not pay the proper tribute to at least some of them.

First, I wish to express my thanks to my wonderful wife Valentina, for her loving and unflagging support. While undertaking a successful and sometimes exhausting career in the world of auction houses, she has always been present to encourage me, serve as my coach, offer recollections and recommendations from her own post-graduate studies and support my efforts throughout this process.

My profound gratitude goes to my supervisors, Prof. Jason Chuah and A/Prof. Katherine Reece-Thomas. I am deeply indebted to them for their mentorship, supervision and counsel and for keeping me on track during this fascinating journey. Their unswerving dedication and commitment went well beyond the expected duties of any professor and I will endeavour to follow their example in my academic career.

I would additionally thank A/Prof. Rolandino Guidotti and A/Prof. Sarah Paterson for being the ones that inspired me all those years ago and Dr. Stefano Maffei for teaching me that ‘I am not young enough to know everything’ (O. Wilde).

I must also express my appreciation to the City Law School academics and members of the staff who actively contributed to this milestone achievement in my career. My gratitude goes in particular to Dr. Mauro Barelli and Prof. Andrew Choo for making this ride as smooth and uneventful as possible; Antonia Clark for supporting me in my job applications; and Hilary Vieitez, who patiently helped me to accrue a great deal of experience in the use of the School’s legal resources.
I would also thank Mrs Lisa F Meller for her constructive criticism of the manuscript and for her diligent proof-reading of this work.

A special and affectionate mention must go to my parents, Paola and Lorenzo, my wife’s relatives, Mauro and Luciana, as well as my brother Edoardo and his better-half Giulia for their unwavering advice and support, particularly when things did not go according to plan and I was assailed by setbacks and second-thoughts about doing a PhD.

No acknowledgement would be truly complete without recognising the essential role of my friends. I feel particularly indebted towards Amar, Anila, Carlo, Elena, Ernest and Julia: their moral support and insightful comments have encouraged me to find creative and ingenuous solutions to the matters covered in this study.

A few words of appreciation are also due to the INSOL International and INSOL Europe scholars, members and staff. From the day I joined these organizations, they made me feel welcome and appreciated. In these years, they promoted the conferences that I co-organised, the research group that I set up and finally encouraged me to be involved in the management of the INSOL groups. I am deeply indebted in particular towards Prof. David Burdette, Prof. Juanitta Calitz, Dr. Jennifer Gant, Prof. Rosalind Mason, Tina McGorman and Dr. Paul Omar.

A final, special mention goes to my cats Ulisse and Mafalda, who have consistently and unrelentingly woken me up at 3 a.m. throughout the last year-and-a-half to remind me that my research is not and will never be a valid justification to neglect their essential needs: cuddles and food (not necessarily in this order)!

**Library Declaration:** The author of this thesis hereby grants powers of discretion to the University Librarian to allow the thesis to be copied in whole or in part without further reference to the author. This permission covers only single copies made for study purposes, subject to normal conditions of acknowledgement.
ABSTRACT

Back in 1986 Thomas H. Jackson published a ground-breaking work for insolvency literature: *The Logic and Limits of Bankruptcy Law*.

Since then, much ink has been spilled in the investigation of the foundations of insolvency law. Many scholars have argued for the implementation of rescue- or debtor-oriented practices, in order to give a “second chance” to the honest but unfortunate debtor, or to save a distressed but viable business. Others have advocated for maximising the return to creditors to protect the rights bargained for by the parties in solvent times.

In other words, the debate has focused on the “logic” of this area of law and it has been primarily either principle or purpose-oriented. This study, on the other hand, focuses on the other pillar of Jackson’s literary work: the “limits” of insolvency law.

Insolvency remedies can be considered as a statutory endorsement of breaches of contracts. Insolvency law is not a synonym of rescue law. As a result, insolvency rules should apply only when contractual or general law remedies are no longer appropriate to deal with the ailing debtor.

The main purpose of this research is therefore to investigate when, to what extent and if at all statutory insolvency rules should depart from the law of contract in market-driven jurisdictions. As a result, this study focuses on selected common law jurisdictions - the United States and the United Kingdom (rectius, England and Wales) - to investigate the circumstances that should justify the enforcement of insolvency (rectius, corporate distress) rules. This thesis complements problem and principle-informed theories to suggest a novel mechanism to determine the limit of insolvency law.

To date, practitioners, scholars and judges have not fully acknowledged this issue and its implications for business practice. Legal systems fail to provide comprehensive guidance on the matter of the co-ordination between insolvency rules and the enforceability of the rights negotiated by the parties in their contracts. The aim of this thesis is to acknowledge, critically analyse, investigate
and suggest solutions to this issue and, in doing so, make an original and significant contribution to the field.

This work will propose an innovative solution to determine when companies should rely on corporate distress remedies. Nevertheless, it does not claim that the proposed approach is the best or optimal one. It highlights the benefit that the proposed conceptualisation is expected to achieve over existing statutory and theoretical approaches and it identifies the factors that are most likely to promote (and to thwart) this new conceptualisation of the law of corporate distress.
**TABLE OF CASES**

**English Cases**

*A Company (No. 006794 of 1983), Re* [1986] BCLC 261 .......................................................... 248

*A Company (No. 007946 of 1993), Re* [1994] Ch. 198 .......................................................... 305

*A Company, Re* [1950] 94 Sol. Jo. 369 .......................................................... 246

*Agrokor DD, Re* [2017] EWHC 2791 (Ch), [2018] Bus. L.R. 64 .................................................. 149

*Allen v Hyatt* [1914] 30 TLR 444 .......................................................... 206

*Alpstream AG v PK Airfinance Srl* [2015] EWCA Civ 1318, [2016] 1 CLC 135 ..................................... 360

*Antony Gibbs & Sons v Société Industrielle et Commerciale des Metaux* [1890] 25 Q.B.D. 399 (CA) .......................................................... 148, 149

*Apex Global Management Ltd v FI Call Ltd* [2015] EWHC 3269 (Ch), 2015 WL 6757849 ................. 206


*Associated Provincial Picture Houses Ltd v Wednesbury Corp* [1948] 1 KB 223 (CA) ................. 265

*Bacon VC Re London & Manchester Industrial Association* [1875] 1 Ch. D. 466 ................................ 261

*Ball v Hughes* [2017] EWHC 3228 (Ch), [2018] 1 BCLC 58 .......................................................... 206

*Bell Group Finance (Pty) Ltd (in liq.) v Bell Group (UK) Holdings Ltd* [1996] BCC 505 (Ch) ............. 261

*Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services* [2011] UKSC 38, [2012] 1 AC 383 .......................................................... 108, 125

*BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2010] EWHC 2005 (Ch), [2011] 1 WLR 1200 .......................................................... 248


*BNY Corporate Trustee Services v Eurosail-UK 2007-3BL Plc* [2013] UKSC 28, [2013] 1 WLR 1408 passim

*Bove v The Hope Life Insurance and Guarantee Company* [1865] 11 HLC ................................ 259

*Bowe Watts Cargo Ltd (in liq.), Re* [2017] EWHC 7879 (Ch), [2017] WL 06326756 .......................... 206

*Brady v Brady* [1989] AC 755 (HL) .......................................................... 188, 217

*Brannigan v Style* [2016] EWHC 512 (Ch), [2016] WL 00386245 .................................................. 209

*Brazilian Rubber Plantations and Estates Ltd, Re* [1911] 1 Ch 425 (Ch) ........................................ 209

*Bristol Airport Plc v Powdrill* [1990] Ch. 744 (CA) .......................................................... 118

*British America Nickel Corp Ltd v MJ O’Brien Ltd* [1927] AC 369 (PC) ........................................ 87

*British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758 (HL) ........................................................................................................ 73, 110

*British Midland Tool Ltd v Midland International Tooling Ltd* [2003] EWHC 466 (Ch), [2003] 2 BCLC 523 .......................................................... 205

*BTI 2014 LLC v Sequana SA* [2016] EWHC 1686 (Ch); [2017] Bus. L.R. 82 .............................. 210, 251, 256
Printing and Numerical Registering Co v Sampson (1874-75) LR 19 Eq. 462. 89

Purewal v Countrywide Residential Lettings Ltd [2015] EWCA (Civ) 1122, [2016] 4 WLR 31... 360
R v Grantham (Paul Reginald) [1984] QB 675 (CA) ................................................................. 206
Raithatha v Baig [2017] EWHC 2059 (Ch), [2017] WL 04526672. 206
Redwood Master Fund Ltd v TD Bank Europe Ltd [2002] EWHC 2703 (Ch), [2006] 1 BCLC 149. 87
Regentcrest Plc (in liq.) v Cohen [2001] 2 BCLC 80. 206

Rococo Developments Ltd, Re [2016] EWCA Civ 660, [2017] Ch. 1. ........................................ 249
Rowntree Ventures Ltd v Oak Property Partners Ltd [2016] EWHC 1523 (Ch), [2016] WL 03564108. 263

Rowntree Ventures Ltd v Oak Property Partners Ltd [2017] EWCA Civ 1944, [2017] WL 06327206. 264

Sahaviriya Steel Industries UK Ltd, Re [2015] EWHC 2726 (Ch), [2016] BCC 450. ................. 98
Secretary of State for Business, Enterprise and Regulatory Reform v Art IT Plc [2008] EWHC 258 (Ch), [2009] 1 BCLC 262. .......................................................... 305

Secretary of State for Trade and Industry v Bell Davies Trading Ltd [2004] EWCA Civ 1066, [2005] BCC 564. .......................................................... 305
Secretary of State for Trade and Industry v Driscoll Management Facilities Ltd [2001] WL 949826. .......................................................... 305

Secretary of State for Trade and Industry v Travel Time (UK) Ltd [2000] BCC 792. .................. 305

Smith and Fawcett Ltd, Re [1942] Ch 304 (CA) ................................................................. 206, 209

Southern Counties Fresh Foods Ltd, Re [2008] EWHC 2810 (Ch), [2008] WL 4923175. ....... 206
The Bell Group Ltd (in liq.) v Westpac Banking Corp (No.9) [2008] WASC 239. ................. 260
Tilley v Bowman Ltd [1910] 1 KB 745. ................................................................. 198
Vallejo v Wheeler (1774) 1 Cowp 143. .......................................................... 258
Walter L Jacob, Re [1989] 5 BCC 244. .......................................................... 306
Westdeutsche Landesbank Girozentrale v Islington Borough Council [1996] AC 669 (HL) .... 197
William C Leitch Bros Ltd (No. 1), Re [1932] 2 Ch 71 (Ch). ........................................... 206
U.S. Cases

Am. Nat’l Bank v Mortgage Am. Corp. (Re Mortgage Am. Corp.), 714 F.2d 436 (5th Cir. 1983) ... 219
Aronson v Lewis, 473 A.2d 805 (Del. 1984) .............................................................................. 211, 213
Askanase v Fatjo, 130 F.3d 657 (5th Cir. 1997) ........................................................................ 219
Avanti Commc’ns Grp. Plc, Re 582 B.R. 603 (Bankr. S.D.N.Y. 2018) .......................................... 56
Axona International Credit & Commerce Ltd, Re 88 BR 597 (Bankr. S.D. N.Y. 1988) ............... 166
Bank of America National Trust Savings Association v 203 North LaSalle Street Partnership, 119 S.Ct. 1411 (1999) ................................................................. 162
Bank of China v Huang (Re Huang), 275 F.3d 1173, 1177 (9th Cir. 2002) .............................. 86
Barcliff, Llc v M/V Deep Blue, Imo No. 9215359, 2016 WL 5660934 (S.D. Al. Sept. 28, 2016) ... 124
Best Buy Drugs, Inc., Re 89 B.R. 997 (Bankr. S.D. Fla. 1988) ................................................. 252
BGM Pasadena, Llc, Re (Bankr. C.D. Cal. 2016) ..................................................................... 86
Bonner Mall Partnership v U.S. Bancorp Mortgage Co. (Re Bonner Mall Partnership), 2 F.3d 899, 911 (9th Cir. 1993) ................................................................. 162
Bovay v H.M. Bylesby & Co. 38 A.2d 808 (Del. 1944) ............................................................. 218
Brotherhood of Railway Employees v REA Express, Inc. 523 F.2d 164 (2d Cir.), 423 U.S. 1017 (1975) ........................................................................................................... 315
Bryan Road, Llc, Re 382 B.R. 844 (Bankr. S.D. Fla. 2008) ....................................................... 86
Cambridge Analytica Llc No. 18-11500 (Bankr. S.D.N.Y. May 17, 2018) ......................... 281
Caremark Int’l Inc. Derivative Litigation, Re 698 A.2d 959 (Del. Ch. 1996) ...................... 211
Castleton Plaza, LP, Re 707 F.3d 821 (7th Cir. 2013) ............................................................. 162
Cede & Co. Technicolor, Inc., 634 A.2d 345 (Del. 1993) ......................................................... 211
Chicago Board of Trade v Johnson, 264 U.S. 1 (1924) .......................................................... 93, 107
Chrysler Llc, Re 405 B.R. 84 (Bankr. S.D.N.Y. 2009) ............................................................... 158
City of Bridgeport, Re 129 B.R. 332 (Bkrtcy. D. Conn. 1991) ............................................... 253
City of Detroit, Re No. 13-53846 (E.D. Mich. July 18, 2013) ................................................. 139, 142
Clarkson Co. Ltd v Shaheen, 660 F.2d 506 (2d Cir. 1981) ....................................................... 219
Clearlake Shipping PTE Ltd v O.W. Bunker (Switzerland) SA, 2017 WL 78514 (S.D. N.Y. January 9, 2017) ......................................................................................................................... 124
Commodity Futures Trading Comm’n v Weintraub, 471 U.S. 343 (1985) ............................. 217
Continental Ins. Co. v Thorpe Insulation Co. (Re Thorpe Insulation Co.), 671 F.3d 1011 (9th Cir.
2012) ................................................................................................................................ 86
Danielewicz v Arnold, 137 Md. App. 601, 769 A.2d 274 (2001) ................................................. 212
Davis v Woolf, 147 F.2d 629 (4th Cir. 1945) ................................................................. 219
DB Capital Holdings, Llc, Re 454 B.R. 804 (Bankr. D. Colo. 2011) ........................................... 87
Ed Peters Jewelry Co. v C&J Jewelry Co., 124 F.3d 252 (1st Cir. 1997) ........................................ 219
Elscent, Inc. v First Wis. Fin. Corp. (Re Xonics, Inc.), 813 F.2d 127 (7th Cir. 1987) ..................... 116
Epic System Corp. v Lewis, No. 16-285, 2018 WL 2292444 (U.S. May 21, 2018) ...................... 385
First Nationwide Bank v Brookhaven Realty Assoc’s, 223 A.D.2d 618, 637 N.Y.S.2d 418, 421 (1996) ...................................................................................................................... 150
Fotochrome, Inc. v Copal Co, Ltd, 517 F.2d 512 (2d Cir 1975) .................................................. 118
Gearhart Indus. Inc. v Smith Int’l Inc., 741 F.2d 707, 720 (5th Cir. 1984) ................................. 211
Geyer v Ingersoll Publ’ns Co., 621 A.2d 784 (Del. Ch. 1992) ............................................... 211, 218, 220
Global Crossing, Re 295 B.R. 726 (Bankr. S.D.N.Y. 2003) ..................................................... 151
Graham v Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963) ................................................. 211
Great Rivers Coop. v Farmland Indus, Inc., 198 F.3d 685 (8th Cir, 1999) ..................................... 211
Harff v Kerkonian, 324 A.2d 215 (Del. Ch. 1974), rev’d in part on other grounds, 347 A.2d 133
(Del. 1975) ....................................................................................................................... 211, 212
Hogard, Re 43 B.R. 590 (Bankr. D. Minn. 1984) ..................................................................... 253
Investors Funding Corp, Re 523 F.Supp 533 (S.D.N.Y. 1980) .................................................. 218
Iridium Operating, Llc, Re 478 F.3d 452 (2d. Cir. 2007) ......................................................... 163
Katz v Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986) ....................................................... 211, 212
Kham & Nate’s Shoes No.2, Inc. v First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) ........... 212
Lehman Brothers Financing Inc. v BNY Corporate Trustee Services Limited 422 B.R. 407 (Bankr.
S.D.N.Y. 2011) ..................................................................................................................... 108
Lehman Brothers Special Financing Inc. v Ballyrock ABS-CDC 2007-1 Limited No. 09-10132 (JMP) (Bankr. S.D.N.Y. May 12, 2011) 108
Lehman Brothers Special Financing Inc. v Metavante Corporation, No. 08-13555 (J MMP) (Bankr. S.D.N.Y. Sept. 15, 2009) 108
Lorenz v CSX Corp., 1 F.3d 1406 (3d Cir. 1993) 212
Master-Halco, Inc. v Scilla, Dowling & Natorelli, LLC, 739 F. Supp. 2d 100 (D. Conn. 2010) 212
Matter of & Mini Car Parts, Ltd., Inc., Re 97 F.3d 1454 (7th Cir. 1996) 116
Midway Games Inc., Re 428 B.R. 303 (Bankr. D. Del. 2010) 213
Millennium Lab Holdings II, LLC, Re 242 F. Supp. 3d 322 (D. Del. 2017) 338
Millennium Lab Holdings II, LLC, Re 543 B.R. 703 (Bankr. D. Del. 2016) 338
Millennium Lab Holdings II, LLC, Re 575 B.R. 252 (Bankr. D. Del. 2017) 338
Murray Realty Co. v Regal Shoe Co., 265 N.Y. 332, 193 N.E. 164, 165 (1934) 149
Neuman v Pike, 591 F.2d 191 (2d Cir. 1979) 212
NNN Parkway 400 26, LLC, Re 505 B.R. 277 (Bankr. C.D. Cal. 2014) 162
Nortel Networks, Inc., Re 737 F.3d 265 (3d Cir. 2013) 119, 142, 167
North American Catholic Education Programming Foundation, Inc. v Gheewalla, 930 A.2d 92 (Del. 2007) 220
Owens Corning, Re 419 F.3d 195 (3d Cir. 2005) 144
Paramount Communications, Inc. v Time, 571 A.2d 1140 (Del. Ch. 1990) 213
Pennzoil v Texaco, Inc., 481 U.S. 1 (1987) 144
Pepper v Litton, 308 U.S. 295 (1939) 220
Production Resources Group, LLC v NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) 218
Quadrant Structured Products Co. v Vertin, 102 A.3d 155 (Del. Ch. May 4, 2015) 218

**Schacht v Brown**, 711 F.2d 1343 (7th Cir. 1983) .................................................................................. 218

**Scott Acquisition Corp., Re** 344 B.R. 283 (Bankr. D. Del. 2006)....................................................... 218

**SGL Carbon Corporation** (200 F.3d 154).................................................................................................. 37

**Sharon Steel Corp., Re** 871 F.2d 1217 (3d Cir. 1989) ....................................................................... 219


**Shopmen's Local Union No. 455 v Kevin Steel Products**, 519 F.2d 707 (2d Cir. 1975) .................... 315

**Simons v Cogan**, 549 A.2d 300 (Del. 1988) ...................................................................................... 212

**Smith v Van Gorkom**, 488 A.2d 858 (Del. 1985) ............................................................................ 211

**SMP Ltd., Re** Case No. 17-11192 (Bankr. S.D.N.Y. 2017) (SMB) ..................................................... 149


**SunEdison**, Re 577 B.R. 120 (Bankr. S.D.N.Y. 2017) ......................................................................... 149, 150

**Texaco Inc., Re** 76 B.R. 322 (Bankr. S.D.N.Y. 1987) ......................................................................... 144

**Treadway Co. v Care Corp.**, 638 F.2d 357 (2d Cir. 1980) .................................................................. 213

**Trenwick America Litigation Trust v Ernst & Young**, 906 A.2d 168 (Del. Ch. 2006) .................... 220

**Triple A&R Capital Inv. Inc., Re** 519 B.R. 581 (Bankr. D.P.R. 2014) .................................................... 86

**Tronox, Inc. v Anadarko Petroleum, Corp. (Re Tronox, Inc)** 450 B.R. 432 (Bankr. S.D.N.Y. 2011) ........... 144

**United States v Byrum**, 408 U.S. 125 (1972) .................................................................................... 211


**United States v Jolly**, 102 F.3d 46 (2d Cir. 1996) .............................................................................. 212

**Unolocal Corp. v Mesa Petroleum Co.**, 493 A.2d 946 (Del. 1985) ....................................................... 213

**Verestar Inc., Re** 343 B.R. 444 (Bankr. S.D.N.Y. 2006) .................................................................... 211, 220

**Victrix Steamship Co., SA v Salen Dry Cargo A.B.**, 825 F.2d 709 (2d Cir. 1987) ................................. 120


**Weitzen, Re** 3 F. Supp. 698 (S.D.N.Y. 1933) .................................................................................... 86

**Wolf v Winstein** (372) U.S. 633 (1963) ................................................................................................. 217

**Wood v Drummer** 30 F.Cas. 435 (No. 17944) (C.C.D. Me. 1824) ..................................................... 218

**Zimmerman v Continental Airlines, Inc.**, 712 F.2d 55 (3d Cir. 1983) ................................................ 116

---

**Cases from other Jurisdictions**

**Canpotex Shipping Servs. Ltd. v Maritime Petrobulk Ltd** 2015 F.C. 1108 (Can.) .............................. 124

Cass. Civ. no. 5215/2008 ......................................................................................................................... 254

**Cour de Cassation, Société Saret v SBBM**, (1992) .............................................................................. 115


**Nicholson v Permakraft (N.Z.) Ltd** [1985] 1 NZLR 242 (CA) .............................................................. 216


**Nortel Networks, Inc., Re** 2009 CarswellOnt 236 .............................................................................. 167

Precious Shipping Public Co Ltd v O.W. Bunker Far East (Singapore) Pte Ltd [2015] 4 SLR 1229
..................................................................................................................124
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABA/Am. Bar Ass.</td>
<td>American Bar Association Journal</td>
</tr>
<tr>
<td>ABLI</td>
<td>Asian Business Law Institute</td>
</tr>
<tr>
<td>Am. Econ. Rev.</td>
<td>American Economic Review</td>
</tr>
<tr>
<td>Am. J. Bankr. L.</td>
<td>American Journal of Bankruptcy Law</td>
</tr>
<tr>
<td>Am. L. Rev.</td>
<td>American Law Review</td>
</tr>
<tr>
<td>Am. Psychol.</td>
<td>American Psychologist</td>
</tr>
<tr>
<td>APR</td>
<td>Absolute Priority Rule</td>
</tr>
<tr>
<td>Arb. Int’l</td>
<td>Arbitration International</td>
</tr>
<tr>
<td>Ariz. L. Rev.</td>
<td>Arizona Law Review</td>
</tr>
<tr>
<td>Australian J. Corp. L.</td>
<td>Australian Journal of Corporate Law</td>
</tr>
<tr>
<td>B.C.L. Rev.</td>
<td>Boston College Law Review</td>
</tr>
<tr>
<td>B.U. L. Rev.</td>
<td>Boston University Law Review</td>
</tr>
<tr>
<td>Bankr. L. Letter</td>
<td>Bankruptcy Law Letter</td>
</tr>
<tr>
<td>BAPCA</td>
<td>Bankruptcy Abuse Prevention and Consumer Protection Act (2005)</td>
</tr>
<tr>
<td>BBA</td>
<td>British Bankers’ Association</td>
</tr>
<tr>
<td>BBB</td>
<td>British Business Bank</td>
</tr>
<tr>
<td>Behav. Sci.</td>
<td>Behavioral Sciences</td>
</tr>
<tr>
<td>Bell J. of Econ. &amp; Man.</td>
<td>Bell Journal of Economy &amp; Management</td>
</tr>
<tr>
<td>Berkeley Tech. L.J.</td>
<td>Berkeley Technology Law Journal</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Name</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
</tr>
<tr>
<td>British Accounting Rev.</td>
<td>The British Accounting Review</td>
</tr>
<tr>
<td>Brook. J. Corp. Fin. &amp; Com. L.</td>
<td>Brooklyn Journal of Corporate, Financial &amp; Commercial Law</td>
</tr>
<tr>
<td>Brook. J. Int'l L.</td>
<td>Brooklyn Journal of International Law</td>
</tr>
<tr>
<td>Brook. L. Rev.</td>
<td>Brooklyn Law Review</td>
</tr>
<tr>
<td>Bus. Law.</td>
<td>Business Lawyer</td>
</tr>
<tr>
<td>BYU L. Rev.</td>
<td>Brigham Young University Law Review</td>
</tr>
<tr>
<td>C.L.W.R.</td>
<td>Common Law World Review</td>
</tr>
<tr>
<td>C.R. &amp; I.</td>
<td>Corporate Rescue &amp; Insolvency</td>
</tr>
<tr>
<td>CA 2006</td>
<td>Companies Act 2006</td>
</tr>
<tr>
<td>CAMAC</td>
<td>Corporations and Markets Advisory Committee</td>
</tr>
<tr>
<td>Camb. L.J.</td>
<td>Cambridge Law Journal</td>
</tr>
<tr>
<td>Cardozo L. Rev.</td>
<td>Cardozo Law Review</td>
</tr>
<tr>
<td>Case W. Res. L. Rev.</td>
<td>Case Western Reserve Law Review</td>
</tr>
<tr>
<td>CBIA</td>
<td>Cross-Border Insolvency Agreement</td>
</tr>
<tr>
<td>CBIP</td>
<td>Cross-Border Insolvency Protocol</td>
</tr>
<tr>
<td>CBIR 2006</td>
<td>Cross-Border Insolvency Regulations 2006</td>
</tr>
<tr>
<td>CDDA 1986</td>
<td>Corporate Directors Disqualification Act 1986</td>
</tr>
<tr>
<td>CDN</td>
<td>Corporate Distress Notice</td>
</tr>
<tr>
<td>CDO</td>
<td>Collateralised Debt Obligations</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swap</td>
</tr>
<tr>
<td>CERIL</td>
<td>Conference on European Restructuring and Insolvency Law</td>
</tr>
<tr>
<td>Chi.-Kent L. Rev.</td>
<td>Chicago-Kent Law Review</td>
</tr>
<tr>
<td>CIL</td>
<td>Customary International Law</td>
</tr>
<tr>
<td>CLL</td>
<td>Covenant Lite Loans</td>
</tr>
<tr>
<td>CLRFC</td>
<td>Company Legislation and Regulatory Framework Committee</td>
</tr>
<tr>
<td>Col. L. Rev.</td>
<td>Columbia Law Review</td>
</tr>
<tr>
<td>COMI</td>
<td>Centre of Main Interest</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Title</td>
</tr>
<tr>
<td>--------------</td>
<td>------------</td>
</tr>
<tr>
<td>Comp. Law.</td>
<td>Company Lawyer</td>
</tr>
<tr>
<td>Conn. J. Int’l L</td>
<td>Connecticut Journal of International Law</td>
</tr>
<tr>
<td>Cornell L. Rev.</td>
<td>Cornell Law Review</td>
</tr>
<tr>
<td>Critic. Perspect. Account.</td>
<td>Critical Perspectives on Accounting</td>
</tr>
<tr>
<td>CSLJ</td>
<td>Company and Securities Law Journal</td>
</tr>
<tr>
<td>CUP</td>
<td>Cambridge University Press</td>
</tr>
<tr>
<td>D.R.I.</td>
<td>Dispute Resolution International</td>
</tr>
<tr>
<td>Deakin L. Rev.</td>
<td>Deakin Law Review</td>
</tr>
<tr>
<td>Del. J. Corp. L.</td>
<td>Delaware Journal of Corporate Law</td>
</tr>
<tr>
<td>Del. L. Rev.</td>
<td>Delaware Law Review</td>
</tr>
<tr>
<td>DIP</td>
<td>Debtor-in-possession</td>
</tr>
<tr>
<td>Duke L.J.</td>
<td>Duke Law Journal</td>
</tr>
<tr>
<td>E.C.F.R.</td>
<td>European Company and Financial Law Review</td>
</tr>
<tr>
<td>EA 2002</td>
<td>Enterprise Act 2002</td>
</tr>
<tr>
<td>EBOR L. Rev.</td>
<td>European Business Organization Law Review</td>
</tr>
<tr>
<td>Edinburgh L. Rev.</td>
<td>Edinburgh Law Review</td>
</tr>
<tr>
<td>EIR</td>
<td>Council Regulation (EC) 1346/2000 on insolvency proceedings</td>
</tr>
<tr>
<td>Emory Bankr. Dev. J.</td>
<td>Emory Bankruptcy Developments Journal</td>
</tr>
<tr>
<td>Env. L. Rev.</td>
<td>Environmental Law Review</td>
</tr>
<tr>
<td>Env. Liability</td>
<td>Environmental Liability</td>
</tr>
<tr>
<td>ERCL</td>
<td>European Review of Contract Law</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EUIR Recast</td>
<td>Regulation (EU) 2015/848 on insolvency proceedings (recast)</td>
</tr>
<tr>
<td>Eur. Econ. Rev.</td>
<td>European Economic Review</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FCA</td>
<td>Financial Conduit Authority</td>
</tr>
<tr>
<td>Fla. L. Rev.</td>
<td>Florida Law Review</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Name</td>
</tr>
<tr>
<td>--------------------</td>
<td>------------------------------------------------</td>
</tr>
<tr>
<td>Fordham L. Rev.</td>
<td>Fordham Law Review</td>
</tr>
<tr>
<td>FRC</td>
<td>Financial Reporting Council</td>
</tr>
<tr>
<td>FRS</td>
<td>Financial Reporting Standards</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>Geo. L.J.</td>
<td>Georgetown Law Journal</td>
</tr>
<tr>
<td>Geo. Mason. L. Rev.</td>
<td>George Mason University Law Review</td>
</tr>
<tr>
<td>Haifa L. Rev.</td>
<td>Haifa Law Review</td>
</tr>
<tr>
<td>Harv. L. Rev.</td>
<td>Harvard Law Review</td>
</tr>
<tr>
<td>Hofstra L. Rev.</td>
<td>Hofstra Law Review</td>
</tr>
<tr>
<td>I.C.C.L.R.</td>
<td>International Company and Commercial Law Review</td>
</tr>
<tr>
<td>I.C.L.Q.</td>
<td>International &amp; Comparative Law Quarterly</td>
</tr>
<tr>
<td>I.E.L.R.</td>
<td>International Energy Law Review</td>
</tr>
<tr>
<td>IA 1986</td>
<td>Insolvency Act 1986</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>III</td>
<td>International Insolvency Institute</td>
</tr>
<tr>
<td>ILRC</td>
<td>Insolvency Law Review Committee</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>Insolv. Int.</td>
<td>Insolvency Intelligence</td>
</tr>
<tr>
<td>Insolv. L.J.</td>
<td>Insolvency Law Journal</td>
</tr>
<tr>
<td>Int. C.R.</td>
<td>International Corporate Rescue</td>
</tr>
<tr>
<td>Int. Insol. Rev.</td>
<td>International Insolvency Review</td>
</tr>
<tr>
<td>Int'l L.J.</td>
<td>International Law Journal</td>
</tr>
</tbody>
</table>
Int’l Rev. Law & Econ.  International Review of Law and Economics
Iowa J. Corp. L.  Iowa Journal of Corporate Law
Iowa L. Rev.  Iowa Law Review
J. Bus. & Tech. L.  Journal of Business & Technology Law
J. Bus. Law  Journal of Business Law
J. Corp. Fin.  Journal of Corporate Finance
J. Corp. L.  Journal of Corporation Law
J. Corp. L. Stud.  Journal of Corporate Law Studies
J. Econ. Behav. & Org.  Journal of Economic Behavior & Organization
J. Econ. Issues  Journal of Economic Issues
J. Econ. Lit.  Journal of Economic Literature
J. Econ. Persp.  Journal of Economic Perspectives
J. Econ. Theory  Journal of Economic Theory
J. Finance  The Journal of Finance
J. Int. Arb.  Journal of International Arbitration
J. Legal Analysis  Journal of Legal Analysis
J. Legal Stud.  Journal of Legal Studies
J. Regul. Econ.  Journal of Regulatory Economics
J. Risk & Uncertainty  Journal of Risk and Uncertainty
J.I.B.L  Journal of International Banking Law
J.L & Econ.  Journal of Law & Economics
J.L. Econ. & Org.  Journal of Law, Economics and Organization
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>JAE</td>
<td>Journal of Accounting and Economics</td>
</tr>
<tr>
<td>JFI</td>
<td>Journal of Financial Intermediation</td>
</tr>
<tr>
<td>JFQA</td>
<td>Journal of Financial and Quantitative Analysis</td>
</tr>
<tr>
<td>JIBLR</td>
<td>Journal of International Banking Law and Regulation</td>
</tr>
<tr>
<td>JIN</td>
<td>Judicial Insolvency Network</td>
</tr>
<tr>
<td>JSCAN</td>
<td>Journal of Strategic Contracting &amp; Negotiation</td>
</tr>
<tr>
<td>L. and Soc'y Rev.</td>
<td>Law and Society Review</td>
</tr>
<tr>
<td>L.Q.R.</td>
<td>Law Quarterly Review</td>
</tr>
<tr>
<td>Labor L.J.</td>
<td>Labor Law Journal</td>
</tr>
<tr>
<td>Law &amp; Contemp. Probs.</td>
<td>Law and Contemporary Problems</td>
</tr>
<tr>
<td>Leg. Stud.</td>
<td>Legal Studies</td>
</tr>
<tr>
<td>LMCLQ</td>
<td>Lloyd's Maritime and Commercial Law Quarterly</td>
</tr>
<tr>
<td>M.L.R.</td>
<td>Modern Law Review</td>
</tr>
<tr>
<td>Marq. L. Rev.</td>
<td>Marquette Law Review</td>
</tr>
<tr>
<td>Melbourne Univ. L. Rev.</td>
<td>Melbourne University Law Review</td>
</tr>
<tr>
<td>Minn. L. Rev.</td>
<td>Minnesota Law Review</td>
</tr>
<tr>
<td>Monash U.L.R.</td>
<td>Monash University Law Review</td>
</tr>
<tr>
<td>N.I.L.Q.</td>
<td>Northern Ireland Legal Quarterly</td>
</tr>
<tr>
<td>N.L.J.</td>
<td>New Law Journal</td>
</tr>
<tr>
<td>Nott. L.J.</td>
<td>Nottingham Law Journal</td>
</tr>
<tr>
<td>Nw. U. L. Rev.</td>
<td>Northwestern University Law Review</td>
</tr>
<tr>
<td>Ohio St. L.J.</td>
<td>Ohio State Law Journal</td>
</tr>
<tr>
<td>OJLS</td>
<td>Oxford Journal of Legal Studies</td>
</tr>
<tr>
<td>OUP</td>
<td>Oxford University Press</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Name</td>
</tr>
<tr>
<td>--------------------</td>
<td>------------------------------------------------</td>
</tr>
<tr>
<td>Penn St. Int’l L. Rev.</td>
<td>Penn State International Law Review</td>
</tr>
<tr>
<td>Q.J. Econ.</td>
<td>The Quarterly Journal of Economics</td>
</tr>
<tr>
<td>RCP</td>
<td>Revised Common Pool</td>
</tr>
<tr>
<td>RLR</td>
<td>Restitution Law Review</td>
</tr>
<tr>
<td>S. Cal. L. Rev.</td>
<td>Southern California Law Review</td>
</tr>
<tr>
<td>S. Tex. L. Rev.</td>
<td>South Texas Law Review</td>
</tr>
<tr>
<td>SAcLJ</td>
<td>Singapore Academy of Law Journal</td>
</tr>
<tr>
<td>San Diego Int’l L.J.</td>
<td>San Diego International Law Journal</td>
</tr>
<tr>
<td>SBEEA 2015</td>
<td>Small Business, Enterprise and Employment Act 2015</td>
</tr>
<tr>
<td>SEC</td>
<td>U.S. Security and Exchange Commission</td>
</tr>
<tr>
<td>SLA</td>
<td>Supply and License Agreement</td>
</tr>
<tr>
<td>SMJ</td>
<td>Strategic Management Journal</td>
</tr>
<tr>
<td>South California L. Rev.</td>
<td>South California Law Review</td>
</tr>
<tr>
<td>SRA</td>
<td>Solicitors Regulation Authority</td>
</tr>
<tr>
<td>Sydney L. Rev.</td>
<td>Sydney Law Review</td>
</tr>
<tr>
<td>Syracuse L. Rev.</td>
<td>Syracuse Law Review</td>
</tr>
<tr>
<td>TCP</td>
<td>Traditional Common Pool</td>
</tr>
<tr>
<td>Tex. L. Rev.</td>
<td>Texas Law Review</td>
</tr>
<tr>
<td>Texas Int’l L.J.</td>
<td>Texas International Law Journal</td>
</tr>
<tr>
<td>Tul. L. Rev.</td>
<td>Tulane Law Review</td>
</tr>
<tr>
<td>U. Chi. L. Rev.</td>
<td>University of Chicago Law Review</td>
</tr>
<tr>
<td>U. Cin. L. Rev.</td>
<td>University of Cincinnati Law Review</td>
</tr>
<tr>
<td>U. Ill. L. Rev.</td>
<td>University of Illinois Law Review</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Form</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
</tr>
<tr>
<td>U.K.</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>U.S.</td>
<td>United States</td>
</tr>
<tr>
<td>UCLA L. Rev.</td>
<td>University of California at Los Angeles Law Review</td>
</tr>
<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
</tr>
<tr>
<td>UNCITRAL Guide</td>
<td>UNCITRAL Guide to Enactment and Interpretation (2014)</td>
</tr>
<tr>
<td>UNSW L.J.</td>
<td>University of New South Wales Law Journal</td>
</tr>
<tr>
<td>Va. J. Int'l L.</td>
<td>Virginia Journal of International Law</td>
</tr>
<tr>
<td>Va. L. Rev.</td>
<td>Virginia Law Review</td>
</tr>
<tr>
<td>Vand. L. Rev.</td>
<td>Vanderbilt Law Review</td>
</tr>
<tr>
<td>Wake For. L. Rev.</td>
<td>Wake Forest Law Review</td>
</tr>
<tr>
<td>Wash. U. L.Q.</td>
<td>Washington University Law Quarterly</td>
</tr>
<tr>
<td>Wis. Int'l L.J.</td>
<td>Wisconsin International Law Journal</td>
</tr>
<tr>
<td>Wis. L. Rev.</td>
<td>Wisconsin Law Review</td>
</tr>
<tr>
<td>WMSI</td>
<td>Wealth Maximisation of Stakeholders' Interests</td>
</tr>
<tr>
<td>Yale J. on Reg.</td>
<td>Yale Journal on Regulation</td>
</tr>
<tr>
<td>Yale L.J.</td>
<td>Yale Law Journal</td>
</tr>
</tbody>
</table>
«In exploring the dynamic interrelation between legislation and case law in this area, it is important to bear in mind the key goals of predictability, certainty and party autonomy and to ensure that these principles are not departed from without good reason»\(^1\)

INSOLVENCY STATUTORY RULES AND CONTRACTUAL FREEDOM: A STUDY ON THE LIMITS OF CORPORATE INSOLVENCY LAW IN THE ANGLO/AMERICAN TRADITION

PART I
CHAPTER 1 - FOUNDATIONS

«Bankruptcy law casts a long shadow.

It is salient not only for financially distressed companies, but also for the risk calculations of lenders, for corporate managers who must assess the potential downside of their own decisions, and for creditors whose protection in bankruptcy law will affect the level, costs, and form of credit they extend. [It] can influence the decisions of corporate managers about the reorganizational and legal structure of a firm. [...] Consequently, while bankruptcy law directly concerns only companies in financial difficulty, in fact it affects more generally all corporations in an open credit economy»

1.1 PREAMBLE

Bankruptcy is rocking, and 'business failure has gone international'.

The worst financial and economic crisis in recent times forced many seemingly viable banks, corporations and municipalities to seek legal protection from their creditors. As happened in the Thirties, national legislators realized that 'the emperor ha[d] no clothes' and that the existing statutory frameworks were not adequate to cope with systemic crises. Political, regional and national authorities were “forced” to descend into the insolvency arena, in order to control the possible domino effect that large, systemic failures would have caused.

Did they only use insolvency procedures for this purpose or does the legislatures’ intervention prove the substantial failure of the traditionally

3 This thesis will generally adopt the terms "business", "company" and "corporation" instead of "firm" because under the English tradition the latter connotes primarily a partnership.
4 The term "bankruptcy" is frequently employed to refer to corporate insolvencies, especially according to the U.S. tradition. Similarly, the notion of "corporate bankruptcy" is employed as a synonym of "corporate insolvency". This will not be the case of this thesis. Out of respect for the British tradition and considering that the research work has primarily been carried out in a London-based HE institution, any mention of bankruptcy can be taken to mean personal bankruptcy, unless in direct quotations.
neutral principle and purpose-driven approaches to define the scope, the limits
and - to a lesser extent - the content of insolvency law?

This work attempts to answer these questions. It adopts a legal perspective to
combine theoretical, normative\(^5\) approaches with a problem-based example-
driven (i.e. doctrinal) method, thus allowing the author to test the validity of its
conclusions on a wide spectrum of cases.

In doing so, this thesis also tries to refute the feeling that ‘bankruptcy is a
gloomy and depressing subject’\(^6\) and a rather ‘dry and discouraging topic’.\(^7\) This
dismal perception has led in the past to consider insolvency law as an
“afterthought”.\(^8\) Even today insolvency reforms neither break the news, nor
excite the electorate. Despite that, public opinion is frequently “taken aback” by
the frequency and consequences of large insolvencies\(^9\) and by the emergence of
controversial restructuring\(^10\) mechanisms.\(^11\) It is high time, therefore, that the
law steals the limelight from high-profile cases.

---

\(^5\) See below section 1.5.

\(^6\) C Warren, Bankruptcy in United States History (Boardbook 1935) 3.

\(^7\) Ibid.

\(^8\) Many examples could be made to prove the validity of this point. One of the most explanatory
deals with the inclusion of the bankruptcy clause (Article 1, Section 8, Clause 4) in the U.S.
Constitution.

When the United States decided to approve a new Constitution to replace the old Articles of
Confederation (1777), they called for a Convention in Philadelphia. This Convention lasted from
25 May to 17 September 1787, when the bill was signed. The bankruptcy clause was first
proposed by the delegate from South Carolina, Charles Pinckney, on 29 August. It was approved,
almost without discussion, on 3rd September.

\(^9\) J Rutenberg and B Vlasic, ‘Chrysler Files to Seek Bankruptcy Protection’ The New York Times
17 September 2018; Unnamed, ‘The Bankruptcy of General Motors: A giant falls’ The
September 2018.

\(^10\) For the distinction between “rescue” and “restructuring”, see below sub-section 1.3(b).

\(^11\) Heatedly debated is the opportunity and legality to "pre-pack", i.e. to negotiate a sale of all or
part of a company’s business or assets with a purchaser before filing for insolvency protection,
with the sale taking place immediately after the appointment of an insolvency practitioner
(administration; England) or the admission into the procedure (Chapter 11; U.S.). See, among
others: L Haddou and J Cumbo, ‘Companies use ‘pre-packs to dump £3.8bn of pension liabilities’
Financial Times (London, 9 April 2017) <https://www.ft.com/content/f3f574fa-0f2c-11e7-a88c-50ba212dce4d?mhq5j=e3> accessed 17 September 2018; M Herman, ‘Abuse of pre-pack
deals ’could turn Britain into an insolvency brothel’ The Times (London, 18 January 2010)
<https://www.thetimes.co.uk/article/abuse-of-pre-pack-deals-could-turn-britain-into-an-
insolvency-brothel-92ls9qt0xt7> accessed 17 September 2018.
1.1(a) Justification for the Research

On the afternoon of 21 August 1985, *A.H. Robins Company, Inc.* (‘A.H. Robins’) filed a petition for reorganisation (commonly known as “Chapter 11”) in the U.S. Bankruptcy Court of Richmond. *A.H. Robins* was a Fortune 400 Corporation, one of the main employers in Richmond and a profitable pharmaceutical enterprise. Its executives believed that this filing represented the most appropriate course of action to protect the interests of the company. In fact, the directors needed to shield the company and its shareholders from liabilities for injuries resulting from the use of the “Dalkon Shield” intrauterine birth control devices.

According to a statement from the president of the company, E. Clairborne Robins Jr., the filing was necessary ‘to protect the company's economic vitality against those who would destroy it for the benefit of the few’. The procedure resulted in the company being sold to the *American Home Products, Corporation* (‘American Home’). *American Home*, as part of the resolution of the insolvency case, agreed to pay $2.3 billion to a trust responsible for covering the monetary disbursements arising from the claims of the injured women. According to the bankruptcy plan, *A.H. Robins*’ old shareholders received *American Home* stock worth four (!) times the pre-bankruptcy price of their *A.H. Robins* shares.

*A.H. Robins* is a case where a profitable company filed for insolvency to maximise shareholders’ investment. This example reinstates the validity of several empirical studies which concluded that equity holders receive more than what they would be entitled to on the basis of insolvency rules, despite

---

12 The company’s net profits after tax for the years 1980 through 1982 totalled over $118 million. Furthermore, an affidavit filed with the *A.H. Robins* petition showed that the company realised net earnings of $35.3 million in the first six months of 1985 – after deduction of tax and all Dalkon Shield expenses – compared to $20 million for the comparable period in the previous year. See Declaration of G.E.R. Stiles, 21 August 1985, p. 14.

13 In this thesis, the terms “shareholder”, “equity-holder” and “stockholder” are used as synonyms.


15 *Wall Street Journal*, 22 August 1985, p. 3, col. 1. It is not clear if the term “the few” referred to the company’s competitors, or to the thousands of women who died or were left sterile after the use of the Dalkon Shield device.

the existence of statutory mechanisms designed to prevent this outcome.\textsuperscript{17} Is this freedom to contract out of insolvency guiding principles (absolute priority, collectivity and \textit{pari passu} distribution) desirable?

The frequency and magnitude of cases in which petitions for insolvency protection are filed for reasons other than the imminent or evident inability of the debtors to pay their debts have increased over the years.\textsuperscript{18} Similar strategies are being considered in ongoing tort cases,\textsuperscript{19} even if some commentators are now arguing that the companies that emerge from these corporate rescue cases should be held liable for pre-insolvency claims.\textsuperscript{20} Despite that, lawmakers have taken no meaningful legislative initiative to limit or otherwise control this course of action.\textsuperscript{21}

\begin{itemize}
\item \textsuperscript{17} 11 U.S. Code §.1129(b)(2) provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, no creditor of lesser priority, or shareholder, receives any distribution under the plan.
\item \textsuperscript{18} Examples include \textit{Texaco} (1987) to defy competitors, \textit{Continental Airlines} (1983 and 1990) to defy rivals and break unionized workers, \textit{Johns Manville Corp.} (1982) to deal with asbestos-related claims, \textit{Wilson Foods} (1983) to break unionized labour cost, \textit{Dow Corning} (1995) to deal with injury claims filed by hundreds of thousands of women who used its silicone breast implants when a global settlement broke down, \textit{Turner & Newall} (2001) to deal with asbestos liabilities and the deficit in the pension fund, \textit{General Motors} (2009) to deal (in part) with the ignition switch scandal and its related claims, \textit{Takata} (2017) to deal with liabilities associated with defective air bag inflators. Certain pre-insolvency sales, such as the transfer of \textit{BHS} (2015) from its previous owner to a former racing driver and bankrupt entrepreneur, may be considered as strategic attempts to postpone insolvency filing, avoid director's liability and secure otherwise voidable transactions.
\item \textsuperscript{19} See the potential developments in the \textit{Johnson & Johnson} case, where on 22 August 2017 a woman has been awarded $417m for it was proven that the company's baby powder contributed to cause an ovarian cancer. The company was potentially aware of this risk since 1980. N Raymond, 'Johnson & Johnson ordered to pay $417m to woman claiming to have developed ovarian cancer from baby powder' \textit{The Independent} (London, 22 August 2017) <http://www.independent.co.uk/news/business/news/talc-johnson-baby-powder-cancer-woman-compensation-417-million-ovarian-california-hygiene-a7905996.html> accessed 17 September 2018. More recently, the same company was ordered to pay $4.7bn in damages to twenty-two women who alleged that its talc products caused ovarian cancer: J Dye, 'Johnson & Johnson hit with $4.7bn verdict in talc cancer trial' \textit{Financial Times} (New York, 13 July 2018) <https://www.ft.com/content/9957c984-8628-11e8-a29d-73e3d454535d> accessed 17 September 2018.
\item \textsuperscript{20} B Warner, 'Reconciling Bankruptcy Law and Corporate Law Principles: Imposing Successor Liability on GM and Similar Sleight-Of-Han 363 Sakes' (2016) 32 Emory Bankr. Dev. J. 537 (arguing that those harmed by defective GM vehicles sold before 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 corporation to sell its assets to itself).
\item \textsuperscript{21} In 1984, after the \textit{Johns Manville} case, Congress enacted a statute which provided that insolvency proceedings 'do not affect any right to trial by jury that an individual has under applicable non-bankruptcy law with regard to personal injury or wrongful death tort claim' [Public Law 98-353, Title I, §.102(a), 28 U.S. Code §.1411(a)].
\end{itemize}
Particularly telling, for the purposes of this research, is the lack of consistency in the statutory requirements for the filing of insolvency protection. For instance, in England, with reference to formal\textsuperscript{22} insolvency procedures, there is no obligation for a company entering into a company voluntary arrangement (‘CVA’) to be insolvent, while with reference to the administration procedure, courts may make such an order upon satisfaction that the company ‘is or is likely to become unable to pay its debts’.\textsuperscript{23}

Similarly, there is no insolvency requirement to file a Chapter 11 petition in a U.S. court. The only obligation upon the debtor is that ‘the plan has been proposed in good faith and not by any means forbidden by law’.\textsuperscript{24} Creditors may apply to have petitions dismissed where this is not the case.\textsuperscript{25}

Furthermore, the concept of “insolvency” is controversial.\textsuperscript{26}

Finally, companies do not only extricate themselves from situations of crisis without the use of statutory insolvency remedies, but they also make use of preventive out-of-court proceedings where the boundaries between company, contract, procedural and insolvency laws are blurred.\textsuperscript{27} Some hybrid proceedings where the final arrangement is approved by the court are generally

---

\textsuperscript{22} “Formal procedures” are collective procedures, which involve all the creditors, under the control or supervision of a court and an independent practitioner. Debtors may retain control of their assets (debtor-in-possession or ‘DIP’ procedures), but their freedom is significantly restricted. An automatic stay of individual enforcement actions is usually granted upon application. The liquidation or rescue plan is binding on all creditors, including dissenting ones.

With reference to England, formal procedures include administration, administrative receivership, creditors’ voluntary liquidation and company voluntary arrangements. With reference to the U.S., they include Chapter 7 (liquidation), Chapter 9 (for municipalities), Chapter 11, Chapter 12 (for family farmers and fishermen), Chapter 13 (for individuals) and Chapter 15 (cross-border cases) of 11 U.S. Code.

\textsuperscript{23} Insolvency Act 1986 (‘IA 1986’), Sch. B1, para 11(a), as amended by the Enterprise Act 2002 (‘EA 2002’).

\textsuperscript{24} 11 U.S. Code, § 1129(a)(3).

\textsuperscript{25} For instance, in \textit{SGL Carbon Corporation} (200 F.3d 154), the court dismissed the company’s Chapter 11 case because of bad faith demonstrated by a lack of “reorganizational purpose”.

\textsuperscript{26} See below section 5.2 of this thesis.

\textsuperscript{27} Hess and others (eds), \textit{The Implementation of the New Insolvency Regulation: Improving Cooperation and Mutual Trust} (Hart Publishing: Baden-Baden, 2017) 25.
binding on all creditors. Other out-of-court restructuring settlements are binding only on the parties who agree on them.\textsuperscript{28} Their use is so widespread that at European level the recognition of hybrid proceedings is now regulated by Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) (‘EUIR Recast’).\textsuperscript{29} The Commission is promoting measures to harmonise and make more efficient preventive restructuring and second chance frameworks.\textsuperscript{30}

The contemporary nature of the cases mentioned above and in footnote 18, as well as the implications for business and turnaround practices suggest that defining the “proper” scope of insolvency law is not a “theoretical” and uninspiring topic. This issue needs to be addressed, particularly as the jurisdictions considered in this study are entering into a period of regulatory reconsideration.\textsuperscript{31}

1.1(b) Outline of the Thesis

This thesis is divided into two blocks.

\textsuperscript{28} See below sub-section 1.3(b).
\textsuperscript{29} Regulation (EU) 2015/848 of 20 May 2015 of the European Parliament and the Council on insolvency proceedings (recast) [2015] O J L141/19, recital 10, which extends the scope of the regulation to ‘proceedings which provide for restructuring of a debtor at a stage where there is only a likelihood of insolvency, and to proceedings which leave the debtor fully or partially in control of its assets and affairs [provided that they] take place under the control or supervision of a court’. These proceedings should, however, be listed in Annex A of the Regulation. For a critical assessment of the European law in the context of the EU Europe 2020 growth strategy: G McCormack, ‘Something Old, Something New: Recasting the European Insolvency Regulation’ (2016) 79(1) M.L.R. 121.
\textsuperscript{31} With reference to England, Ian Fletcher observed that ‘after 30 years, the time is surely approaching for a comprehensive review and overhaul of the Principal Act’: IF Fletcher, The Law of Insolvency (5th edn, Sweet & Maxwell: London, 2017) 24 (emphasis added). As for the U.S., the likelihood of a major overhaul has been voiced by many commentators and resulted in the American Bankruptcy Institute’s Report of the Commission to Study the Reform of Chapter 11 – available at: <https://abiworld.app.box.com/s/vvircv5xzv83aavl4dp4h> accessed 17 September 2018.
Part I focuses on presenting the seminal theories on the framework of insolvency law and on de-constructing and questioning their validity to determine when insolvency remedies should be applied. The author focuses his analysis on autonomy-based (chapter two), proceduralist (chapter three) and principle-informed (chapter four) approaches. Upon having identified the qualifying elements of each approach, this thesis analyses how they work in practice and critically assesses them on the basis of the criteria introduced in sub-section 1.3(c).

Part I of the thesis reasserts the centrality of the theoretical debate on the limits of insolvency law. It observes that while all of the analysed theories are extremely persuasive and offer guidance in some cases, none of them offer a procedurally fair and efficient conceptualisation of when and to what extent insolvency rules should derogate from contracts.

There is therefore the need to conceptualise an alternative framework, which preserves the aspirational goals promoted by these approaches. These are party autonomy (autonomy-based theories), legal and commercial predictability (proceduralist theories) and inclusivity (principle-based theories).

---

32 The de-constructivist approach adopted in this thesis means that theories (and concepts) are unpacked and reduced to their qualifying elements, which are then assessed on the basis of the criteria outlined in sub-section 1.3(c). The de-constructivist analysis is instrumental to investigate if the premises upon which these theories and concepts are based meet the criteria that - according to the author - a corporate insolvency framework should feature.

33 Generally, autonomy-based approaches to corporate distress argue that there is no need for a discrete and mandatory system of insolvency rules. Parties could and should be allowed to contract out of insolvency. Companies should determine what happens in case of a general or technical default. "General default" occurs whenever a company misses a payment of either principal or interest. "Technical default" refers to any violation of a covenant other than the payment of principal or interest.

34 By and large, proceduralist approaches to corporate distress argue that insolvency rules should be restricted to procedural provisions aimed at facilitating parties in reaching an agreement on the outcome (liquidation, restructuring of the company, and rescue of the business or sale of its assets or entities) of the case. Insolvency rules should never amend the rights freely negotiated by the parties in pre-insolvency times.

35 Broadly speaking, principle-informed approaches to corporate distress argue that insolvency rules could amend rights freely negotiated by the parties in pre-insolvency times if and to the extent that it is necessary to pursue some overarching values, objectives and principles.

36 "Inclusivity" refers to the opportunity granted to all stakeholders to exercise participation rights and to the expectation that the person presiding over the insolvency procedure represents their interest and is held accountable for the failure to do so. Whereas collectivity binds creditors, "inclusivity offers them a pro-active role in the procedure itself": S Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67(2) M.L.R. 247, 250.
Part II marks the passage from the theoretical to the operational part of this work. In chapter five this thesis critically evaluates the standards (i.e. “insolvency”, “risk” and “common pool”) that have insofar been used to determine the limits of insolvency law. These standards are tested against the aspirational goals outlined in the previous paragraph.

This second part of the thesis reasserts the centrality of the common pool debate\(^{37}\) in its revised dimension. Insofar common pool situations have been assessed only among those stakeholders that have legally enforceable claims against the debtor. This has promoted the use of insolvency remedies in a strategic manner,\(^{38}\) i.e. to foster the interests of some stakeholders at the expense of others.

Building upon these findings, chapter six introduces a novel approach to determine: a) the scope and, to a more limited extent, the content of insolvency law; and b) the policies and objectives that should prevail in light of the predominant nature (maximisation of the assets or the capital) of the corporate distress procedure and of problems\(^{39}\) (solvency or revised common pool – ‘RCP’) faced by the parties. In other words, chapter six offers a new framework of corporate distress law.

The new framework assumes that insolvency procedures should be run for the interests of those who control the company (collectively known as “risk bearers”). This thesis defines these residual risk bearers as those who have controlling rights in the debtor by reason of the nature of their rights.\(^{40}\) Those who control the company are not simply those who own its shares or have proprietary or personal claims against the debtor. Statutes should ensure that

\(^{37}\) Borrowed from the law and economics literature, the “common pool” metaphor suggests that the fishermen who fish at a single “pool” may fish too much and deplete the pool, if no agreement can be reached to the other users of the pond. It would be in the general interest of each fisherman to limit their fishing practice: in the long run, this would result in higher return for them (because fishes would be allowed to procreate and ‘multiply’). Selfish, short-term practices would lead to over-fishing, for fear that others will do the same. Since rational, distributive solutions require collective actions, insolvency law ought to pursue only this goal.

\(^{38}\) A strategic filing has been described as ‘one that helps firms to implement strategic changes to relationships with customers, suppliers, or other trading partners in a manner that positively alters the likelihood of sustainable performance improvements and survival’: SD James, ‘Strategic Bankruptcy: A Stakeholder Management Perspective’ (2016) 69 J. Bus. Res. 492, 492.

\(^{39}\) For a definition of RCP problems, see below sub-section 1.3(a).

\(^{40}\) See sub-section 4.3(c) for a general definition and a non-exhaustive list.
all controlling stakeholders can take part and influence the outcome of corporate distress procedures.

Chapter six therefore introduces and describes the theory of “wealth maximisation of stakeholders’ interests” (‘WMSI’). It suggests that the boundary between general law and corporate distress remedies should be determined either by the emergence of either solvency or RCP problems among the company’s stakeholders.

This theory overcomes the need to establish a hierarchy of principles and purposes in insolvency law. It is based on a more informed understanding of the distinct facets of the RCP dilemma. The use of a RCP standard would produce a less conflicting application of corporate distress rules in cases where the rules derogate from contractually negotiated rights.

This thesis suggests the implementation of regulatory reforms driven by a public policy concern, i.e. that the expectations of risk bearers are not sufficiently recognised and protected under the existing insolvency framework.

At the same time, as evidenced in section 6.6, the author is not oblivious of the complications that arise from the implementation of “shake-up” proposals. Therefore, he recommends an evolutionary approach that would not determine a major overhaul of the existing Anglo-American business and insolvency culture.

This thesis therefore adopts a “procedural incrementalist” attitude that would enrich the foundations of the Anglo-American corporate distress law. The proposed theoretical framework can be transposed into legislative measures, provided that it meets sufficient favour in academic, commercial and political communities. The thesis explores how best to promote the legislative implementation of the WMSI theory.

---

41 The concept of “procedural incrementalism” was first introduced by JAE Pottow, ‘Procedural Incrementalism: A Model for International Bankruptcy’ (2004) 45 Va. J. Int’l L. 935. Pottow argued that the UNCITRAL Model Law on Cross-Border Insolvency bridged the theoretical divide between universalists and territorialists. This thesis aims at achieving a similar objective with reference to the different theories on limits of insolvency law.
This thesis focuses on Anglo-American laws and proceedings, because English and American legal systems are highly influential in the evolution of insolvency law, both at European and global level. Nevertheless, other cases are considered whenever it appears that their facts or decisions have influenced the evolution of the law or have the potential to do so in the future.

1.2 STATE OF THE ART

Insolvency specialists have produced no shortage of good academic works which advocate and defend a normative vision of this area of law.

Neo-libertarian papers suggest to treat corporate insolvency rules as private law remedies. Based on economic analysis, they maintain that private negotiations should be preferred, from a standpoint of efficiency, over compulsory statutory rules. Furthermore, they uphold that the heuristics currently favoured by academicians to justify insolvency law principles and its

---

42 The United Kingdom is considered as a unitary jurisdiction even if some of the provisions included in the main legislation in the field (the Insolvency Act 1986) do apply only to England and Wales. All references to the laws applicable in England should be taken to be applicable in Wales also.

43 The U.K. withdrawal from the European Union may adversely impact the role that English law will have for the evolution of European laws. However, at the time of writing, it is impossible to make a reasoned speculation on the matter. This conclusion is shared by several commentators: G McCormack and H Anderson, 'Brexit and its Implications for Corporate Insolvency in the UK' (2017) 7 J. Bus. Law 533 (warning about the risks that the UK withdrawal from the EU may have on the recognition in other European Member States of UK-sanctioned schemes involving European companies).


45 Another taxonomy for these theories is to describe them as “autonomy-based approaches”. Major contributors to this line of thinking include RA Epstein, Simple Rules for a Complex World (Harvard University Press: Cambridge, MA, 1995); DG Baird, ‘A World Without Bankruptcy’ (1987) 50(2) Law & Contemp. Probs. 173 (arguing that living in a world without bankruptcy or any similar collective procedure is not as far-fetched or ridiculous as it might appear at first glance); BE Adler, 'A World Without Debt' (1994) 72 Wash. U. L.Q. 811 (who built upon Baird’s reasoning to argue that it is possible to give away not only with bankruptcy, but also with debt); A Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107(6) Yale L.J. 1807 (contending that the only mandatory rules in an insolvency system should be structural and that insolvency laws exist only to increase efficiency by solving the creditors’ coordination problem). A more comprehensive list is included in section 2.2 of this work.
purposes falls short of a satisfactory explanation for the autonomy of this area of law.

These commentators refer to emerging trends in domestic and cross-border cases and the possibilities offered by alternative dispute resolution mechanisms (such as arbitration) to deal with collective, collection and rescue issues to prove the validity of their theories.

Proceduralist or Contractarian theories\(^{46}\) share the neo-libertarian autonomy-oriented focus but disagree on the call for “privatising” insolvency practice. They argue for a proceduralist approach to the subject, in which insolvency rules should not amend the substantive rights negotiated by the parties before the commencement of the procedure. In their view, insolvency law ought to be reduced to a ‘narrow and purely reactive’ set of rules, which would have no need to be separate from general private law.\(^{47}\)

According to these theories, cross-border insolvency law should be understood as an example of “transnational law”, i.e. a common approach created by economic and social actors in an exercise of self-government. This law, which supersedes and therefore does not necessarily rely upon the authority of national states,\(^{48}\) should not affect the rights recognised by the laws governing the pre-insolvency transactions. Contractarians therefore argue that the multitude of protocols\(^{49}\) agreed upon by the parties whenever multi-national

---

\(^{46}\) This is the very same word used by Baird to define those academics (as himself) who resist the inclusion of separate (re)distributive goals in insolvency law. An outcome, on the contrary, advocated by “traditionalists”: DG Baird, ‘Bankruptcy’s Uncontested Axioms’ (1998) 108 Yale L.J. 573. See also: MG Shanker, ‘The Abuse and Use of Federal Bankruptcy Power’ (Fall 1975) 26(3) Case W. Res. L. Rev. 3 (who believed that rules valid only in front of bankruptcy courts are a tension-creating situation); TH Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlement, and the Creditor’s Bargain’ (1982) 91 Yale L.J. 857 (who argued that insolvency law should deal only with inter-creditor questions on the basis of the creditors’ bargain model). A more comprehensive list is included in section 3.2 of this work.


\(^{49}\) The use of protocols in cross-border insolvency cases dates back to the collapse of Maxwell Communications empire: Maxwell Communication Corp., 170 B.R. 8000 (Bankr. S.D.N.Y. 1994). Since then, they had been used in a variety of cross-border procedures including, in more recent times: Calpine Corp. (2007), Bernard L. Madoff Investment Securities LLC (2009), Lehman Brothers Holdings Inc. (2009) and Nortel Networks Inc. (2009). For a literature on the subject see, among others: SL Bufford and others, International Insolvency (Federal Judicial Center 2001); B Wessels, ‘Cross-Border Insolvency Agreements: What are they and are they here to stay?’, in Faber and others (eds), Insolventie en Overeenkomst (Wolters Kluwer: Alphen aan den
corporations file for insolvency protection prove that parties have a proceduralist understanding of insolvency law.

Traditionalist or Communitarian models\textsuperscript{50} sit at the other end of the spectrum. According to these theories, insolvency should be understood as an autonomous set of rules, capable of treating with fairness and justice the honest but unfortunate debtors, who are no longer capable of paying their debts as they fall due.

Unlike proceduralists, traditionalist scholars argue that insolvency rules ought to alter the rights legally recognised to the parties in solvent times because the law affects constituent interests that are not protected under general private law. Insolvency law is seen as ‘an attempt to reckon with a debtor’s multiple defaults and to distribute the consequences among a number of different actors’.\textsuperscript{51} It should intervene to prevent the negative externalities that would result from the mechanic pursuit of creditors’ wealth maximisation.

Some scholars ‘incorporate communitarian philosophies and take on board distributive rationales’\textsuperscript{52} in part due to the difficulty of explaining what constitutes the public interest in insolvency law.\textsuperscript{53} In their multiple value or eclectic views,\textsuperscript{54} insolvency law should include (re)distributive goals, a premise which may sometimes lead to conflicting outcomes. They therefore recognise that it may sometimes be challenging if not impossible to provide consistent, valid-for-all answers to policy and framework questions.\textsuperscript{55}

\textsuperscript{50}Prominent contributors to this line of thinking include DR Korobkin, ‘Contractarianism and the Normative Foundations of Bankruptcy Law’ (1992) 71 Tex. L. Rev. 541; K Gross, ‘Taking Community Interests into Account in Bankruptcy: An Essay’ (1994) 72 Wash. U. L.Q. 1031. A more comprehensive list is included in section 4.2 of this work.

\textsuperscript{51}Warren, ‘Bankruptcy Policy’ (n 44), 781.


\textsuperscript{54}Major contributors to this line of thinking include: Warren, ‘Bankruptcy Policy’ (n 44); and Korobkin (n 44) in the U.S.; Finch and Milman (n 52) in the U.K.

\textsuperscript{55}This brief categorization of the standpoints taken by the commentators to justify the role of insolvency law is far from exhaustive. For instance, Korobkin (contractarian model) argued that
Not all communitarians adopt the same approach to the analysis of this area of law. American commentators concentrate on the analysis of the goals of the law. On the contrary, European and English scholars focus their attention on the principles and values (such as expertise, accountability, technical efficiency, transparency and fairness) that should guide the definition of the scope and the evolution of insolvency law.  

Overall, communitarian scholars offer several justifications of the normative commitments which should underlay their particular vision of insolvency law. However, lesser effort had been placed on trying to explain how and why the law should take this distinctive shape, what is and should be its proper scope. Additionally, it is not clear how should judges and practitioners deal with conflicting principles, both within (preferences and priorities vs pari passu distribution, etc.) and outside (e.g. freedom of contract in contract law and priority of liens in admiralty law vs principle of collectivity in insolvency law, etc.) this area of law. There have been, of course, significant exceptions and the analysis of ‘the political determinants of (...) [such a] significant piece of legislation’ has been carried out. Previous authors have evidenced the role that interest groups (creditors, lawyers and judges), political ideologies, individuals and even external factors (e.g. economic crises) have played in shaping and modifying the law.

---

58 On limitations to freedom of contract, see generally MA Eisenberg, ‘The Bargain Principle and its Limits’ (1982) 95 Harv. L. Rev. 741. On the justifications for the enforceability of contracts, see: MR Cohen, ‘The Basis of Contracts’ (1933) 46 Harv. L. Rev. 533, 562: ‘a regime in which contracts are freely made and generally enforced gives greater scope to individual initiative and thus promotes the greatest wealth of a nation’.
These studies have contributed to the investigation of the complex relationships between stakeholders.\textsuperscript{61} However, they rarely questioned the scope of insolvency law. The primary reason for lack of doctrinal investigation on this subject has been attributed to the theoretical nature of the above-mentioned questions. Cases like \textit{A.H. Robins} (described in \textsection\textsuperscript{1.1}(a)) suggest why this may represent a distorted view of an otherwise significant research topic.

Finally, there have been scholars who, in their studies, specifically investigated the interaction between insolvency rules and contract law.\textsuperscript{62} Their theories have been highly influential in guiding the author's analysis. However, it appears pertinent not to introduce these theories at this stage, but to discuss and assess them only after the author has introduced his own theory on the matter.\textsuperscript{63}

\section*{1.3 Key Concepts and Evaluative Criteria}

1.3(a) The “Common Pool” Narrative (Revised)

This research revolves around a comprehensive notion of “common pool” that departs from the traditional literature in the field.

The common pool notion adopted in this thesis includes both anti-common and semi-common situations and it is defined as “revised common pool” (‘RCP’) to distinguish it from the traditional notion. The reason for this choice is the

\textsuperscript{61} If not otherwise specified, in this doctoral thesis the term “stakeholders” is used to refer to the following group of people: judges, insolvency and legal practitioners, law-makers, debtors and creditors, tort claimants, society at large and any other group of people who have a different set of interests against the debtor.


\textsuperscript{63} This critical assessment will be carried out in section 6.5 of this thesis.
author’s belief (which is further investigated in chapters five and six) that common, anti-common and semi-common situations are intrinsically connected and feature prominently in all formal and hybrid corporate distress procedures.

A (traditional) common pool (TCP) dilemma usually arises whenever a company is unable to pay its debts as they fall due or when it appears from the company’s books that it is hopelessly insolvent. Such a “dilemma” or “situation” exists when there are not (or there will not be in the near future) enough assets to meet the creditors’ claims. These participants know that they would be better off if they managed to grab the assets when there are still some left. However, individual (ir)rational actions would result in lower overall returns to creditors on the whole and would cause disparities of treatment among similarly ranking claimants. This two-fold dilemma may develop into a problem whenever parties fail to co-ordinate their actions in order to maximise their collective benefit.

In legal terms, the TCP dilemma has been defined as the problematic which arises when self-interested actions of individuals fail to achieve a socially optimal result. As such a definition is applicable to several economic disequilibria, some economists claim that a TCP dilemma exists when negative production or consumption externalities caused by the use of exhaustible resources cannot be resolved by the definition of property rights.

---

65 Jackson (n 44) 10; 12-14.
The existence of TCP dilemmas has been questioned. In an article published in the Yale Law Journal,\textsuperscript{67} two eminent law and economics scholars argued that, since creditors do not share the same interests and priorities, it is fallacious to conclude that this prisoner’s dilemma exists. Other authors, on the other hand, have questioned the existence of such a problem only with reference to limited sectors of the economy.\textsuperscript{68} Additionally,\textsuperscript{69} it has been observed that common pool and collectivist approaches fail to recognise the interests of non-contractual creditors\textsuperscript{70} and focus on non-efficiency objectives.\textsuperscript{71}

This thesis argues that, whenever a company faces both financial and economic distress,\textsuperscript{72} a common pool (albeit “revised”) problem among stakeholders may arise.

This problem has traditionally been described as “allocative”. Allocative issues arise whenever disputes among stakeholders may hinder the overall recovery rate and when distribution of resources among claimants occurs in an inefficient way. As too much money is spent to recover and sell the debtor’s assets, insolvency procedures should be designed to enhance the factor of efficiency in the process of allocating the assets.

This requires addressing not only questions of external allocation of capital, i.e. the way in which money is spent or resources are distributed among claimants,

\textsuperscript{69} Finch and Milman (n 52) 30.
\textsuperscript{70} These critiques are numerous and voluminous: Warren, ‘Bankruptcy Policy’ (n 44); Korobkin (n 50); Gross (n 50); F Mucciarelli, ‘Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension’ (2013) 14 EBOR L. Rev. 175, 179. For an overview, see: Finch and Milman (n 52) 28-33.
\textsuperscript{71} Korobkin (n 57).
\textsuperscript{72} Financial distress occurs whenever a company cannot meet or has difficulties in paying off its financial obligations but its business (i.e. the products or services that it offers to the market) is still sound. In other words, if a company is in economic distress its business plan is not working, while if it is in financial distress it faces liquidity problems: G McCormack, Corporate Rescue Law – An Anglo-American Perspective (Edward Elgar Publishing: Cheltenham, 2008) 9. On the distinction and its usefulness, see generally: G Andrade and SN Kaplan, ‘How Costly is Financial (No Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed’ (1998) 53 J. Fin. 1443; Baird (n 46) 580-583.
but also internal allocation issues, i.e. the use of capital to further the interests of selected parties.\textsuperscript{73}

It would be inaccurate, however, to overlook the existence of \textit{(re)distributive issues}. These occur when the statutory ranking of claimants is questioned and the absolute priority rule (‘APR’)\textsuperscript{74} bypassed, for instance where shares of the newco are given to oldco shareholders when some of the debtor’s creditors have not yet been fully repaid.

\textit{(Re)distributive issues} are related to the notion of distributive justice, which concerns the nature of a socially “just” allocation of goods among those who are entitled to them and in line with \textit{(re)distributive}\textsuperscript{75} values.\textsuperscript{76}

Allocative and \textit{(re)distributive} common pool issues do not cover all the issues faced by stakeholders in corporate distress procedures. If a person or company uses their contractual or statutory prerogatives to prevent the adoption of a course of action that appears in the collective interest of the creditors, a holdout situation emerges. This condition, which is neither allocative nor \textit{(re)distributive}, has been described as an anti-common situation.

\textbf{Anti-common issues} occur whenever the use of a resource for the stakeholders’ best interest is prevented by the veto power exercised by a minority of players.\textsuperscript{77} These issues are frequent in restructuring and rescue

\textsuperscript{73} Paterson (n 62).
\textsuperscript{74} The ‘absolute priority’ principle mandates that unless creditors are to be paid in full, or unless each class of creditors consents, the company’s old shareholders are not entitled to receive or retain any interest in the rescued business: see sub-section 3.2(a)(iii). This principle is reinstated in the UNCITRAL \textit{Legislative Guide} and it is a fundamental element of the U.S. Bankruptcy Code. While not expressly mentioned in the EC Recommendation on a new approach to business failure and insolvency [C(2014) 1500 final, 12 March 2014], Recital 22 of this document requires that insolvency priorities should be respected. Equally, comparative and empirical works in the area have proven that, while this principle is not incorporated in the insolvency statutes of European Member States, courts are required to indirectly consider it whenever they are required to address the overall fairness of a reorganisation plan: see G McCormack and others, \textit{European Insolvency Law} (Edward Elgar Publishing: Cheltenham, 2017) 253.
\textsuperscript{75} Throughout this thesis, the words “distributive” and “(re)distributive” are used as synonyms.
procedures designed to make an efficient use of the existing resources. Anti-common practices may lead to underuse or sub-optimal use of the assets. The emergence and growth of new financial instruments such as credit default swaps (‘CDS’), collateralised debt obligations (‘CDO’) and covenant-lite loans (‘CLL’) have resulted in heightened debt fragmentation and decoupling. This fragmentation increases the likelihood that parties will hold out, as it is more challenging to reach an agreement over a preferred course of actions when parties are many and with competing interests.

Finally, TCP and anti-common issues are complemented by semi-common situations, a notion conceptualised by Smith\textsuperscript{78} that refers to the issues which may arise from the interaction between private and common property.

Semi-common situations have been conceived with reference to medieval farming and grazing arrangements, where pieces of farmland were individually owned but the land as a whole was shared for grazing purposes.\textsuperscript{79} Other authors have suggested that semi-common structures are found in other sectors.\textsuperscript{80}

The distinctive element of semi-commons is that they ‘encompass the tragedies of both the commons and the anticommons’.\textsuperscript{81} If a party defects, he or she proportionately harms every member of the group, including himself or herself. Additionally, any reform of the existing arrangements requires the consent of the parties affected, a situation which bears many similarities with the anti-common dynamic.

This research is expected to prove that RCP dilemmas exist in every sector of the economy and can address not only issues of distributive justice and

\begin{itemize}
\item Insolvency Law and the Need to Tackle Two common Problems: Common Pool and Anticommons’ (2012) 21 Int. Insolv. Rev. 67.
\item Ibid 132.
\item Fennell (n 77) 17.
\end{itemize}
allocative efficiency, but also holdout and semi-common matters. A proper understanding of the RCP notion would therefore clarify the scope of corporate distress law and what to expect from its provisions. As Warren argued,

[m]any of the people who are angry with the bankruptcy system, are angry because they have not received what they had every right to expect: payment on time, a safe working environment, a steady job at a fair wage, and a management team that made thoughtful decisions and brought prosperity to the business. Those problems, however, are not bankruptcy problems.⁸²

⁸² E Warren, 'The Untenable Case' (n 44), 478.
Defining the scope of corporate distress law is the first step to avoid unfair criticism over corporate distress practice and its outcomes. The RCP notion is central for the purposes of this thesis. This work will prove that corporate distress procedures shall begin with a simple recognition of one fact: that proprietary, personal and risk bearer claims against a debtor can no longer be satisfied under general private law because of the existence of RCP problems. The existence of RCP problems is one of the two conditions (the other being the existence of solvency problems) that justify the use of collective over individual strategies.

1.3(b) “Rescue” and “Restructuring”

In order to cope with a situation of distress, the company and its management can opt for out-of-court workouts or judicially sanctioned procedures. Similar to other works, this thesis shares the view that all of these procedures could be aimed at liquidating the debtor’s assets or at turning around the company or its business. If the turnaround is successful, it is usually argued that the company has been rescued or restructured.

---

83 The RCP notion will be used mainly in the second part of this thesis (chapters five to seven). In the first part – except where otherwise mentioned – the author uses the common pool definition as a synonym of common pool situations only, in accordance with the traditional literature on the subject. To distinguish the two notions (revised from traditional), the latter is labelled as “traditional” common pool or ‘TCP’ and it refers to allocative and (re)distributive common pool situations.

84 For the distinction between these notions, see sub-section 4.3(a) of this thesis.

85 Paterson (n 62). The author proposed a new taxonomy where the creditors’ wealth maximisation goal advocated by law and economics theorists remains valid only for the portion of the law (named “insolvency law”) which deals with the distribution of the debtor’s assets. On the other hand, “restructuring law” (which is in that paper intended as the other half of insolvency law) should promote rescue and facilitate the reallocation of resource in the economy to best use.

In insolvency treaties, the words “rescue” and “restructuring” are frequently used as synonyms. This is not the case for this work, for the reasons explained below.

Belcher has observed that ‘if rescue is defined simply as the avoidance of distress and failure, all management activity can be thought as a constant and repeated rescue attempt’. This notion captures the complexity and nuances associated with any turnaround procedure. Yet, it is not sufficiently specific for the purposes of this work.

In this thesis, both rescue and restructuring are defined as ‘a major intervention necessary to avert eventual failure of the company’. However, the term “rescue” is here employed only with reference to formal or hybrid insolvency proceedings, i.e. those proceedings that are mandated and regulated by corporate distress law. By the end of this work it will become apparent that only in rescue cases it is admissible to use corporate distress remedies. In accordance with Burdette and Omar,

‘corporate rescue is now associated with what is termed the revival of companies on the brink of economic collapse and the salvage of economically viable units to restore production capacity and employment, as well as the continued rewarding of capital and investment’.

This thesis therefore includes within the notion of “rescue” also those hybrid, secret and upstream procedures that whilst commenced as informal workouts require a judicial sanction to produce their effect.

Rescues lead to the emergence of a “rescue culture”, ‘a philosophy of reorganising companies so as to restore them to profitable trading and enable

---

87 Ibid 12.
90For a divergent view: Eidenmüller (n 62) 71 (arguing that a proceeding can be characterised as an insolvency proceeding and therefore fall within the realm of insolvency law only if it ‘restricts, in one form or another, the enforcement of all individual creditor rights’).
them to avoid liquidation''. Nevertheless, ‘the mere survival of a company [...] does not necessarily indicate that a successful rescue has occurred'' if the company continues to operate as a “zombie” entity. Additionally, rescue does not necessarily result in the rehabilitation or the preservation of a corporate shell, as the main goal of a rescue framework is the preservation of income-producing businesses by means of a reduction, rescheduling or extinction of corporate debt.

The term “restructuring” refers to all those procedures or contractual workouts negotiated “in the shadow” of a formal or hybrid rescue regime. These occur (or should occur) outside the realm of corporate distress law and do not (or should not) derogate from the general law of contract unless with the preliminary agreement of all of the affected parties.

“Restructuring” is used in the context of this work as a synonym of “turnaround management”, i.e. a process dedicated to corporate renewal which uses analysis and planning to save troubled companies and return them to profitability. Restructuring should always be the preferred option for companies in mild trouble (i.e. declining market position and significant yet manageable losses, but still with a strong balance sheet) or with moderate liquidity issues (i.e. at least one year of losses and the prospect of a downward trend in profits, market shares and revenues).

Restructuring procedures belong to the domain of commercial, general law, hence the rules governing these processes should not affect contractual rights unless with the agreement of all of the parties.

---

91 Goode (n 56) para.11-03. See also: M Hunter, ‘The Nature and Functions of a Rescue Culture’ (1999) J. Bus. Law 491, 198-499 (arguing that it is a multi-aspect concept characterised by a positive and protective role, and a corrective and punitive one).
92 Finch and Milman (n 52) 198. For what amounts as a “successful” rescue, see: Belcher (n 86); V Finch, ‘Corporate Rescue Processes: the Search for Quality and the Capacity to Resolve’ (2010) 6 J. Bus. Law 502.
93 A “zombie” company is any corporation that uses its cash flow to repay the interests of existing debt, with little or no prospective of repaying the principal loan or creating added value for its stakeholders.
94 This, in fact, has never been the main goal of English corporate rescue procedures: R Stevens, ‘Security after the Enterprise Act’ in J Getzler and J Payne (eds), Company Charges: Spectrum and Beyond (OUP: Oxford, 2006) 153, 155; McCormack (n 72) 75; Goode (n 56) 330.
95 Harmer (n 88) 146-147.
1.3(c) A Pragmatic, Value-Bereft Framework of Insolvency Law

As it will be clarified in sub-section 6.3(b), rescue should occur only in formal or hybrid corporate distress procedures. What procedures should be regulated by corporate distress law?

Courts described insolvency as the area of law that provides mechanisms ‘of collective execution against the property of the debtor by creditors whose rights are admitted or established’. This law should therefore mainly enforce but not create rights, while (insolvency) courts have to determine the existence of these rights (but not create new ones) if they are challenged in the course of the procedure.

Insolvency/Corporate distress law should therefore be understood as the area of law that deals with the distress, liquidation and rescue of ailing companies. It should include the discipline of any statutory mechanisms that have the effect of giving to either the debtor or their legal representative the power to unilaterally accept, disclaim or amend existing contracts to collectively pursue the interests of the debtor’s “risk bearers”.

As a result, this area of law should include the majority of the procedures currently labelled as insolvency remedies such as liquidation, administration and company voluntary arrangements in England and Wales and all statutory procedures mentioned in the 11 U.S. Code in the United States.

Additionally, corporate distress law should include any other mechanism which may or may not be designed to tackle the debtor’s distress that produce deviations from contractual rights. These mechanisms may include the schemes of arrangements (in England currently regulated by part 26, §§.895 - 901 of

---

97 These terms are used as synonyms in this introductory chapter. Chapters two to five will mainly refer to the notion of corporate insolvency law, as this is the most widely accepted definition used by scholars and practitioners to describe the set of rules that deal with corporate distress. Chapter six explains why it is preferable to adopt the notion of corporate distress law as opposed to insolvency law.


99 Ibid [15].

100 Re Lines Bros (in liq.) [1983] Ch. 1, (CA).

101 This suggestion is in line with current judicial practice, as recognition and enforcement of schemes of arrangement sanctioned by British courts has become commonplace in Chapter 15.
CA 2006), despite their sometimes-dubious collective nature, the possibility of being used by solvent debtors and the English government's deliberate attempt to leave them outside the boundaries of insolvency law to promote their use by foreign companies. The decision to include them in the list of formal procedures is consequential if we consider that pursuant to the UNCITRAL Model Law on Cross-Border Insolvency as ratified in Great Britain by means of the Cross Border Insolvency Regulations 2006, English courts can recognise and give effect to foreign schemes of arrangement of distressed debtors.

This definition may embrace out-of-court workouts only in those cases where the courts’ involvement or special statutory or regulatory privileges would grant the debtor the power to unilaterally, directly or indirectly modify existing contracts (i.e. hybrid procedures). Even preventive restructuring mechanisms, whose collocation among corporate or insolvency law remedies is currently
debated, would find a home within the realm of this area of law. In fact, these are rescue proceedings.

The second step is to determine **which vision** or approach better defines the scope of corporate distress law. In order to achieve this aim, this thesis conducts a de-constructive analysis of the existing theoretical frameworks. The desirability of each of these visions is tested on the basis of pre-determined evaluative criteria.

This is, by no means, a novel attempt. A framework for analysing the rationale of insolvency law has been proposed by several authors, including Finch.\(^{106}\) The British scholar recommended the adoption of an “explicit value” approach built upon the studies undertaken by Stokes\(^ {107}\) to legitimate the distinctiveness of company law. Finch in particular developed her theory on insolvency law by combining Stoke’s communitarian/traditionalist criticism towards previous arguments for legitimation of company law with contractarian assumptions.

Finch’s theory had the benefit of viewing both company and insolvency law not simply as restraints or limitations of discretionary or contractual powers. The criteria she adopted to legitimise insolvency statutes (efficiency, expertise, accountability and fairness) were ‘not offered as values plucked from the sky but as values that would be endorsed by parties of differing political persuasions […] albeit on their own precise terms’.\(^ {108}\)

One of the problems of Finch’s approach is that it fails to offer an alternative theoretical vision.\(^ {109}\) Additionally, and this is in the author’s view the main reason for concern, the use of the suggested criteria requires the acceptance not only of a multi-value vision of insolvency law, but also of “shared” values. In reality, these values end up being the ethical standard recommended and supported by the author herself.\(^ {110}\)

---

\(^ {106}\) Finch and Milman (n 52) 41.


\(^ {108}\) Finch and Milman (n 52) 45.

\(^ {109}\) Ibid.

\(^ {110}\) To be fair, Finch acknowledged (but dismissed) this problem by claiming that ‘trade-offs between different rationales do remain a problem but, unless a single vision of the just society is
More recently, Anderson tried to account for English corporate insolvency law by identifying ‘a rational explanation for the form that the rules and institutions of the modern law take or, where there is no other obvious explanation, at least the history which has resulted in the present position’.

While apparently less ambitious than Finch’s attempt, Anderson’s work is nevertheless extremely valuable in investigating the purpose and function of corporate distress rules. However, where Finch’s approach is theoretical in nature, Anderson’s study is predominantly doctrinal, its main focus being the analysis of existing rules and cases to inform consideration of future developments of English insolvency law.

To combine the best of both visions, the author recommends the adoption of a pragmatic and more neutral approach based upon two pillars: procedural efficiency - criterion (i) below - and procedural fairness - criteria (ii) to (iv) below. These evaluative criteria conform to the approach recommended by other studies, aimed at fostering cooperation in cross-border insolvency cases.

Value-driven considerations (as in the case of Finch’s work, where the same criteria are employed in their substantive rather than procedural understanding) are rejected due to their unpredictability, the challenge to

---


113 Other authors argue that insolvency law should promote the substantive goal of fairness. See, among others: R Mokai, *Corporate Insolvency Law: Theory and Application* (OUP: Oxford, 2005) 24-25; I Mevorach, *The Future of Cross-Border Insolvency: Overcoming Biases and Closing Gaps*
agree on common standards and their dependency on the sensibility of the commentator. At the same time, pragmatic views (as in the case of Anderson's work) could be employed for evaluative, not simply explanatory purposes (as in the case of this research).

The value- bereft criteria are:

(i). Promotion of procedural efficiency\textsuperscript{114};
(ii). Protection of entrepreneurialism and maximisation of shareholders’ return;
(iii). Protection of market integrity and creditors’ expectations;
(iv). Protection of vulnerable stakeholders.\textsuperscript{115}

The inclusion of the criterion of “procedural efficiency” can be explained by the need to address the problem of paucity of resources in insolvency. The notion usually comes into consideration with reference to two distinct matters: allocation of resources (within and outside the rescue proceedings) and management of the rescue case.

The meaning of efficiency (when provided)\textsuperscript{116} varies between jurisprudential contexts. It is possible to categorise efficiency as a substantive (ends-efficiency) or procedural (means-efficiency) goal.\textsuperscript{117} A substantive goal of the law is the particular end that the law seeks to achieve and which justifies the existence and the mechanics of the statute. On the other hand, procedural goals are the benchmarks used to assess if a particular mechanism achieves its substantive goal in the desired manner (i.e. efficiently).

\textsuperscript{114}The notion of ‘procedural efficiency’ differs from the definition of ‘allocative efficiency’ introduced in sub-section 1.3(a).
\textsuperscript{115}This thesis adopts a particularly narrow definition of “vulnerable stakeholders”. It includes only those claimants or third parties who are negatively affected by the debtor’s failure and have no contractual protection or statutory right to influence the rescue or liquidation of the company. As a result, the notion includes tort claimants and the society at large (for instance, in cases of environmental polluters), but not employees.
\textsuperscript{116}For instance, neither the UNCITRAL Model Law on Cross-Border Insolvency (1997) and the Guide to Enactment (2014), nor the EUIR recast specify the meaning of this notion.
\textsuperscript{117}Mokal (n 113) 24-26.
It is extremely controversial whether (economic) "efficiency" should represent the sole, substantive goal of insolvency law.\textsuperscript{118} Unsurprisingly, much of the controversy between contractarian and communitarian scholars can be explained by the rejection from the latter of an economic-oriented approach to efficiency.

For this reason, this thesis embraces the notion of procedural rather than substantive efficiency to test the validity and soundness of the theories introduced in the following chapters. However, procedural efficiency is a concept often associated with achievement of policy goals (e.g. rescue or liquidation),\textsuperscript{119} quickness of the procedure\textsuperscript{120} and reduction of costs.\textsuperscript{121} This is not the case in this thesis. In this context, to determine if an insolvency regime is efficient, the author discusses whether the proposed regime determines when, to what extent and if at all statutory corporate distress rules should apply and should depart from the common law of contract.

As for "procedural fairness", this thesis assumes that this criterion is met whenever parties are given timely notice of the rescue proceedings, the opportunity to influence the outcome of the case and they are treated equally. Since "equality" is a relative concept, procedural fairness is tested autonomously with reference to the distinct players potentially involved in any

\textsuperscript{118} Even the International Monetary Fund recognises that "economic efficiency is not the only consideration when designing insolvency laws": Legal Department of the International Monetary Fund, \textit{Orderly & Effective Insolvency procedures: Key Issues} (Washington D.C. 1999), “Rehabilitation Procedures” <http://www.imf.org/external/pubs/ft/orderly/> accessed 17 September 2018.

\textsuperscript{119} It has been suggested that an insolvency procedure is not efficient if it employs the resources of a company where alternative uses would have proven more valuable: M White, ‘Does Chapter 11 Save Economically Inefficient Firms?’ (1994) 72 Wash. U. L. Rev. 1319.


rescue case: the debtor, its contractual creditors and other vulnerable stakeholders.

Procedural fairness stands on three pillars. The first one concerns protection (and promotion) of entrepreneurialism, as well as maximisation of shareholders’ return. It facilitates a fresh start for the insolvent debtor and it incentivises the role of entrepreneurs as agents of growth. The second pillar protects contractual creditors’ legitimate expectations, while the third one factors in the rights, interests and expectations of non-contractual claimants.

The pragmatic nature of this work requires the introduction of a further step, i.e. the need to assess the:

(v). Acceptability of the proposed solution(s) in light of the current legislative and cultural framework, with reference to both domestic and cross-border cases.

These criteria are not immune from criticism, primarily since conflicts between criteria are still possible and uniform, “easy answers” are all but within reach. They have been preferred because they do not require the acceptance of shared values by the participants in the corporate distress game.

1.4 RATIONALE OF THE THESIS

The primary purpose of this thesis is to define the limits of insolvency law by reassessing the centrality of the common pool narrative in the form of the RCP notion. Reference to this notion (and to the complementary concept of “insolvency”) would determine under which conditions insolvency rules should prevail over conflicting paradigms.

Previous works failed to fully appreciate ‘the fault lines between mandatory, state-imposed regulation and contractual, market-based solutions’. Additionally, insufficient investigation has been carried out to explore the rationale underpinning the common pool concept, as well as the potential implications for the insolvency practice.

122 Schillig (n 62) 2.
The author aims at verifying if a problem-based, example-driven approach to corporate distress law is capable of better respecting the peculiarity of this area of law than more traditional principle or purpose-based approaches. He also wants to investigate if such an approach may result in a steadier definition of its scope, as well as in fewer controversies in cross-border or cross-subject\textsuperscript{123} cases.

This thesis identifies the alternative conditions that could justify the commencement of a formal or hybrid corporate distress procedure. Nowadays, several countries make the opening of these proceedings contingent upon the proof that the ailing company is insolvent or in some significant distress. Where this is not the case – such as, for instance, in the Anglo/American schemes – debtors make use of rescue procedures to restructure their business and disregard contractual obligations.

Conditioning the opening of collective procedures to the existence of insolvency or RCP problems would affect neither the determination of the course of action (liquidation or rescue of the business or the company), nor the choice of the mechanism. Stakeholders would still be entitled to make their own decisions on the basis of the nature of the existing and expected problems (common, anti-common or semi-common), as well as on the nature and degree of the distress (financial, economic or both) that the debtor is experiencing.

Furthermore, this work tries to raise awareness. This thesis demonstrates the influence that large insolvency proceedings and their key stakeholders have on the evolution of the law and, to a lesser extent on the economy and on society at large.\textsuperscript{124} It also demonstrates the bias towards maximisation of creditors’ return pursued by the key and most influential stakeholders in this arena. As a result, it

\textsuperscript{123} "Cross-subject" cases are procedures where the definition of controversial aspects of the dispute requires the application of principles and rules from different areas of law, such as contract law, admiralty law, etc. Examples of controversial questions that arise from the intersection of different areas of law are: "Is the \textit{ipso facto} clause of this particular contract enforceable in this case?"; "Can the creditor arrest the vessel if he/she has an enforceable maritime lien against the insolvent debtor?"; etc.

\textsuperscript{124} For the purpose of investigating how the socioeconomic ('behaviourism') and ideological ('attitudinalism') background of each of these stakeholders affects their behaviour in insolvency cases, as well as their influence on practice and on the law, this doctoral thesis refers to some key concepts conceived by legal empiricists.
recommends a novel approach to determine what principles should apply on
the basis of the nature and purposes of corporate distress proceedings.

A disclaimer is also appropriate. It is proper to acknowledge the author’s
background. Legal writings which adopt a theoretical narrative inevitably
reflect the writer’s assumptions and beliefs. Despite aspirations to be
scientific and objective, the author recognises that his opinions influence and
sometimes distort the way he sees (and reads) “reality”. Nobody lives in an
ivory tower and, in the case of legal scholars, observers are frequently active
players in the observed. This is not the best premise for an impartiality plead.

The researcher’s largely pragmatic but not necessarily pro-deregulation
attitude and his general preference for the principle of “comply-or-explain”
point to a broad rejection of any “one-size-fits-all” approach. In the author’s
opinion, where equitable or contractual remedies are available, states should
refrain from legislating. However, when states do legislate, they should aim at
correcting the inequalities created by a de-regulated market on the basis of
neutral, preferably scientifically and empirically tested evaluations.

Market participants should not rely upon the state to sort out problems that
they themselves could remedy. Insolvency law may be public, but management
of risk is intrinsically private and statutes should acknowledge this boundary.

Decision makers, therefore, should be careful to limit their intervention to cases
in which the market would not deliver solutions compatible with the theoretical
underpinnings of this area of law. Equally, they should ensure that their

125 On the importance of being honest about the writer’s relevant ethical premises: M Pendleton,
‘Non-empirical Discovery in Legal Scholarship - Choosing, Researching and Writing a
Traditional Scholarly Article’ in M McConvil le and others (eds), Research Methods for Law
(Edinburgh University Press: Edinburgh, 2012) 164. The author argues that ‘the ethical and
normative major premises on which an argument is advanced, or indeed the rejection of such a
concept, should be apparent and made transparent at the beginning of a piece of scholarly
writing’.

126 The existence of this “aspiration to impartiality” has been questioned by many legal scholars.
Arthur S. Miller observed that “[t]he assumption apparently is that the person who labors in
Academia has some sort of special credentials and operates in a kind of special medium that
permits him to transcend the very human limitations of his brethren in private practice or on the
bench or in government. This I doubt. I think the proposition is untenable”: AS Miller, ‘The Myth of

127 According to the founding father of legal realism, “[l]egislation must learn the same lesson as
case law. It must deal chiefly with principles; it must not be over-ambitious to lay down universal
rules”: R Pound, ‘Law in Books and Law in Action’ (1910) 44 Am. L. Rev. 12, 34.
intervention corrects these inequalities and does not simply support the conventional autonomy-based narrative.

While acknowledging the non-absolute objectivity\(^{128}\) of this study, the author at least claims to adopt an unbiased approach to this research. In particular, the structure of the research and its legal analysis should prove that the author has tried to develop logical deductions from major premises and not from the expected or desired conclusions.

1.4(a) Main Research Questions

The main purpose of this research is to investigate when, to what extent and if at all statutory “insolvency” (rectius, corporate distress) rules, principles and judicial and business practices should depart from the common law of contract. In order to achieve this outcome, it tries to answer three main queries:

1. Should insolvency law be concerned with providing remedies to RCP problems?
2. Should insolvency law interfere with the established nature (allocative or (re)distributive) of creditors’ entitlements?\(^{129}\)
3. How should an insolvency system look like assuming it is designed to promote specific goals (maximisation of assets or capital) while respecting the natures (common, anti-common or semi-common) of the underlying RCP problem?

To investigate these main research questions, this thesis is structured in chapters, which will attempt to answer the following ancillary queries:

1. Have the existing theoretical frameworks of corporate insolvency law provided procedurally efficient and fair guidance on when to file for corporate distress remedies (chapters two, three and four)?
2. What is the current understanding of the common pool narrative and of the other requirements most commonly used to determine when

\(^{128}\) “Objectivity” is here used to refer to any research and writing about legal matters in which the writer’s value judgments do not permeate at all in the written text.

\(^{129}\) This question implies that ignoring the true nature of a claimants’ claim is equal to interfering in the claimants’ rights, expectations and, ultimately, entitlements.
companies should file for insolvency? What are their strengths and shortcomings (chapter five)?

3. Is the common pool narrative central for the definition and scope of insolvency law, or should other eligibility standards be preferred (chapters five and six)?

1.4(b) Research's Findings

Currently, neither in the U.S. nor in England and Wales admissibility to a corporate distress procedure is subject to an eligibility test that considers the effect on the controlling stakeholders (i.e. risk bearers) of the decision to enforce insolvency remedies. The risk bearer\textsuperscript{130} interests of the stakeholders affected by the decision and the relative relevance of their claims is generally neglected.

The RCP standard represents the first attempt to introduce such evaluation. The de-constructivist analysis carried out in this thesis shows that the standard has the potential to improve the existing normative framework.

This thesis observes that the enforceability of corporate distress remedies and the adoption of a particular course of action (i.e. assets’ or capital maximisation) should depend on the nature and characteristics of the RCP dilemma faced by the debtor and its creditors rather than on the need to promote specific policy goals. It therefore argues that whenever parties face a RCP dilemma but are able to negotiate an agreement that pursues the best interest of all stakeholders (by means of consensual winding-ups, informal workouts or other restructuring procedures) there should be no derogation from general contract law principles.

In hybrid procedures (such as pre-packs, schemes of arrangement or CVAs), statutory intervention and derogation from the general law of contract should be kept to a minimum. Vice versa, when parties are incapable of reaching an agreement in the best interest of all stakeholders (a situation described as a RCP problem) or when the company is insolvent, the theory proposed in this

\textsuperscript{130} For a definition of this notion, see sub-section 4.3(a) of this thesis.
thesis justifies the adoption and mandatory enforcement of corporate distress remedies that derogate from the general law of contract.

1.5 Methodology

The methodology of this thesis is designed to define the conditions by means of which corporate distress statutes may affect contractual freedom.

As this represents a normative question that seeks to shape insolvency policy and law-making and which is influenced by public policy considerations, the legal approach adopted in this thesis is more theoretical than doctrinal.\textsuperscript{131} In other words, the thesis does not focus much on the exposition of specific rules, the analysis of their relationships and the study of possible difficulties that arise from their implementation, although reference to insolvency provisions is constant throughout this study. It is more concerned with the analysis of a pivotal concept: the RCP dilemma and the effect that a more complete understanding of this notion, both in theory and practice, would have on the focus and evolution of corporate distress.

Apart from desk-study and archival research, this thesis adopts primarily an \textit{applied doctrinal methodology},\textsuperscript{132} since it is an internal inquiry on the meaning of the law. This methodology is commonly accepted in law. Legal research in insolvency law is still primarily doctrinal,\textsuperscript{133} with authors mainly concerned with examining judicial decisions and identifying matters of interest for their audience.


\textsuperscript{132} In accordance with the taxonomy of legal research styles proposed by Arthurs in 1983: HW Arthurs, \textit{Law and Learning: Report to the Social Sciences and Humanities Research Council of Canada by the Consultative Group on Research and Education in Law} (Information Division, Social Sciences and Humanities Research Council of Canada: Ottawa, 1983).

\textsuperscript{133} For a defence of doctrinal methodologies: HT Edwards, 'The Growing Disjunction between Legal Education and the Legal Profession' (1992) 91 Mich. L. Rev. 34 (arguing that while links to other social sciences - such as economics and psychology - open new opportunities to legal scholars, the latter should, nevertheless, remain primarily concerned with the analysis of cases, the law, and their implications); DL Rhode, 'Legal Scholarship' (2002) 115(5) Harv. L. Rev. Ass. 1327; NJ Duncan and T Hutchinson, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) Deakin L. Rev. 83.
Theory is often viewed in sharp contrast to practice and, consequently, either ignored or discarded. This work assumes that ‘the influence of theory cannot be cavalierly discarded’. Accordingly, it tries to combine doctrinal and case-related methods with theoretical approaches to design a new corporate framework for the jurisdictions studied in this volume.

Primarily expository and explanatory research (chapters two to four) aimed at understanding “what the law is” has been complemented by evaluative considerations, which represent the predominant method in the second block of the thesis (chapters five and six).

Purely doctrinal methodologies have not been considered appropriate to investigate the policy implications arising from the implementation of a new eligibility criterion to file for corporate distress remedies and the changes to the existing statutory framework.

Black letter lawyers and practitioners may turn their nose up to legal theory blaming its lack of practical use. Nevertheless, theoretical approaches are best suited to design legal frameworks and theory-building is one of the goals of this thesis.

This doctoral thesis endorses the generalized call for more scientific albeit not necessarily empirical work, since it is believed that theories should be proven to work in a realistic setting. Their acceptance or rejection should not depend on whether they are conceived in a perfect market – zero transaction cost (‘PM-ZTC’) environment. Additionally, example-driven analysis can help bridge the gaps between different jurisdictions and laws.

---

135 Similar approaches have been adopted by other scholars with reference to under-regulated areas, such as the discipline of pre-packs in England: P Walton, ‘When is Pre-Packaged Administration Appropriate? – A Theoretical Consideration’ (2011) 20 Nott. L.J. 1.
While ‘one cannot derive the normative from the positive’, reality cannot simply be treated as a nuisance in a world of perfectly balanced, yet unrealistic premises. One of the goals of this work is to conceive ‘practical solutions on a pragmatic basis’ which can provide tentative answers to the highlighted queries and ‘in which legal concepts and rules become our tools rather than our masters’.

By adopting this combined approach, this work embraces a sui generis legal realist perspective focused on the legal and societal notion and understanding of the common pool concept. It recognizes that real-world constraints and events bind insolvency policy and that policy discussions can be meaningful only when this circumstance is acknowledged. As Elizabeth Warren puts it, ‘[t]he basis for bankruptcy policy is so deeply rooted in market imperfections that any attempt to discuss such policy in a perfect market is a zen-like exercise’.

This research is also based on the following assumptions. The first axiom is that corporate distress law results in derogation from established contractual rules and practices. The second axiom follows from the previous premise and

---

138 DG Baird, ‘Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren’ (Summer 1987) 54(3) U. Chi. L. Rev. 815, 817. The same view is shared by P Shuchman, ‘An Attempt at a “Philosophy of Bankruptcy”’ (1973-1974) 21 UCLA L. Rev. 403. These authors criticize conventional approaches and methods to study insolvency law, because they consider that extrapolating a philosophy from existing rules, principles and cases is inadequate for most purposes beyond technical consistency and logical validity.


140 Ibid 196.


142 Warren, ‘Bankruptcy Policy’ (n 44), 778.

143 Ibid 379.
considers that insolvency remedies should be used only when contractual or
general law mechanisms prove unfit to deal with ailing debtors.

Insolvency law may result in the liquidation or the rescue of the company or the
business, as well as in the rehabilitation of the debtor. Nevertheless, corporate
distress law is a set of statutory rules and established practices and
interpretations that define a ‘system of collectivized debt collection’. Corporate
distress rules (and their informing principles) should therefore be appropriate
to deal with the nature of the underlying common pool problems and the
purposes (rescue, rehabilitation or liquidation) of the proceedings.

Back in 1996, Donald R. Korobkin classified insolvency scholarship into four
main categories: observational (to establish facts - empirical research),
normative (to evaluate theories), standard reform (to make use of empirical
evidence to propose legal reform) and critical reform (to make use of normative
claims to propose legal reform).

While being primarily normative, this work escapes from this classification, for
its focus (the scope, rather than the purposes of this area of law), the use of legal
methods (e.g. observation is not limited to case law, but also to the way in which
stakeholders behave and influence the evolution of insolvency practice and law)
and its scope (predictive, rather than normative).

In other words, with reference to the methodology, the originality of this work
does not lie in the methods used, but in the way in which established methods
are used.

This thesis combines a theoretical approach with an example-driven narrative
because the author believes that conceptualisations built on metaphors and
empirically-untested assumptions can be harmful, as they can lead to results
substantially different from those presumed to be likely. Reference to real cases
can also help to investigate and appreciate how stakeholders shape and re-
shape the situations in which they face coordination problems. By considering

144 Jackson (n 44) 7.
145 Korobkin (n 57) 83.
these cases, the proposed framework will not yield analytical, simple and clear predictions but it will offer and debate solutions that might feature closer approximation to reality than pure, theory-driven approaches.

1.6 CONCLUDING REMARKS

No existing theory provides a consistent explanation for how and why some stakeholders are generally able to extricate themselves from RCP dilemmas without the use of statutory remedies and why the existing Anglo-American statutory system protects these privileges. Equally, no theory explains why the laws imposed by the Anglo-American governments should fail to give the opportunity to other stakeholders to intervene early and avert the downward spiral that may transform a RCP dilemma into a problem.

This thesis attempts to develop a series of reasoned conjectures about the circumstances according to which the stakeholders should promote their collective interest. It does not rely on the use economic indicators to proactively determine the moment in which a distressed business should file for corporate distress protection.

The issues addressed in this thesis may strike many readers as technical, if not arcane. The author tried to demonstrate the originality and opportunity to undertake this research with constant reference to corporate cases. Many of the complexities, however, arise from the fact that there is no easy road to address these issues. It is hoped that this study will shed some light on some of the questions that should be addressed to make the Anglo-American corporate distress framework more procedurally fair and efficient for the benefit of all stakeholders.
CHAPTER 2 - THE LIMITS OF INSOLVENCY LAW IN AUTONOMY-BASED FRAMEWORKS

«Perhaps the most remarkable characteristic of bankruptcy scholarship is the absence of consensus on the appropriate answers to what would seem to be the two most basic questions in its domain: should there be a separate system of debt resolution [...]? And, if such a system is established, what should be its goals?»

2.1 INTRODUCTION

Do we need insolvency law? Is there a rationale for an independent insolvency regime? These questions are more problematic than they seem and the permanence on the cusp of the academic debate for such a lengthy period testifies the centrality of the matter.

No uniform answers have been reached in the academic community. For instance, neo-libertarian insolvency scholars argue that corporate insolvency procedures should be governed by private law remedies agreed either by the parties in their negotiations or identified by the debtor in the company's articles of association. Based on economic analysis, they believe that privately-

---

2 The current debate began with TH Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain’ (1982) 91 Yale L.J. 857, where the author argued that grab-law, individual remedies were inefficient, thus justifying the existence of a collective and statutory insolvency system.
negotiated remedies should be preferred to compulsory statutory rules from an efficiency standpoint.

These theories have been challenged in the past and this chapter is concerned with the de-constructing them. It seems like a reasonable approach to investigate the strengths, shortcomings and characteristics of those theories that deny the autonomy of this branch of law before addressing the issue of the content and limits that should characterise it.

-Late Sixties: England and France-

Passengers were starting to use planes for their travels. Much as today, passengers could buy their tickets from the airline company itself, even if the flight was not or only partially operated by that company. Nevertheless, the company that materially provided the service deserved to be compensated if it was different from the company to which the passenger paid the fare.

A daily or individual payment of inter-company liabilities would have been massively unpractical and would have generated high administrative costs. Therefore, many companies joined the International Air Transportation Aviation (‘IATA’), a Canadian-incorporated entity that operated a clearing house system with the purpose of avoiding the necessity of making numerous payments among its members.

Basically, each IATA participant agreed to determine at the end of each month its balance of liabilities towards all the other members of this corporation. In case of overall negative net liabilities, that participant had to pay the corresponding amount to IATA, which would use it to compensate those other members who had a positive balance of liabilities.

5 See chapter one, fn 32.
The system made commercial sense. As observed by Morris of Borth-y-Gest LJ, ‘[t]here was no trace in the scheme of any plan to divert money in the event of liquidation’. It seemed therefore that when parties entered into contracts in good faith as part of their usual business, the validity of this and similar contracts should be upheld against any office-holder who afterwards took control of the company.

However – and this was the majority view in the case of British Eagle – such an arrangement replaced a relationship of creditor to debtor between the IATA members with a tri-lateral agreement. That tri-lateral agreement resulted in contractual set-offs where English insolvency rules would have imposed: a) to British Eagle’s IATA net debtors an obligation to pay to the insolvent estate the money owed to the company at the date of liquidation; and b) to British Eagle’s IATA net creditors a right to share rateably as unsecured creditors in the distribution of the proceeds.

In other words, if IATA rules applied, British Eagle would have been a net debtor towards IATA for £44,771. Vice-versa, if English insolvency rules applied, British Eagle could have recovered from fourteen IATA members £27,025 while fifty-three other members would have to prove in liquidation claims totalling £71,796.

---

6 British Eagle International Airlines Ltd v Compagnie Nationale Air France [1975] 1 WLR 758 (HL) [763C].
7 Ibid.
8 Ibid [769A and B].
As a general rule, if contracts are not entered into by the parties with the purpose of circumventing the principles underpinning insolvency law, there should be no reason why they should be binding only upon the contracting parties but not on the office-holders. However, the House of Lord concluded that whenever any claimant is able to demonstrate the existence of a relationship of creditor to debtor, the contracting parties are not allowed to “contract out” of the insolvency legislation as such behaviour would be contrary to public policy.9

This judgment seems a gravestone to any discussion about contracting out of insolvency law: according to English judges, it is simply not possible. What if, however, it is argued – as neo-libertarian, autonomy-based theorists do – and proved that there is no autonomous justification for a discrete system of insolvency rules? In that case, the right question to ask would be: “Why should the legislator derogate from (i.e. contract out of) the general contract law principle of party autonomy?”.

To investigate if there is an autonomous justification for insolvency law, section 2.2 de-constructs and reviews the suggestions to repeal statutory insolvency rules altogether [neo-libertarian proposals]. This section does not provide a full assessment of autonomy-based theories as it is concerned with highlighting the features of these conceptualisations that are relevant for the debate on the limits of insolvency law. Sub-sections 2.2(a) and (b) test the validity of these theories by referring to real cases which apply some of the arguments suggested by “no-insolvency scholars”.

Section 2.3 describes the peculiarities of asset-segregated industries and it addresses the claim that their intrinsically different nature makes them perfect candidates for being insolvency de-regulated. Section 2.4 challenges the normative assumptions upon which all these theories are based and it investigates whether autonomy-based solutions are procedurally efficient and fair. Section 2.5 concludes that neither the market alone nor limited amendments to other branches of law provide comprehensive solutions to the

---

9 Ibid [780H].
issue that lies at the basis of insolvency law: the common, anti-common and semi-common nature of the RCP dilemma.

From a terminology point of view, this chapter is not concerned either with attempts made by insolvent debtors to evade the system (known as ‘evasive behaviour’\(^{10}\) or with creditors’ abusive demands of excessive credit terms and preferential treatment on the eve of insolvency. This behaviour has long been recognised as being contrary to the collective interests of insolvency participants\(^ {11}\) and it is curtailed by mandatory provisions enabling the avoidance of abusive transactions.

### 2.2 Autonomy-Based Solutions to Insolvency Law

In order to make a case for insolvency law, it must be demonstrated that it addresses issues neglected by the other fields of law. Additionally, it is crucial to prove either that stakeholders are not able to agree on contractual and inclusive solutions absent statutory guidance, or that autonomy-based regimes are non-desirable for policy or cultural reasons.

The branches of law which share the most with insolvency law are commercial and contract law. The latter includes provisions about remedies for breach of contracts.

Despite the existence of a vast spectrum of remedies to contractual breaches, both laws fall short of addressing specifically the systemic failure of a contracting parties. The starting points of commercial/contract and insolvency law differ: failure to meet an obligation on one hand, systemic failure on the other. These considerations suggest that at least limited adjustments are needed to apply commercial law remedies to corporate demise cases.

With these limited adjustments, commercial and contract law remedies could prove effective in addressing the systemic failure of the debtor, thus rendering redundant the creation of a separate system of rules governed by autonomous

---


\(^{11}\) Avoidance provisions have formed part of debt enforcement and insolvency laws in England since 1376: Ibid 4.
principles. This is the position of the commentators whom I would classify as neo-libertarians.\textsuperscript{12}

Autonomy-based solutions and neo-libertarian views rely upon two assumptions.\textsuperscript{13}

The first, prominent premise is the contractual heuristic of the firm,\textsuperscript{14} according to which “everything is negotiable”. Under this approach, corporations are understood simply as a nexus of contractual relationships, the proper function of corporate law being uniquely to provide a set of default rules that govern their life and dissolution. As a result, parties (primarily managers and investors) should be able to freely modify the content of their relations unless this would cause detrimental effects (i.e. negative externalities) to third, non-contracting actors.

The second, consequential premise is that insolvency law does not deal with any issue, which has not previously been addressed in other areas of law.\textsuperscript{15} Since there is nothing peculiar in insolvency, there is no need for separate rules. It is only ‘[a] \textit{misapprehension of financial economics} [that] \textit{gives rise to the intuition that a proper insolvency system must screen firms that should live from those that should die}’.\textsuperscript{16}

These assumptions had been criticised in the past, when it was contended that ‘[i]\textit{magining the world without bankruptcy law gives us an opportunity to identify precisely what it is that bankruptcy law adds to our legal regime and hence what bankruptcy policy is or should be}’.\textsuperscript{17}

\textsuperscript{12}For a comprehensive list of these scholars and their works, see section 3.2 of this thesis.

\textsuperscript{13}For a general definition of autonomy-based theories, see above section 1.2, ftn 33. The two terms (autonomy-based and neo-libertarian) are used to describe those theories that argue for the use of private, contractual remedies to address the issues raised by the distress of any corporate entity.


\textsuperscript{15}Adler, ‘A World Without Debt’ (n 3).

\textsuperscript{16}Adler, ‘A Theory’ (n 3) 344.

\textsuperscript{17}Baird (n 3).
Based upon these assumptions, it is not surprising that the most persuasive autonomy-based theories advocate for the abolition of debt altogether.\textsuperscript{18} Where Baird proved that allocation issues gave rise to TCP problems (an assumption which will be disputed later section 5.4 of this work), Adler demonstrated that it is possible (at least in theory) to repeal the allocation deadlock with the “chameleon equity” corporation.\textsuperscript{19} Its structure would prevent parties from collecting individually against the distressed corporation [dilution mechanism]. He argued that ‘creditor inability to act collectively may not be a problem, but a solution’.\textsuperscript{20}

Adler and other authors argue that contracts alone could solve the fabled TCP problem that is the primary justification for insolvency law.\textsuperscript{21} They explain in their “public choice theory” that the perseverance of inefficient laws is only the result of a pressure on the legislature to retain the existing system.\textsuperscript{22}

Adler’s reasoning is persuasive, but only with respect to the allocative side of the TCP problem, i.e. the risk of an inefficient individual race to the debtor’s assets by its creditors. Additionally, it is based upon considerations tested (and applicable) to a limited subset of insolvency cases.\textsuperscript{23} Similar proposals\textsuperscript{24} suffer

\begin{footnotesize}
\begin{enumerate}
\item Adler, ‘A World Without Debt’ (n 3).
\item The chameleon equity corporation is a company, which issued differently ranked debt to its creditors. Because creditors have no right to act individually against the company, should the debtor be unable to meet all of its fixed obligations, the lower class (equity) will be wiped out and the next-higher class will become the equity group. This solution, however, does not work with reference to non-contractual claimants and it underestimates the windfalls that may result from fluctuations in the market value of the debtor. See Adler, ‘Financial and Political Theories’ (n 3).
\item Adler, ‘A Theory’ (n 3) 346.
\item Adler, ‘A Theory’ (n 3) 346; Adler, ‘Financial and Political Theories’ (n 3).
\item Adler, ‘Finance’s Theoretical Divide’ (n 3). This conclusion has been challenged by other authors. For a comprehensive analysis of the evolution of U.S. bankruptcy law and the behind-the-scene explanations of some of its relevant features, see: PJ Coleman, Debtors and Creditors in America (Madison: State Historical Society of Wisconsin, 1974); DA Skeel, Jr., Debt’s Dominion: A History of Bankruptcy Law in America (Princeton University Press: Princeton, 2001) who, while adopting the same public choice approach, identifies three eras in the evolution of U.S. bankruptcy law on the basis of the ability of key interest groups to influence Congress’ legislative production. Skeel concludes that it is unsatisfactory to explain the evolution of the law only as a by-product of lobby pressures.
\item Adler himself recognizes, in fn 3 - Alder, ‘A World Without Debt’ (n 3) - that his argument applies only to selected corporate debtors. It was tested on public corporations that filed for Chapter 11 protection and had issued fixed obligations to a large number of investors. The narrow scope of its analysis affects the relevance of his conclusions.
\item Bradley and Rosenzweig (n 3). After having proven the inefficiencies of Chapter 11 in particular and reorganisation procedures in general, the authors propose to abolish court-supervised reorganisations by reassigning the failing (but not failed) company’s property rights
\end{enumerate}
\end{footnotesize}
the same shortcomings. Other scholars, current legislative provisions and real cases\textsuperscript{25} demonstrate that TCP issues have a (re)distributive nature as well. A solution which addresses only part of the problem is unsatisfactory.

[2] Similarly flawed in the sense that it addressed only one of the aspects of the TCP problem (this time, the (re)distributive side) is Bowers' theory,\textsuperscript{26} which relies entirely on the debtor's ability to maximise the assets of his company.

(Re)Distributive insolvency rules are based on the fundamental policy of insolvency law that all creditors (at least, those of the same class) are equal and should be treated in the same manner. Even assuming that the morality of equal treatment is not disputed, Bowers observes that the existing bankruptcy policy is incomprehensible. If creditors were equal to each other, debtors would have no need to prefer or disfavour any of them and there would be no need for statutory rules that prescribed equality of treatment. Yet, in the British Eagle case, IATA companies would have been favoured over non-IATA members.

At the same time, those same rules that should promote equality in reality encourage practices that favour differential treatment among similar creditors. For instance, if a supplier is deemed essential for the debtor, payments towards this company can remain current throughout the pre- and post-insolvency period even if other similarly-ranking creditors are paid little or nothing.

Bowers argues that rules that allow for differential treatment among creditors are not wrong as ‘nonequality is the only distributional standard which is wealth

\textsuperscript{25} See below in this and the following chapters.

\textsuperscript{26} JW Bowers, 'Groping and Coping in the Shadow of Murphy’s Law: Bankruptcy Theory and the Elementary Economics Failure' (June 1990) 88(7) Mich. L. Rev. 2097. By applying the Murphian theory of failing behaviour, the author argues that systematic attempts to explain insolvency law - such as the creditors' maximisation heuristic - are inadequate. He also argues that both solvent and insolvent debtors faced with losses are the best-placed actors to manage their assets in optimal ways. He concludes that 'debtors will use [private property rights] \textit{either to minimize the impact of losses, without harming their creditors, or to pay creditors in advance for any harm creditors may suffer by the exercise of that power}' (at 2141). See also: JW Bowers, 'Rehabilitation, Redistribution or Dissipation: The Evidence of Choosing Among Bankruptcy Hypotheses' (1994) 72 Wash. U. L.Q. 849.
maximizing’. He might be right in demonstrating that Jackson and Baird’s approach to bankruptcy is based on unsound economics and that collective procedures do not ameliorate the “vulture problem”. In the end, however, he simply proved the need to reform existing procedures, while he fell short of making a case for their full repeal.

[3] It has been advocated that some of the issues raised by the above-mentioned party autonomy-enhancing solutions may be overcome if third, independent parties such as courts adopted a supervisory position over the liquidation or reorganisation process. Their intervention or, even better, the threat of their intervention, would ensure that creditors dealt with deadlocks in a timely manner and that sales and reorganisations would happen without distortions and abuses.

Such an approach was first advocated by Roe [partial-float proposal]. He argued that the resulting reorganisation would be fast, inexpensive and result in a sound capital structure for the new corporation. Courts should intervene only when creditors are hindered by ‘a basic form of the prisoner’s dilemma: [when] the aggregation of individualistic, “rational” decisions lead to an inferior collective result’.

Leaving aside the apparently simple but practically cumbersome mechanics of this proposal, its fundamental deficiency lies in its assumption that markets are sufficiently mature and efficient to value companies and drive their restructuring efforts.

Who would buy a mom-and-pop store if not the current owner(s)? What if the value of a company is seriously compromised by external factors, such as

---

27 Bowers, ‘Groping and Coping’ (n 26) 2103.
28 Where Jackson used the metaphor of the fishermen overfishing in a pond, Bowers uses the image of a flock of vultures trying to satisfy their appetite over a thin dying critter: Bowers, ‘Groping and Coping’ (n 26) 2105-07.
29 A circumstance further substantiated by the narrow scope of Bowers’ sample, since his analysis applied to Chapter 11 cases filed by corporations listed on the New York or American Stock Exchanges.
31 Ibid 544.
32 Basically, Roe suggested creating a reorganised corporation and selling a portion of its stock (10%) on the market, to determine the value of the insolvent assets and distribute the shares and the proceeds to existing creditors according to the APR.
temporary fluctuations in the market? What about the treatment of secured creditors, or multi-party reorganisations? What about those periods of time in which there is no liquid market, such as during the 2007-2010 financial crisis?

Real cases suggest that this theory may work, but only for a limited spectrum of debtors, i.e. those which trade in the stock market or for which investors may determine the market value with little effort and cost. As the author recognizes, in all other cases ‘jamming the market valuation into the context of an ongoing reorganization would risk re-creating the very problems that an objective market valuation might eliminate: delay and judicial inexpertise’.33

[4] In an attempt to make Roe’s proposal more “palatable” to a wider audience and a larger set of cases, Bebchuk34 conceived a new method for dividing the reorganisation pie among creditors [option proposal].

Under her suggestion, insolvency filings would result in the cancellation of all of the company’s debts and their conversion into equity. Junior claimants would then be given the opportunity to buy shares in the new company. Proceeds would be used to repay (more) senior creditors and, if they proved insufficient, shares in the reorganised corporation would be allocated to them according to the amount still owed. If nobody exercised their purchase rights, the company would be allocated to most senior creditors.

Despite its merits over Roe’s proposal and further refinements from other authors,35 this theory still does not address the fundamental criticism that markets may not be capable of assessing the reorganised corporation. Furthermore, some claimants (e.g. MSMEs, consumers, tort creditors) are unlikely to bid for the new corporation even when they believe that it is worth more than the amount owed to secured creditors.

33 Roe (n 30) 601.
35 P Aghion and others, ‘The Economics of Bankruptcy Reform’ (Oct. 1992) 8(3) J.L. Econ. & Org. 523. The authors advocated for non-cash bids, such as shares or securities on the bidder’s assets or - following a reorganisation - on the distressed debtor. According to this proposal, upon insolvency, the company’s debts would be cancelled, former creditors would receive all the equity of the distressed company (now, new, all-equity company) and these creditors (as new owners) would decide whether to liquidate or reorganise the company. The judge would supervise the procedure and allow non-cash bids. Bids should be submitted within three months from insolvency and the new owners would vote for the best bid. See also: AJ Casey, ‘Auction Design for Claims Trading’ (2014) 22 Am. Bankr. Inst. L. Rev. 133.
Even if shares in the newco could be bought without monetary disbursements (i.e. promise of future work in the company; concession of patent or intellectual rights; etc.), this would only ‘intensify the auctioneer’s incentive problem, since non-cash bids are inherently more difficult to evaluate than cash’.36 Nobody questions that Bebchuk’s proposal may work with reference to institutional creditors of medium and large companies with multiple claimants, where information is largely available, there is a market for the newco stock and creditors are willing to bid. Unfortunately, we are left in the dark about the authors’ claim that the scheme ‘may also have a role to play in case of small companies’,37 or why other categories of creditors would not be worse off than under alternative, statutory solutions.

The trouble is, therefore, that this scheme may result in windfalls for institutional and sophisticated creditors. It ‘would reach a fair result, and would be cost effective, [primarily] if the corporation’s going concern value was lower than the senior debt, and the senior creditors wanted to operate the former corporation’s business themselves’.38

[5] Some authors, inspired by the work of Rasmussen and Schwartz,39 recommended the implementation of an ex-ante restructuring mechanism. They do not criticise the mandatory nature of the insolvency system, but the prohibition of conceiving contractual, negotiated alternatives. They argue that parties would be better off in dealing with the “coordination problem” (i.e. the allocative side of the TCP problem) if they were able to choose their preferred bankruptcy system by contract.40 This is more or less what parties had in mind in drafting the IATA agreement.

39 Rasmussen (n 3); Schwartz, ‘A Normative Theory’ (n 3).
40 ‘Viewing bankruptcy through the lens of contract theory reveals bankruptcy’s anachronistic character: bankruptcy is a government enterprise. The state runs the postal system and restricts competition with both by law’: Schwartz ‘A Contract Theory’ (n 3) 1851.
These authors challenge the frequently unquestioned assumption that insolvency law should aim at *ex-post* efficiency, either in its allocative or (re)distributive understanding. They argue that insolvency law should look at *ex-ante* efficiency, i.e. at reducing the cost of capitals for companies.\(^{41}\)

The authors’ rejection of the common pool analysis is not entirely convincing. It rests on the premise that debtor and creditors could structure their allocation rights without mandatory rules, but it ignores the position of other risk-takers\(^{42}\) such as involuntary claimants.

Furthermore, for the purposes of this study, these *ex-ante* restructuring proposals do not undermine the premises of the insolvency system, but only its exclusivity claim. They do not question the opportunity of structural, mandatory rules. As a result, they do not question the rationale for the existence of insolvency as a separate branch of law.

**[6]** A partially different position was expressed by LoPucki\(^{43}\). His *team production theory* is based on one hand on the original “team production theory of corporate law” introduced by Blair and Stout in 1999\(^{44}\) and, on the other, on the contractarian, hypothetical bargain approach suggested by Korobkin and Baird. While the latter authors do not question the distinct and unique role of insolvency law, LoPucki considers corporate reorganisation as ‘*a contract term by which creditors and shareholders agree to subordinate their legal rights to the preservation of the going concern*’.\(^{45}\)

Under the team production theory, the corporation is not “owned” by the shareholders or by the creditors (upon insolvency). The corporation is seen as a function, whose membership is given to all individuals who make firm-specific

\(^{41}\)This conclusion is shared by other authors who consequently adopt the same *ex-ante* maximisation approach. See, among others: LM LoPucki, ‘A Team Production Theory of Bankruptcy Reorganization’ (2004) 57(3) Vand. L. Rev. 741.

\(^{42}\)The word “risk-taker” is used as a synonym of “risk bearer” throughout this work.

\(^{43}\)LoPucki (n 41).

\(^{44}\)MM Blair and LA Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85 Vand. L. Rev. 247. Under the team production theory of corporate law, any corporation is a ‘team’ of members. These members - who include stockholders, creditors, executives but also employees, suppliers, customers, local governments, regulatory agencies and others - *delegate* the board of directors to act for the benefit of the company. Because they *own* the company, they are entitled to something more than simply compensation for their work.

\(^{45}\)LoPucki (n 41) 743.
investments. When an insolvency event occurs, the directors would be left in full control, and if reorganisation was possible, they would be required to share the entitlements of the ailing corporation to all its members. The directors would act as trustees and share the company’s assets according to the entitlements of each interested party.

This proposal suffers from a primary deficiency: its scope. It is conceived for large companies and it can operate primarily among sophisticated players. Critics also challenged its (re)distributive focus (shared by Rasmussen and Schwartz’s theory), since it would expose ‘the interests of non-participating creditors to the redistributinal impulses of the active, knowledgeable participants’.46

Furthermore, some authors concluded, albeit indirectly, that we already live in a world where ‘bankruptcy (i.e. insolvency law) is a backup’,47 since the leading creditors could opt for pre-pack or auction procedures (either inside or outside a statutory rescue framework) whenever they perceive the latter are in their best interest.

Finally, it was highlighted that in a market where companies finance themselves from several sources (which is especially true for large corporations), debtors have to deal with manifold (categories of) creditors, who seldom have uniform expectations when a company fails the repayment of its loans. Negotiating ex-ante with all or the majority of them may prove very expensive and ultimately utopian.

These observations prove that ‘[t]he case in which Schwartz’s proposed solution fails is not some rarity; it is the norm’48 (and the same goes for LoPucki’s considerations). Nevertheless, these theories might have leverage as ‘if there is a possibility that free contracting over bankruptcy systems would increase welfare, and if there otherwise is nothing wrong with free contracting, then free contracting should be permitted’.49 It is not surprising, therefore, that other

48 LoPucki (n 46) 329.
49 Schwartz, ‘Bankruptcy Contracting’ (n 3) 344.
authors tried to combine “the best” aspects of these approaches. However, as for Rasmussen and Schwartz’s proposals, what is challenged is only the exclusivity, not the existence of the insolvency framework.

2.2(a) Autonomy-Based Remedies in Domestic Cases

Law in practice differs from printed statutes. This sub-section investigates if and to what extent autonomy-based proposals work in practice. The goal is to determine if these proposals may present a comprehensive alternative to an insolvency system characterised by discrete and mandatory rules that deviate from contract law tenets.

The linkage between insolvency and contracts is not restricted to procedures involving companies operating in certain sectors of the economy or within or across jurisdiction. Therefore, this thesis carries out an analysis of autonomy-based remedies in a wide array of situations, starting with domestic cases. The following sections will extend the scrutiny to cross-border cases and asset-segregated industries.

Several studies have been carried out to demonstrate if and to what extent debtors can sidestep the mandatory nature of insolvency law. These studies

50 See the proposal for a contextual model by K Gross, Failure and Forgiveness - Rebalancing the Bankruptcy System (Yale University Press: New Haven, 2009). According to her proposal, insolvency law should be based upon three pillars (debtor, creditors and community), who would not compete or dominate each other’s. The author concludes that insolvency law shall be treated as a ‘vehicle for social change. […] Many suggest that bankruptcy should not be the panacea for all social ills. Let the bankruptcy resolve just the allocation of limited resources among creditors. […] But the law can, and frequently is, a vehicle for social change. […] We should not let the opportunity to intervene slip by’ (249).

51 "Domestic cases" are insolvency procedures with no cross-border implications. A procedure has a cross-border implication not only when the debtor's assets are spread in more than one jurisdiction, but also when its contracts are subject to all but the lex concursus. The circumstance that the debtor’s creditors are foreign may not affect the nature of the procedure, which may still be governed by the substantive and procedural rules of a single jurisdiction. In the latter case, we are in front of a domestic insolvency procedure.

52 See, among others: Roe (n 30); Bebchuk (n 34) (proposing a new method to divide the reorganisation pie among the participants in rescue procedures); Bowers, 'Groping and Coping' (n 26) (stating that insolvency law can never be made to work as it is supposed to and can never be fixed); Rasmussen (n 3); Bowers, 'Rehabilitation' (n 26) (arguing that nobody has yet offered a persuasive set of reasons to alter or overturn the set of property and contract rights granted by general law); A Schwartz, 'Contracting About Bankruptcy' (1997) 13(1) J. L. Econ. & Org. 1227 (arguing that the prohibition on contracting for preferred bankruptcy procedures should be lifted because it exacerbates underinvestment); Schwartz 'A Contract Theory' (n 3)
generally conclude that debtors (and creditors) can rely on a multitude of contracting-out mechanisms,\(^{53}\) and that courts are prepared to recognize their enforceability.\(^{54}\) However, the same studies prove that these remedies are frequently used to refinance or restructure existing indebtedness, rather than to contract out of insolvency law.

One of the best known and most widely accepted mechanism to forgo strict observance of insolvency law is represented by “stay waivers”, contractual covenants (generally imposed by secured lenders) which nullify the automatic stay (as it is referred to in the U.S.) or the moratorium (as it is called in the U.K.) on creditor enforcement actions during Chapter 11 or administration procedures.\(^{55}\)

These provisions are particularly common in the U.S. In the past, they were generally deemed unenforceable.\(^{56}\) However, nowadays courts adopt a case-by-case approach. For a detailed analysis of their enforceability in the Anglo-American context, see J Bromley and others, ‘Arriving at a Compromise with, and Identifying Key Stakeholders (…)’ in C Mallon and other (eds), The Law and Practice of Restructuring in the UK and the US (2nd edn OUP: Oxford, 2017).

Due to their level of sophistication, they have been defined as ‘keyhole surgery alternatives to the more radical procedures […]. For some companies, they will be all that is required to enable a return to full health’, 132.

\(^{53}\) While this thesis mentions only ‘stay waivers’ and ‘contractual standstills’, parties have conceived a variety of mechanisms that share with them the contractual nature and deregulatory purpose. These include among others amendments, participations, debt buy-backs, inter-creditor agreements, and make-whole provisions. For a detailed analysis of their enforceability in the Anglo-American context, see J Bromley and others, ‘Arriving at a Compromise with, and Identifying Key Stakeholders (…)’ in C Mallon and other (eds), The Law and Practice of Restructuring in the UK and the US (2nd edn OUP: Oxford, 2017).


\(^{56}\) Re Weitzen, 3 F. Supp. 698 (S.D.N.Y. 1933); accord Continental Ins. Co. v Thorpe Insulation Co. (Re Thorpe Insulation Co.), 671 F.3d 1011 (9th Cir. 2012), where the 9th Circuit held that 'public policy prevents a debtor from waiving the prepetition protection of the Bankruptcy Code' (1026). With a similar approach: Bank of China v Huang (Re Huang), 275 F.3d 1173, 1177 (9th Cir. 2002); Nat’l Hockey League v Moyes, No. CV-10-01036-PHX-GMS, 2015 WL 7008213 (D. Ariz. Nov. 12, 2015).
case valuation and set specific standards for the recognition of their validity.\(^{57}\) If waivers have been negotiated as part of forbearance agreements\(^ {58}\) or a failed renegotiation plan,\(^ {59}\) their validity is generally upheld by the courts.

Stay waivers are usually complemented by less controversial provisions, such as **contractual standstills** (also called “forbearance agreements”). These clauses prevent the signatory parties from accelerating the crisis of the distressed debtor by filing for insolvency proceedings. In the standstill period, the debtor tries to negotiate a set of permanent amendments or a full balance sheet restructuring with the borrowers.

These provisions cannot be characterised as contractual remedies to insolvency, since they only temporarily affect the right of a party to file: they do not **waive** that right. Accordingly, their validity is usually upheld both in England and in the U.S., provided that they have not been unilaterally imposed but agreed after exhaustive negotiations and that they contain safeguards against an abuse of minority stakeholders.\(^ {60}\)

---

\(^{57}\) For instance, in *Re Bryan Road, Llc*, 382 B.R. 844 (Bankr. S.D. Fla. 2008), the court held that it would consider the following factors before deciding if a stay relief agreement could be enforced: (i) sophistication of waiving party; (ii) consideration for waiver, including creditor’s risk and length of time covered by waiver; (iii) whether other parties are affected; and (iv) feasibility of debtor’s plan. The court recognised the enforceability of the waiver in this case. It concluded that courts should look ‘to totality of circumstances in each particular case in deciding whether “cause” exists to grant relief from automatic stay’ by reason of 11 U.S.C.A. § 362(d)(1), at 854.

In *Re Alexander SRP Apartments, Llc*, No. 12-20272, 2012 WL 1910088 (Bankr. S.D. Ga. Apr. 20, 2012), Lamar J held that “appropriate circumstances” may justify a waiver. He concluded that, in the case in front of him, these circumstances were proven since (1) the waiver was not inserted in the initial loan documents, and in renegotiating the original terms of the agreement significant concessions were granted by the lender. Additionally (2), the borrower was a sophisticated, knowledgeable, and experienced developer, and (3) there was no fact attendant to the transaction which revealed fraud, mistake, coercion, or any other factor where public policy would negate the waiver. Finally (4), no other creditors or parties in interest have objected to the motion for stay relief, despite the fact that they could be harmed by its approval.

\(^{58}\) *Re BGM Pasadena, Llc* (Bankr. C.D. Cal. 2016), where the court held that waivers that are approved after notice and an opportunity for hearing in the context of an earlier bankruptcy case are enforceable. Followed by *Re Triple A&R Capital Inv. Inc.*, 519 B.R. 581 (Bankr. D.P.R. 2014).

\(^{59}\) This is a plan negotiated as part of an informal, private workout where the debtor attempted and managed to persuade the creditors to accept an amendment of the original conditions of the contracts that regulated their relationship on the promise of higher payoff.

\(^{60}\) This risk surfaces whenever these clauses recognise standstill rights to a qualified majority. To protect the rights of dissenting lenders, the legislator introduced some safeguards in the law: see, for instance, the *Trust Indenture Act of 1939, 15 U.S.C. s. 77(b)* (2010). Under common law, the courts established that this right can be exercised only in good faith and for the purpose for which it was conferred *(Redwood Master Fund Ltd v TD Bank Europe Ltd [2002] EWHC 2703*
As a matter of fact, courts still follow a critical, presumptively negative approach towards the enforceability of pre-bankruptcy waivers only in cases involving single asset debtors, even though in these cases the presumption is rebuttable by the creditor who holds the waiver.

Even more striking in their effect is the resort to pre-package rescue procedures. First introduced in practice in England, they have quickly gained the favour of the industry and practitioners. Henceforth, they have rapidly spread to several western jurisdictions, despite the lukewarm reaction of several insolvency academics and insistent calls for regulation or, at least, prevention of their abusive use.

---

(Ch), [2006] 1 BCLC 149) and only if it is in the interest of the creditors on a whole (see British America Nickel Corp Ltd v MJ O'Brien Ltd [1927] AC 369 (PC)).


62 In reality, pre-packaged deals have been a common feature of commercial practice in continental Europe since the 18th century. See D de Ruysscher, 'Business Rescue, Turnaround Management, and the Legal Regime of Default and Insolvency in Western History (Late Middle Ages to Present Day)' in J Adriaanse and JP van der Rest (eds), Turnaround Management and Bankruptcy (Routledge: London, 2017) 35.


65 Calls for reform have been pressing even in England and Wales where in 2014, the Secretary of State for Business, Innovation and Skills commissioned a report on pre-package administration. This report - T Graham CBE, Graham Review into Pre-Pack Administration: Report to The Rt Hon Vince Cable MP (The Insolvency Service, 16 June 2014) <https://www.gov.uk/government/publications/gra...> accessed 17 September 2018, known as "Graham Review" - was designed to have a more objective picture of the situation, as well as to promote trust and transparency in the use of pre-packs. It concluded that, while there still is place for pre-packs in the UK's insolvency landscape, there is also a need for some major improvements on how they are administered.
Pre-pack sales consist of informal workouts with selected creditors rendered enforceable to the totality of the cohort thanks to a rubber-stamp approval by the competent court. In other words, pre-pack sales mean "arranging the sale of all or part of a company’s undertaking before formal insolvency is entered, with the sale to be executed at or soon after the appointment of an administrator".66

Given to the magnitude of the debate on pre-packs, it is pertinent to restrict the analysis to a less debated, but potentially even more contentious exception to the enforceability of statutory rules: *ipso facto or termination clauses.*

*Ipso facto* is a Latin phrase, directly translated as "by the fact itself", which means that a certain phenomenon is a resultant effect of the action in question, instead of being brought about by a previous action. It is a term of art used in philosophy, law and science.

In contractual practice, *ipso facto* clauses are negotiated to determine the automatic default and termination of an agreement due to a company's bankruptcy, insolvency or shaky financial condition. They operate in the interest of the non-defaulting party.

The enforceability of *ipso facto* clauses is particularly controversial in insolvency cases. Should debtors wish to reorganise their activity, the disappearance of key suppliers would present the final blow to their hopes. If a supply contract included an *ipso facto* clause, the non-defaulting party (i.e. the creditor) could rely on it to prevent any future performance under that contract unless certain conditions (such as payment of outstanding balance and provision of additional warranties for future performance) were met. The suppliers could therefore hold the rescue procedure to ransom, thus giving rise

---

66 Graham Review, at [5.15]. According to SIP 16, pre-packs are ‘an arrangement under which the sale of all or part of the company’s business or assets is negotiated with a purchaser prior to the appointment of an administrator and the administrator effects the sale immediately on, or shortly after, appointment’: R3, ‘Statement of Insolvency Practice 16 – Version 3’ (effective from 1st November 2015) <https://www.r3.org.uk/what-we-do/publications/professional/statements-of-insolvency-practice/e-and-w/sip-16-list> accessed 17 September 2018.

Some authors, however, tried to explain their success. Particularly convincing is Skeel’s observation that - unlikely purely out-of-court alternatives to insolvency law - pre-packs require the involvement of legal practitioners, as well as a (limited) contribution from courts. Therefore, both judiciary and lawyers' lobbies are willing to turn a blind eye on some of their most striking abuses - see Skeel (n 22) 228. The author argued that while ‘bankruptcy lawyers find true waivers pernicious’, the same could not be said for pre-packs.
to anti-common-type situations. This prompted calls to prevent their enforceability, at least whenever the distressed company is operating as a going concern in a formal insolvency procedure.\textsuperscript{67}

However, creditors counter-argue that freedom of contract is paramount\textsuperscript{68} and that they could not be forced to supply goods for free. In addition, terms and conditions negotiated by the parties in solvent times affect the transaction price. A sudden change of these terms to favour only one of the parties in the deal appeared unjust and unfair.

More pro-debtor\textsuperscript{69} laws tend to ban the enforceability of \textit{ipso facto} clauses, at least when the company operates as a going concern in a formal insolvency procedure.

---

\textsuperscript{67} Recent studies also demonstrated that in almost half (49\%) of the surveyed cases, key trade suppliers demanded ransom payments or attempted to renegotiate contract terms as a condition of continuing to supply in trading insolvencies: R3: Association of Business Recovery Professionals, 'Membership Survey - Termination Clauses' (London, 2013), <https://www.r3.org.uk/media/documents/policy/research_reports/R3_Membership_Survey_Termination_Clauses_09_August_2013.pdf> accessed 17 September 2018.

\textsuperscript{68} Freedom of contract represents a pivotal, public policy principle especially in England. In \textit{Printing and Numerical Registering Co v Sampson} (1874-75) LR 19 Eq. 462, at 465 Ct of Chancery, Sir George Jessel, the Master of the Rolls, stated that ‘[…] if there is one thing more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of Justice. Therefore, you have this paramount public policy to consider – that you are not likely to interfere with this freedom of contract’. More recently, in \textit{Prime Sight Ltd v Lavarello} [2013] UKPC 22, [2014] AC 436 [47], Toulson LJ held that ‘parties are ordinarily free to contract on whatever terms they choose and court’s role is to enforce them’.

\textsuperscript{69} The distinction between pro-debtor and pro-creditor jurisdictions comes from PR Wood, \textit{Principles of International Solvency} (Sweet and Maxwell: London, 1995). While the partition he proposed may no longer be actual, the offered criteria are still valid. In particular, the author classifies as ‘pro-creditor’ any insolvency jurisdiction whose main focus is to ‘help the creditor escape the debacle, e.g. by recognizing a wide security or a set-off’, while ‘pro-debtor’ insolvency jurisdictions seek to ‘aggrandize the debtor’s estate, e.g. by restricting security, refusing insolvency set-off, […]’ (36). For a challenge to the standard characterization as U.S. law being ‘pro-debtor’ and U.K. law being ‘pro-creditor’, see: G McCormack, ‘Apples and Oranges? Corporate Rescue and Functional Convergence in the US and UK’ (2009) 18 Int. Insolv. Rev. 109. It is acknowledged that these labels tend to over-simplify an otherwise very complex classification problem. As a general rule, pro-creditor systems tend not to infringe significantly on the rights bargained by creditors in solvent times. On the opposite end of the spectrum, pro-debtor systems erode those rights whenever it appears to be appropriate to achieve the rehabilitation of the distressed business. Among others: M Pomerleau and W Shaw, \textit{Corporate Restructuring. Lessons from Experience} (The World Bank: Washington D.C. 2005) 308. More recently, it was observed that traditional pro-debtor countries such as the U.S. tend to have a legislation that protect the interests of managers and shareholders to a wider extent and in a more comprehensive manner than pro-creditor jurisdictions such as the U.K. At the same time, it was observed that secured creditors enjoy a similar level of protection in both pro-creditor and pro-debtor countries, even if the form of the protection is different: G McCormack, \textit{Corporate Rescue Law – An Anglo-American Perspective} (Edward Elgar: Cheltenham, 2008) 288, 292-298.
procedure. This approach is being followed, among others, in the U.S. and Canada.

Under Canadian insolvency legislation **ipso facto** clauses are unenforceable. Section 34 of the Companies’ Creditors Arrangement Act provides that a person may not terminate, alter agreements or claim accelerated payment or forfeiture of the term under any agreement *solely* because insolvency proceedings were commenced or the company went insolvent.\(^{70}\)

A similar approach is followed in the United States, where §.365(e)(1) of the U.S. Bankruptcy Code makes it illegal for a party to terminate an executory contract on the basis of insolvency of the counterparty *alone*. The U.S. narrative is further analysed below in **sub-section 2.2(a)(i)**.

Pro-creditor countries tend to adopt a more cautious approach when it comes to restricting the enforceability of clauses freely negotiated between the parties. They often have a widespread belief that ‘[t]he freezing or stay on self-help termination is unquestionably one of the most draconian and controversial of all stays, because of its massive impact on transactions’.\(^{71}\) Nevertheless, even in the country where sanctity of contract is the paramount principle of commercial law [the United Kingdom],\(^{72}\) certain carve-outs have been introduced by the law.

A similar approach was followed in Australia, where there were no restrictions on creditors or third parties exercising rights of termination under executory contracts. Specifically, there was no such restriction for corporate failures, since Australian bankruptcy law rendered those clauses void if the relevant obligor

\(^{70}\) s. 34 Companies’ Creditors Arrangement Act (R.S.C., 1985, c.C-36).


\(^{72}\) Associated Japanese Bank (Int’l) Ltd v Credit du Nord SA [1989] 1 WLR 255 (HC/QB) 257 where Steyn J held that ‘[t]hroughout the law of contract two themes regularly recur – respect for the sanctity of contract and the need to give effect to the reasonable expectations of honest men’. Similarly, in *Re Collins’ Application* [1975] 30 P&CR 527, 531 the Lands Tribunal (Mr Douglas Frank QC) - in weighting the balance between public interest and private rights - considered that ‘for an application to succeed on the ground of public interest it must be shown that that interest is so important and immediate as to justify the serious interference with private rights and the sanctity of contract’.
becomes insolvent. Only essential services, leases and rents could not be interrupted should an insolvency event arise.

Australia has, however, recently experienced a period of regulatory reconsideration. This has led to the adoption, by means of the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 (Cth), of “pro-debtor” solutions similar to those currently implemented in the U.S. and Canada. Changes to the discipline of ipso facto clauses apply to all contracts signed on or after 1st July 2018 and the English government is also exploring the opportunity to introduce a general ban on the enforceability of ipso facto clauses in insolvency.

More liberal approaches are, on the other hand, advocated and followed in Singapore, where restrictions on the enforceability of ipso facto clauses in formal or hybrid insolvency procedures were deemed unnecessary by the government. The evolution of the laws in all these three countries (England, Australia and Singapore) is further analysed in sub-section 2.2(a)(ii).

---

73 §301(1) of the Bankruptcy Act 1996 (Cth).
74 S.600F of the Corporations Act, according to which ‘if (a) a relevant authority of an eligible company requests, or authorises someone else to request, a person or authority to supply an essential service to the company in Australia; and (b) the company owes an amount to the supplier in respect of the supply of the essential service before the effective day; the supplier must not: (c) refuse to comply with the request for the reason only that the amount is owing; or (d) make it a condition of the supply of the essential service pursuant to the request that the amount is to be paid’. According to the section, essential services include provision of electricity, gas, water and a carriage service within the meaning of the Telecommunications Act 1997.
2.2(a)(i) Pro-Debtor Laws and Carve-Outs: The Case of the United States

Under § 365(e)(1) of U.S. Code, notwithstanding any provision in a contract, lease or other law:

*an executory contract or unexpired lease [...] may not be terminated or modified [...] at any time after the commencement of the case solely [emphasis added] because of a provision in such contract or lease which is conditioned on:

- The insolvency or final condition of the debtor;

- The commencement of a case under this title;

- The appointment or taking possession by a trustee [...] or custodian.

The only cases in which *ipso facto* clauses are legitimate are when: (1) the applicable law excuses a party from accepting performance from or rendering performance to the trustee or the assignee and the party does not consent to assumption; or (2) the contract is to make a loan, extend debt financing or financial accommodation to the debtor or to issue security of the debtor.

The “*ipso facto*” principle is reflected in § 541(c)(1) and § 545 of U.S. Code with respect to statutory liens. Nevertheless, the Code does not interfere with the validity of restrictions that apply both inside and outside of insolvency: only those which apply specifically by reason of an insolvency event are made void.

---

**THE CHICAGO BOARD OF TRADE CASE**

Membership in the Chicago Board of Trade was restricted to people, upon payment of a $25k fee. Corporations could trade only if two of their directors were CBoT members.

A bankrupt member of CBoT wanted to sell its membership for profit. While he was not indebted towards CBoT members, he was also personally responsible for the debt of its corporation towards the CBoT. The other members, therefore, objected to the transfer according to the CBoT’s articles of incorporation. They wanted to be paid before agreeing on the transfer.

The bankrupt’s trustee opined that such a clause breached federal insolvency rules. If enacted, CBoT creditors (of the corporation) could enforce their claims in preference over the bankrupt’s creditors (or block the sale).

The Supreme Court reversed the lower courts’ rulings by holding that this limitation did not represent a breach of U.S. federal insolvency rules.

In other words, rules of exchange that did not apply only by reason of insolvency are not *ipso facto* clauses under U.S. federal law.
This principle has been set out in the *Chicago Board of Trade*, where the Supreme Court held that restrictions on the sale of a “seat” in the Chicago Board of Trade which apply outside bankruptcy were valid also in formal insolvency procedures.

Notwithstanding their unenforceability, *ipso facto* clauses still abound in formbooks and pre-printed contracts. This is not only because they were enforceable before the 1978 amendments, but also because they often appear in conjunction with other clauses (e.g. reference to state insolvency proceedings) that might still render them enforceable in case of insolvency.

This appears to be the case with reference to the second exception mentioned above, traditionally referred to as a “safe harbor” for financial contracts, swaps, repurchase agreements (“repos”) and similar transactions. Justifications for such exceptions, however, have proven controversial.

It has been argued that the main purpose of limited-in-scope safe harbor provisions was to preserve liquidity and minimize volatility in the marketplace in the event that the counter-party to such transactions might become a debtor under the Bankruptcy Code. It is also intended that Congress wanted to protect the derivative markets from both the disruptive effect of bankruptcy proceedings (systemic risk) and cherry-picking practices that would allow the out-of-money party to retain favourable derivatives, while rejecting unfavourable contracts. Safe harbors were enacted to promote stability in financial markets.

If an automatic stay applied to financial contracts, it would fundamentally alter the terms of trade by giving the debtor the ability to gain an advantage from

---

76 *Chicago Board of Trade v Johnson*, 264 U.S. 1 (1924).
77 Safe-harbor provisions refer to 11 U.S. §§362(b)(6), 362(b)(7), 362(b)(17), 546, 556, 559, 560 and 561. They present a set of bankruptcy rules that provide more beneficial treatment to counterparties of certain financial and commodity contracts. The benefits include: (a) the enforceability of the contractual right to terminate, liquidate or accelerate the contract (*ipso facto* clauses); (b) exceptions from the automatic stay with regard to rights of netting and set-off; and (c) exemptions from the trustee’s powers to avoid certain transactions.
favourable price movements, while limiting its liability for unfavourable ones (cherry-picking). The problem arises in particular with reference to "systemically important corporations", whose principal assets include large bundles of financial contracts (e.g. Lehman Brothers).

Accordingly, the Bankruptcy Abuse Prevention and Consumer Protection Act (‘BACPA’) 2005 and the Financial Netting Improvement Act (‘FNIA’) 2006 – despite suggestions that safe harbors should be repealed81 – extended the scope of safe harbor protections. These laws broadened the definitions of certain safe harbor agreements, created greater uniformity and clarity and tried to reduce systemic risk in the marketplace by minimizing the risk of disruption in the event of one party’s insolvency.

It is therefore possible to argue that, in the financial sector, the enforceability of ipso facto clauses represents the rule, rather than the exception.

Nevertheless, the majority of commentators find the justifications behind the recognition of safe harbors only partially satisfactory. They observe that ‘the unique nature of such financial and derivative transactions did not significantly harm the debtor or unnecessarily deprive it of a valuable asset needed for reorganization’,82 Moreover, if safe harbors allowed the derivative markets to

80 There is no such definition in the literature. However, the Basel Committee on Banking Supervision relies on selected criteria (size, interconnectedness, complexity, lack of substitutability and global scope) to describe "globally systemically important banks" ('G-SIBs'). G-SIBs are so large and unique that their collapse would cause negative externalities, spill-over risks and competitive distortions. As a result, the Committee suggests that they should not be allowed to fail: Basel Committee on Banking Supervision, 'Globally Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement' (Bank for International Settlements, July 2013) 3 <https://www.bis.org/publ/bcbs255.pdf > accessed 17 September 2018. It is argued that the same criteria and methodology could be used to determine what corporations are systemically important at a global, regional or domestic level in other sectors of the economy.


function without jeopardizing the stability of the financial system, it is not clear why companies like AIG or banks like Northern Rock and Lloyd’s required a bailout. This led some commentators to conclude that safe harbors are likely to increase systemic risk ‘by fostering a run on the bank’ and make derivative markets more vulnerable in times of systemic crises.

They consequently called to repeal or at least to limit the scope of these exceptions. Additionally, they observed that – despite Congress’ efforts – the piecemeal approach followed in recognizing these safe harbor provisions has led to legal uncertainties. There remain ambiguities about the rights, contracts and parties that are protected by these provisions, as well as whether the statutory goals are achieved.

These scholars argued that some liquidation cases (notably, the AIG case) could have been avoided if the safe harbor provisions were narrower in scope. They considered that safe harbor provisions allowed the beneficiaries either to take assets out of the estate or to stop cash flow that would otherwise have been beneficial to the distressed company.

---

83 Lubben, ‘Repeal’ (n 81) 323.
85 Edwards and Morrison (n 81); Lubben, ‘Derivatives and Bankruptcy’ (n 81); Lubben, ‘The Bankruptcy Code’ (n 81); CW Mooney, Jr., ‘The Bankruptcy Code’s Safe Harbors for Settlement Payments and Securities Contracts: When Is Safe Too Safe?’ (2014) 49 Tex. Int’l L.J. 245.
87 Gilbane (n 82) 246. Against, see: R D’Aversa, Jr. and others, ‘Bankruptcy Code Safe-Harbor Protections for Parties to Financial Contracts’ (2006) 22(2) Review of Banking and Financial Services 7 (arguing that the reforms introduced by BAPCPA 2005 and FNIA 2006 presented a victory for the capital markets; increased liquidity and promoted stability; and eliminated many of the ambiguities under the pre-amendment Bankruptcy Code); MD Sherrill, ‘In Defense of the Bankruptcy Code’s Safe Harbors’ (2015) 70(4) Bus. Law. 1007 (arguing, however, that although derivative markets may occasionally be the forum for abusive practices, they were likely a net positive to American society and safe harbor provisions guarantee their efficient operation).
88 Lubben, ‘Repeal’ (n 81).
89 In Lubben’s words, they are considered as ‘windfall gifts to the financial industry and avenues for abuse’ (Ibid 321).
Recently Jackson called to adopt some form of short stay that would apply to the non-defaulting party’s right to terminate and set-off its derivative contracts.90 Other commentators advocated for repealing safe harbor provisions in relation to payment suspension clauses, flip clauses and walkaway clauses91 based on the consideration that markets need clarity and their doubted enforceability results in more litigation and less focus (and resources) on reorganisation.

The latter position appears to be more radical and enjoys less support since – even if safe harbors were repealed – financial markets are unlikely to return to the pre-1978 situation. Legitimate concerns of financial institutions need to be addressed. While alternative solutions have been envisaged,92 it seems that the Congress intended to extend rather than limit party autonomy to exclude certain contracts and clauses from the scope of insolvency law, thus therefore enforcing the feeling that the statutory ban on the enforceability of *ipso facto* clauses is more apparent than real.

This debate over the enforceability of *ipso facto* clauses and safe harbour provisions in the U.S. shows that autonomy-based remedies may in some cases lack theoretical justification. In these instances, mandatory insolvency rules that deviate from negotiated clauses should be preferred to contractual solutions.

2.2(a)(ii) Pro-Creditor Laws and Carve-Outs: The Cases of England, Australia and Singapore

Recent reforms and proposals for reform in England and Australia seem to suggest the emergence of a more debtor and rescue-friendly approach to financial distress in “pro-creditor” countries. This can potentially affect the treatment of *ipso facto* clauses in the law. On the other hand, other pro-creditor


91 Marchetti (n 78) 373-374.

92 Lubben, ‘Repeal’ (n 81).
countries such as Singapore seem to stick to their established set of rules and values, while not rejecting a priori pro-rescue approach to insolvent debtors.

While as a matter of fact ipso facto clauses are enforceable in England,\textsuperscript{93} even if explicitly triggered by an insolvency event, the Insolvency Act 1986 (‘IA 1986’) has restricted this right for essential suppliers.\textsuperscript{94} Additionally, English statutes have to be construed according to the established rules and judicial interpretation. As reiterated in recent cases, the cohort of creditors is protected by the operation of the anti-deprivation principle.\textsuperscript{95}

Lately, the British government decided to further extend this restriction to the autonomy of parties.\textsuperscript{96} This is to ensure that insolvency practitioners rescuing struggling businesses were able to secure the continuation of supplies that are essential for the business.\textsuperscript{97}

Pursuant to s.233 of the Act, the listed suppliers cannot compel future performance to the payment of debts incurred before the commencement of the insolvency proceeding.\textsuperscript{98} A further restriction applicable to essential suppliers


\footnotesize{\textsuperscript{94} For a more detailed description of the notion and scope of the anti-deprivation principle in common law jurisdictions other than the U.S. see below sub-section 2.2(a)(iii).}

\footnotesize{\textsuperscript{95} The Insolvency (Protection of Essential Supplies) Order 2015 SI 2015/989, which amended s.233 and introduced s.233A to the Act. These provisions apply only to contracts entered into on or after 1 October 2015. For an analysis, see: V Finch and D Milman, \textit{Corporate Insolvency Law: Perspectives and Principles} (3\textsuperscript{rd} edn, CUP: Cambridge, 2017) 515; IF Fletcher, \textit{The Law of Insolvency} (5\textsuperscript{th} edn, Sweet & Maxwell: London, 2017) 554-555; S Leslie, ‘Changes Made to Insolvency Legislation on 1\textsuperscript{st} October 2015’ (2015) 5 C.R. & I. 210.}

\footnotesize{\textsuperscript{96} The Insolvency (Protection of Essential Supplies) Order 2015 SI 2015/989, which amended s.233 and introduced s.233A to the Act. These provisions apply only to contracts entered into on or after 1 October 2015. For an analysis, see: V Finch and D Milman, \textit{Corporate Insolvency Law: Perspectives and Principles} (3\textsuperscript{rd} edn, CUP: Cambridge, 2017) 515; IF Fletcher, \textit{The Law of Insolvency} (5\textsuperscript{th} edn, Sweet & Maxwell: London, 2017) 554-555; S Leslie, ‘Changes Made to Insolvency Legislation on 1\textsuperscript{st} October 2015’ (2015) 5 C.R. & I. 210.}


\footnotesize{\textsuperscript{98} Sections 372 and 372A IA 1986 extend this framework to individual voluntary arrangements (IVAs). On the powerful position of suppliers of strategic raw materials, see Leyland DAF Ltd v Automotive Products Plc [1993] BCC 389 (CA) 400, where the Court of Appeal held that an unpaid seller who refuses to supply further goods (with the exception of those listed in s.233 of}
has been introduced by s.233A of the Act. According to this provision, any insolvency-related term of a contract for the supply of essential goods and services that seeks to either terminate or vary the terms of the contract where the customer entered into a CVA or administration procedure is rendered automatically void.

Even if the case law is not particularly favourable to the suppliers’ entitlements, the government is keen to promote reforms that assist with corporate rescue and ensure higher levels of inclusivity and participation among stakeholders.

However, the changes introduced in recent laws may be less radical than they appear at first glance. For instance, with reference to the recent amendments currently introduced to the IA 1986 in England, while the list of suppliers has extended since previous iterations and new provisions were added for administration and company voluntary arrangements, creditors still benefit from significant protections. Additionally, while courts could void insolvency-
related contractual terms to charge higher prices or terminate the contract by reason of the debtor’s insolvency filing for administration or company voluntary arrangement, the supplier can still:

a) Rely on other, non-insolvency-related contractual terms for the purpose of terminating the contract (similar to what happens under U.S. law). Examples may include changes in consumption, or downgraded credit rating;

b) Rely on insolvency-related terms insofar as they relate to other insolvency (such as bankruptcy or liquidation) and restructuring (e.g. currently schemes of arrangements) procedures.

Despite that, things are not settled in England, which still seems to be looking to a more U.S., pro-debtor approach to achieve a higher ranking in the World Bank’s “Resolving Insolvency” Reports. Arguably, in 2016 and 2018 the Insolvency Service launched new consultations aimed at improving the corporate insolvency framework and at making this country one of the best places in the world to start a business.

With reference to the determination of which contracts are “essential” (with the effect that ipso facto clauses would be null and void), the position of the office-holder or the court consent to the termination (the latter usually in case of undue hardship).


104 Insolvency Service (n 97). The review suggested to: (a) extend the use of statutory moratorium (similar to the automatic stay in the U.S.) outside administration procedures to allow debtors to develop a rescue plan free from enforcement actions and the need to agree on contractual standstills; (b) extend the right of the debtor to protect and maintain essential supply contracts; (c) introduce a new flexible rescue plan; and (d) recognise preferential nature to rescue finance.

105 Insolvency Service, Insolvency and Corporate Governance (n 100). This consultation aims at introducing new laws that enhance directors’ accountability, reduce the risk of value extraction schemes and strengthen corporate governance in pre-insolvency situations. The purpose of the consultation, therefore, is not to increase the chances of successful turnaround of distressed debtors but to reduce the risks that viable companies are made insolvent by the unethical or unprofessional behaviour of its directors and their advisers.
government is that their scope should be further widened (despite the latest changes which became enforceable on 15 October 2015). While not as far reaching as introducing a U.S.-style *ipso facto* ban, that proposal would have nevertheless extended the existing exemptions to freedom of contract laid down in ss.233 and 233A of the Act to any type of contract for the provision of goods and services.

Interestingly, this position was supported, albeit with a narrow margin, by respondents. However, 41% of them disagreed with the criteria proposed by the government to identify essential contracts as they were deemed too “debtor-friendly”, while others argued that provisions of finance and financial services should be excluded from the proposals.

The majority of the respondents also observed that the government’s proposal did not offer “sufficient safeguards” to suppliers. They further questioned whether courts were the proper place to challenge the designation as “essential” of a specific contract and they warned about the risks of increased litigation, costs and delays in insolvency procedures.

The only essential suppliers (‘Bristol Wessex Billing Services Ltd’) who submitted an opinion to the Insolvency Service argued for the extension of the scope of the definition. However, *Bristol Wessex Billing Services Ltd* would not be impacted by any reform in the area (since the services it provides are already considered “essential”).

---

106 Insolvency Service (n 97).
108 Mirroring the statutory treatment of these contracts under U.S. law, described above in subsection 2.2(a)(i).
109 Insolvency Service (n 107) 8.
110 *Bristol Wessex Billing Services Ltd* and RWE npower. Other respondents were primarily large businesses (3), law firms (13), universities (5, either as institutions or as individual professors) and trade bodies (16).
111 For a more in-depth analysis of the treatment of executory contracts in English law, see Cooke (n 93). For a more detailed analysis of the impact of recent reforms and proposals for reform on the subject, see Vaccari (n 93).
Recently, the government published a combined response\textsuperscript{112} to both this and the 2018 *Insolvency and Corporate Governance*\textsuperscript{113} consultation. Rather surprisingly, in an audacious move which – if enacted – would represent a significant step towards the adoption of a pro-rescue, debtor-oriented approach to corporate insolvency, the government stated that it no longer intended to require the designation of essential suppliers by the debtor or its office-holder. Instead, it wanted to legislate:

‘to prohibit the enforcement of ‘termination clauses’ by a supplier in contracts for the supply of goods and services where the clause allows a contract to be terminated on the ground that one of the parties of the contract has entered formal insolvency’.\textsuperscript{114}

This is a very bold proposal, especially for England where freedom of contract has always represented a pivotal principle\textsuperscript{115} and previous attempts to introduce such a ban – such as in the standing committee stage of the EA 2002 – failed spectacularly.\textsuperscript{116}

If this proposal was enacted, England would join Australia in implementing a U.S.-style general ban on the enforceability of termination clauses. To sum up, even with reference to pro-creditor countries, consideration for party autonomy has never justified a full carve-out from insolvency rules and existing proposals for reform seem to further restrict the contractual power to sidestep statutory insolvency remedies.

The same evolution in the law can be observed in Australia. While traditionally labelled as a pro-creditor jurisdiction, the country is trying to embrace a more pro-debtor and pro-rescue attitude. There has long been a view that to encourage rescue, *ipso facto* clauses should not be allowed to operate in insolvency. The Harmer Report\textsuperscript{117} recommended that these clauses be void

\textsuperscript{112} Insolvency Service (n 75).

\textsuperscript{113} Insolvency Service, *Insolvency and Corporate Governance* (n 100).

\textsuperscript{114} Insolvency Service (n 75) 60.

\textsuperscript{115} See above fn 68.

\textsuperscript{116} F Toube and J Rumley, ‘A Brave New World? Should the UK Ban Ipso-Facto Clauses in Non-Executory Contracts?’ (2018) 31(3) Insolv. Int. 78.

against a liquidator or an administrator. However, this recommendation was not implemented in the subsequent legislative bills.

The Corporations and Markets Advisory Committee (‘CAMAC’) considered this matter in 1998 (in its report *Corporate Voluntary Administration*) and in 2004 (in its report *Rehabilitating Large and Complex Enterprises in Financial Difficulties*). On both occasions, CAMAC opposed any change to the current law. While CAMAC recognised the advantages of restrictions on *ipso facto* clauses when a company is in voluntary administration, it gave greater weight to countervailing commercial considerations. Only the Parliamentary Joint Committee on Corporations and Financial Services in its 2004 Report *Corporate Insolvency Laws: A Stocktake* was more responsive to concerns about *ipso facto* clauses.

On the other hand, ARITA and other commentators considered the enforceability of *ipso facto* clauses to be inconsistent with the overall purpose of Australia’s insolvency legislation and, in particular, with the objective of promoting corporate rescue and rehabilitation. As Benson observed,

‘*Where such clauses are effective, a company often finds itself without key suppliers or, worse still, losing control of its enterprise through the appointment of receivers and managers by a secured creditor. This potentially erodes any enterprise value that may have been preserved through an appropriate deed of company arrangement*.’

---


121 N Mirzai, ‘*Ipso facto clauses: should they be enforceable under Pt 5.3A?’* (2011) 19(4) Insolv. L.J. 4.

Recently the Productivity Commission was asked to conduct a broad ranging review of the existing system to specifically investigate, analyse and propose recommendations:

a) On the nature and the scale/extent of barriers to enter and exit the market for businesses and their impact on economic performance; and

b) On identifying appropriate options for reducing these entry- and exit-barriers, including personal/corporate insolvency regimes on business exits.

The Productivity Commission issued an *Inquiry Report (7 December 2015)* on the topic.\(^\text{123}\) In the Draft Report (21 May 2015),\(^\text{124}\) the Commission did not find the commercial concerns raised by CAMAC convincing. It considered that *ipso facto* clauses could severely constrain the ability of a business to continue trading during a rescue process, prevent the sale of corporate businesses as going concerns, and reduce or even eliminate returns to creditors in an ensuing liquidation.

This position was backed by ARITA and other commentators such as the law firm Ashurst,\(^\text{125}\) which suggested that – should the suspension be introduced into the law:

- It should not be applied to contracts aimed at extending new debt financing or at granting financial accommodation (a solution substantially equivalent to the U.S. position);

- It should extend the personal liability rules to external administrators in relation to credit sale contracts entered into during his or her office; and

- It should not interfere with the current right of a creditor with a security interest over the whole or substantially the whole of the property of the company to take enforcement actions.


Accordingly, Recommendation 14.5 of the Final Report reads that:

_The Corporations Act 2001 (Cth) should be amended such that ipso facto clauses that have the purpose of allowing termination of contracts solely due to an insolvency event are unenforceable if the company is in voluntary administration or the process of forming a scheme of arrangement. Amending legislation should make clear that the party experiencing the insolvency is in no way absolved of any other contractual obligations. External administrators should be given the ability to apply to the Court to require continued performance of a contract where the Court is satisfied that the supplier is attempting to avoid this moratorium, and that the continuation of the contract is in the best interests of the creditors as a whole. In circumstances where this moratorium could lead to undue hardship, suppliers should be able to apply to the Court for an order to terminate the contract._

In December 2015, the government issued an “Innovation Statement”, which included a proposal to ban _ipso facto_ clauses that terminated a contract solely by the occurrence of an insolvency event._126_ In April 2016, a proposal paper was released setting forth the proposed model to constrain party autonomy._127_ Submissions were sought and the reply from the industry and practitioners was generally welcoming._128_ The government analysed the feedback and released a long-awaited_129_ new bill on 28 March 2017._130_ Under the proposed reform, which was passed by the Parliament and came into force (for the part on _ipso

---

126 Productivity Commission (n 123).
129 This is not surprising, given the long support of the insolvency profession and the general business community for the introduction of this reform. See, among others: H Anderson and others, ‘Corporate Insolvency. The Productivity Commission, Corporate Insolvency and Phoenix Companies’ (2015) 33 CSLJ 425.
131 Exposure Draft, Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (Cth).
facto clauses) on 1 July 2018,\textsuperscript{132} the enforcement of ipso facto clauses is stayed during a formal rescue procedure, subject to exceptions ‘where ipso facto clauses are inherently necessary to the operation of a contract’.\textsuperscript{133}

Formal rescue procedures include schemes of arrangement (where that scheme is for the purpose of avoiding insolvent liquidation), administration or any other procedure where a managing controller is appointed over all or substantially all of the property of the company.\textsuperscript{134} The suspension of the enforceability of these clauses is subject to exceptions, including for the contracts specified in forthcoming regulation or Minister declaration.\textsuperscript{135} Insofar, ministerial declarations have been forthcoming in the area of finance arrangements.\textsuperscript{136} In any case, courts retain an overarching discretion to override any stay and to grant interim orders with reference to the cases where the enforcement of ipso facto clauses is banned.\textsuperscript{137} No guidance has yet emerged on how courts will interpret the reforms and apply the discretion.\textsuperscript{138}

Among the pro-creditor countries, only Singapore seems to adhere strictly to the original approach to the enforceability of ipso facto clauses.\textsuperscript{139} In this country, the lack of compulsory and binding rules on formal insolvency procedures aimed at rescuing a company means that most debt restructurings are contractual and, therefore, must be agreed by all creditors. As to date, there is no guidance from the Singapore Government or its monetary authorities on the conduct of contractual rescues.

In December 2010, the Ministry of Law of Singapore appointed the Insolvency Law Review Committee (‘ILRC’) to review the existing legislation in the field, both corporate and personal, since not much has been done since the Company Legislation and Regulatory Framework Committee (‘CLRFC’) submitted its

\begin{itemize}
  \item \textsuperscript{132} The Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 (Cth).
  \item \textsuperscript{133} Explanatory Memoranda, Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (Cth), 2.8.
  \item \textsuperscript{134} Ibid [2.24] - [2.26].
  \item \textsuperscript{135} Ibid [2.24] - [2.26].
  \item \textsuperscript{136} Corporations (Stay on Enforcing Certain Rights) Declaration 2018 (Cth).
  \item \textsuperscript{137} Ibid.
  \item \textsuperscript{139} For a more detailed analysis, see Streten (n 138).
\end{itemize}
conclusions in 2002.\textsuperscript{140} In response, in October 2013, the ILRC submitted a \textit{Final Report}.\textsuperscript{141}

In debating the opportunity to introduce statutory restrictions on the enforceability of \textit{ipso facto} clauses in insolvency, the Committee noted that only few jurisdictions (U.S., Canada and France) included a general, legislative ban albeit with significant exceptions on their validity. On the other hand, others countries (such as England and Australia at that time, but also Japan, China, Germany and Hong Kong) did not impose general limits on their enforceability. The same report, however, recognized that some restrictions may apply in relation to essential contracts where the distressed company is trying to turnaround its operations.

The Committee also considered that, if freezing or invalidity of \textit{ipso facto} clauses was declared, counterparties should be allowed to apply to court to object the stay and ask for the enforcement of the clause ‘\textit{on the basis that they are unduly prejudiced}’,\textsuperscript{142} thus increasing litigation (and costs) in insolvency cases.

These considerations brought the Committee to conclude that - despite the changes recently implemented in England and Australia - there was not a strong case for the introduction of statutory restrictions on the enforcement of \textit{ipso facto} clauses. This conclusion was not challenged or otherwise objected by the parties who submitted their feedback to the final version of the proposal for a legislative reform.\textsuperscript{143} As a result, the Companies (Amendment) Act 2017\textsuperscript{144} which contains major changes to Singapore’s rescue and insolvency law does

\textsuperscript{142} Ibid 122.
\textsuperscript{144} <https://www.acra.gov.sg/uploadedFiles/Content/Legislation/Companies%20(Amendment)%20Act%202017%20gazette.pdf> accessed 17 September 2018.
not restrict the operation of contractual carve-outs (such as *ipso facto* clauses) where a scheme is proposed or a moratorium is granted.\textsuperscript{145}

It is therefore possible to conclude that, while pro-creditor countries uphold the enforceability of contractual remedies to the highest possible extent, the laws of these countries also restrict the enforceability of autonomy-based solutions such as *ipso facto* clauses. Similar to what has been observed for the U.S., mandatory insolvency rules that deviate from negotiated clauses are sometimes preferred to contractual solutions. In other words, no system currently allows parties to entirely contract out of insolvency.

2.2(a)(iii) Carve-Outs and the Role of the Judiciary

This digression on the treatment of *ipso facto* clauses around the globe also proves that differences in the law may be less marked than the separation between pro-creditor and pro-debtor families seems to suggest. The tendency to recognise the enforceability of autonomy-based carve-outs (and party autonomy) is always limited to promote potentially conflicting goals such as the rescue of distressed yet viable businesses.

Parties can insulate numerous contracts from the effect of insolvency law. Additionally, nothing in the U.S. or Canadian insolvency laws should prevent a party from stepping away from a contract if the right is not triggered by insolvency alone,\textsuperscript{146} but by circumstances that significantly modify the assessment of risk upon which the contract was negotiated.\textsuperscript{147}

While businesses (and, primarily, creditors’ lobbying groups) seem to welcome the preservation of contractually negotiated carve-outs in insolvency, the same

\textsuperscript{145} For a critical analysis of the new Singaporean law: G McCormack and W Yee Wan, ‘Transplanting Chapter 11 of the U.S. Bankruptcy Code into Singapore’s Restructuring and Insolvency Laws: Opportunities and Challenges’ (2018) J. Corp. L. Stud. (1473-5970) 1. In particular, the authors argue (at 9) that both in England and Singapore, the enforceability of *ipso facto* clauses in schemes affect the debtor’s ability to use these procedures as rescue mechanisms. This is because suppliers can unilaterally terminate or modify existing contracts upon the opening of formal insolvency procedures or whenever certain events occur.

\textsuperscript{146} For instance, §365(e) 11 U.S. Code states that ‘an executory contract [...] may not be terminated or modified [...] solely because a provision in such contract [...] that is conditioned on [...] the commencement of a case under this title’ (emphasis added).

\textsuperscript{147} See the Supreme Court’s ruling in *Chicago Board of Trade* (n 76).
cannot be said for other stakeholders who may rely on courts to protect their rights and expectations.

Unfortunately, no uniform views exist in the courts on the enforceability of these carve-outs. This conclusion emerges distinctly if we compare English and U.S. case law.148

As shown in cases such as BNY,149 Ballyrock150 and Metavante,151 U.S. judges tend to deny the enforceability of such clauses even when they are negotiated by sophisticated parties and as part of complex financial agreements. This is not because they do not appreciate the importance of the principle of freedom of contract: they simply value more the enforceability of the automatic stay in insolvency cases.

On the other hand, English courts in cases like Belmont Park,152 Mayhew v King153 and Lomas154 observed that counterfeited transfers of assets triggered

---

148 As for the U.S., this thesis looked in particular at the decisions from the federal bankruptcy courts of the Southern District of New York and of Delaware, due to their influential role.
150 Lehman Brothers Special Financing Inc. v Ballyrock ABS-CDC 2007-1 Limited No. 09-10132 (JMP) (Bankr. S.D.N.Y. May 12, 2011).
151 Lehman Brothers Special Financing Inc. v Metavante Corporation, No. 08-13555 (JMMMP) (Bankr. S.D.N.Y. Sept. 15, 2009). The Southern District of New York recently reinstated this interpretation in Re Lehman Brothers Holdings Inc. 533 B.R. 476 (Bankr. S.D.N.Y. 2016), when Chapman J held that priority provisions of swap agreements, which had effect of flipping this priority based on event of default that occurred upon filing of bankruptcy petition by debtor and related entity, were prohibited ipso facto clauses (but note the new focus on the effects of the provisions, rather than on the language of the clause).
153 The same principles were reinstated in Revenue and Customs Commissioners v Football League Ltd [2012] EWHC 1372 (Ch), [2012] Bus. L.R. 1539 where the court observed that the Football League’s article 77 - which conditioned the payment of any sum to the clubs to the fixture of any obligation for the relevant season - did not present a breach of the anti-deprivation principle since an insolvent claimant cannot be deprived of what it has not yet acquired into its possession. Had the debtor not fulfilled its obligation, the Football League would have not been bound to pay any sum to the club. However, the ipso facto termination was not determined by the insolvency of the club. As a result, the court correctly concluded that there was no breach of the anti-deprivation rule.
154 Chaucer Insurance Plc v Towergate Stafford Knight Co Ltd (t/a Folgate London Market Ltd) [2010] EWHC 1121 (Ch), [2010] 2 BCLC 440 where the Court held that a contract, which granted an indemnity to a company, but also provided that the indemnity would cease upon the company’s insolvency, offended the principle of anti-deprivation as it deprived the company’s administrators of an asset which could have been distributed to creditors.
155 Lomas v JFB Firth Rixson Inc. [2010] EWHC 3372 (Ch), [2011] 2 BCLC 120 and [2012] EWCA Civ 419, [2012] 2 All E.R. (Comm) 1076. In particular, the Court of Appeal observed that the indefinite suspension of the payment obligation of the non-defaulting party might on one view
by the insolvency filing could not be withheld in light of the anti-deprivation rule.155

The starting point of their analysis was remarkably similar to those of their U.S. and Canadian colleagues. However, English judges also considered the complexity of the cases, the highly skilled nature of the parties and the intention as objectively manifested during the negotiation.156 They concluded that some of the litigated clauses did not breach the anti-deprivation standard. Consequently, in Belmont Park and Lomas they held that clauses that had been classified as ipso facto terms in other jurisdictions, would not gain the same qualification in England. The validity of autonomy-based remedies was upheld.

This has led some commentators to observe that ‘England and the US are two countries united by the common law but divided by their approach to anti-deprivation principles’.157 Upholding the validity of these clauses has the effect of allowing the beneficiaries to contract out of insolvency law. This seems to be at odds with the words of Lord Collins SCJ in Belmont:

*The anti-deprivation rule and the rule that it is contrary to public policy to contract out of pari passu distribution are two sub-rules of the general principle that parties cannot contract out of the insolvency legislation.*158

---

155 The anti-deprivation rule is that ‘no person possessed of property can reserve that property to himself until he shall become bankrupt, and then provide that, in the event of his becoming bankrupt, it shall pass to another and not his creditors’ - Witmore v Mason (1861) 2 J & H 204, 212 per Sir William Page Wood V-C. It has been argued that this principle marked the separation between ‘the individualistic, private law model of freedom of contract on the one hand, and the collectivist, public law model of insolvency law on the other’ as it presents a prohibition to avoid insolvency legislation: R Bork and M Voelker, ‘The Anti-deprivation rule as an Anti-avoidance Rule’ (2016) 29(5) Insolv. Int. 65, 74.

156 In Rainy Sky SA v Kookmin Bank [2011] UKSC 50, [2011] 1 WLR 2900, the Supreme Court held that the ultimate aim of interpreting a provision - especially one of contractual nature - is to determine what the parties mean by the language they used. See also HHY Luxembourg Sarl v Barclays Bank Plc [2010] EWCA Civ 1248, [2011] 1 BCLC 336.


158 Belmont Park (n 113), at [1].
Lord Collin’s decision is questionable. The anti-deprivation rule applies at the outset of both liquidation and administration proceedings. In anti-deprivation cases, English courts try to determine if the contested clause or agreement has been intended from the outset to contract out of insolvency law. The *pari passu* principle, on the opposite, comes into consideration only once the formal insolvency procedure is under way.

Additionally, it may be an overstatement to claim that the anti-deprivation principle is expression of the general rule that parties cannot contract out of insolvency. If that was the case, to challenge the enforceability of contracts or clauses in breach of the anti-deprivation principle it should be sufficient to demonstrate that the contested clause or agreement has the effect of contracting out of insolvency. This is not the case, as English courts focus on the good faith and intention of the parties as objectively discerned from their contracts.

English courts have consistently recognised the validity of clauses that prevent the application of insolvency statutory remedies. For instance, creditors can enter into “non-petition agreements” whereby they bind themselves not to trigger formal insolvency proceedings and thus rendering the debtor “bankruptcy remote”.

This “substance-focused” approach has been recently reiterated in other cases, irrespective of the sector of the industry in which the parties operated. For instance, in *Cavedish* the Supreme Court - overruling established case law on the subject – upheld the enforceability of the withholding and forfeiture

---

159 This proof would be sufficient if a party challenged a clause or agreement for breaching the *pari passu* principle of distribution. See, for instance, *British Eagle* (n 6) [780G], where Cross LJ considered that the existence of good business reasons was irrelevant to determine the validity of ‘clearing house’ arrangements which had the effect of altering the rules for the distribution of the assets of the insolvent estate.


clause challenged in the case, by advocating the need for overcoming artificial categorizations.

The Supreme Court is unwilling to provide parties with a clear test, capable of determining *ex-ante* if a clause breaches the anti-deprivation principle or not. Their “*pragmatic reasoning*” is increasingly focused on the substance of the contract (not its qualification) and on the effect it has on the parties.

At first instance, it may seem that courts are protecting the parties’ right to contract out of insolvency. In reality, they are protecting party autonomy and good faith. It would be inappropriate, therefore, to conclude that these decisions suggest that the judiciary supports autonomy-based solutions to strike out insolvency rules.

The previous paragraphs described the law and the judicial approach to *ipso facto* clauses in selected common law jurisdictions. What seems to emerge is that courts – irrespective of their location, the enforceable laws, the level of sophistication of the parties and the applicable precedents – are unlikely to withhold the validity of autonomy-based clauses that are primarily and purposefully designed and have the effect of avoiding insolvency legislation.165

Despite the English court’s attitude to preserve the validity and enforceability of freely negotiated clauses, there is a widespread judicial and legislative inclination to strike out clauses purposefully designed to contract out of insolvency law both by pro-debtor and pro-creditor cultures.166

---

163 The withholding and forfeiture clause mentioned in the text is in fact a default clause operating in a joint operating agreement subject to the English law. Such a clause is quite common in oil and gas industry contracts and results in the defaulting party under a share purchase agreement to re-transfer the purchased shares at a set price. For a more detailed description of the case and its implications: J Aldersey-Williams and others, ‘Default Clauses in Joint Operating Agreements: Recent Guidance from the English Courts’ (2016) 2 I.E.L.R. 36.

164 Bork and Voelker (n 155) 75.

165 A conclusion shared by other commentators: R Bork and M Voelker (ibid). Even if their conclusions are drawn from the *Belmont Park* case, similar considerations are applicable to the other jurisdictions mentioned in this sub-section, since the reported case laws evidence a common inclination to swift from formal to substantive analysis of the effects of the clauses, whose validity is questioned in court.

166 Moss (n 157) 27.
2.2(b) Autonomy-Based Remedies in Cross-Border Cases

Due to the increased global nature of commerce, insolvency cases often present cross-border elements. The degree of involvement of foreign authorities and courts depends not only on the location of the assets of the debtor, but also on other factors (e.g. corporate structure, sector of the economy in which the company operates, etc.).

Nowadays, part of the complexity determined by the cross-border nature of an insolvency case has been reduced thanks to the implementation of uniform conflict of law rules and principles.

On the one hand, the 1997 UNCITRAL Model Law on Cross-Border Insolvency ('UNCITRAL Model Law') and its 2014 Guide to Enactment and Interpretation ('UNCITRAL Guide')\(^{167}\) determine the application of common rules on access, recognition, relief, assistance and cooperation for cases opened in some forty-four countries (including Australia, Singapore, the U.K. and the U.S.) and forty-six jurisdictions, which have transposed and implemented the Model Law into their national legislation.\(^{168}\) Nevertheless, not even the U.K. and the U.S. implement and interpret these soft law provisions (as enacted in their statutes) in the same manner.\(^{169}\)

On the other, all European Member States (with the exception of Denmark) have to comply with the EUIR Recast.\(^{170}\) This binding regulation provides a set of conflict of law rules applicable to any insolvency proceedings concerning debtors based in the European Union and with operations in more than one

---

At national level, the U.S. adopted the UNCITRAL Model Law as Chapter 15 of the 11 U.S. Code as part of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act ('BAPCA'). The UNCITRAL Model Law was then implemented in Great Britain by the Cross-Border Insolvency Regulations 2006 ('CBIR 2006'). In this country, the UNCITRAL Model Law applies alongside with the EUIR Recast and s.426 IA 1986. The latter provides for particular relief and assistance in insolvency proceedings commenced in some Commonwealth countries and former British colonies. Finally, a number of prominent decisions by the House of Lords, the Supreme Court and the Privy Council have reasserted the centrality of common law principles on recognition, enforcement and assistance in foreign insolvency proceedings.

Can therefore negotiated solutions prevail over insolvency rules in cross-border cases? Some authors have argued that this could and should be possible thanks to a consensual but binding dispute resolution mechanism: arbitration.

---


172 Before the adoption of the Model Law, recognition, enforcement and assistance in cross-border insolvencies were regulated by s.304 11 U.S. Code. This statute relied on the discretion of the judges to apply the principles of comity and respect for the laws and rulings of other countries in the U.S. Because of the commonality in approach with the Model Law, much of the common law that was developed before the enactment of Chapter 15 still guides courts’ analysis.


Other authors adopt a more cautious position and seem to suggest that arbitration could only be used for certain insolvency-related disputes, or as a non-binding or semi-binding solution: E Sussman and JL Gorskie, 'Capturing the Benefits of Arbitration for Cross Border Insolvency' in
This alternative dispute resolution mechanism could represent a viable alternative to achieve uniformity and cooperation in cross-border insolvency disputes,\(^\text{175}\) despite its intrinsic shortcomings.\(^\text{176}\) These include the fact that there are no uniform views across jurisdictions on whether arbitration agreements made prior to insolvency are enforceable upon the commencement of a formal or hybrid procedure. Equally, it is not clear if all insolvency issues can be subject to arbitration or if arbitral awards can be enforced pending or after insolvency. The list of issues could go on and there is no shortage of legal literature which discusses the effects of insolvency on arbitration (and vice versa)\(^\text{177}\) and the enforceability of arbitration clauses in insolvency cases.\(^\text{178}\)

This sub-section investigates if arbitration, as an autonomy-based procedure,\(^\text{179}\) can replace statutory rules in insolvency cases.

---

\(^{175}\) Against: PK Wagner, ‘Insolvency and Arbitration: A Pleading for International Insolvency Law’ (2011) 5(2) D.R.I. 189, 200 (observing that ‘the parties’ choice of certain applicable laws, either direct or indirect, are not an appropriate starting point to finding the applicable law governing the effects of the insolvency on arbitration’, since ‘there is no possibility for one party to contract out of the procedures provided by the applicable insolvency law’).

\(^{176}\) Confidentiality as opposed to the need to reach binding solutions for all parties involved in the insolvency proceedings; consensual, private nature of arbitration as opposed to mandatory nature of insolvency law; doubts on the enforceability of ‘insolvency’ awards. These are only some of the issues that arbitration of insolvency dispute raises: K Maxwell, ‘Arbitrating Insolvency Disputes: An Imperfect Solution?’ (Practical Law Arbitration Blog, 29 November 2016) <http://arbitrationblog.practicallaw.com/arbitrating-insolvency-disputes-an-imperfect-solution/> accessed 17 September 2018.


\(^{179}\) Arbitration is considered an “autonomy-based procedure” despite the existence of statutory rules that govern the arbitral procedure and the recognition of the award because its
A key question to determine if arbitration can be used as a restructuring or collection mechanism is to verify if “core insolvency issues” like the negotiation of a rescue plan are matters ‘capable of settlement by arbitration’\(^{180}\) (at least in the jurisdictions considered in this research). In other words, it is necessary to determine the objective arbitrability\(^{181}\) of insolvency matters.

Due to the public nature of insolvency law as opposed to the private nature of arbitral remedies, many courts and jurisdictions are unwilling to defer to arbitration disputes that arise from the operation of their insolvency provisions, even if parties included them in the scope of the arbitration agreement.\(^{182}\) This is a likely outcome in civil law countries, where insolvency law belongs to the public law domain and issues of public law are traditionally viewed as non-arbitrable.\(^{183}\)

In the Anglo-American world, this may be less of a problem. For instance, in the U.S. the Federal Arbitration Act and the Bankruptcy Code are considered statutory schemes bearing equal dignity.\(^{184}\) Determination of whether centralised solutions of disputes should prevail over the enforcement of arbitration agreements could not be determined solely according to the law.

---

\(^{180}\) Under article V.2 of the *Convention on the Recognition and Enforcement of Arbitral Awards* (New York, 1958), the enforcement of an international arbitral award may be refused if, under domestic law, the subject matter is not capable of arbitration.

\(^{181}\) See below fn 183.

\(^{182}\) This is, for instance, the position adopted in Singapore: A Chan and others, 'Cross-Border Insolvency and Its Impact on Arbitration' (2014) 26 SAcLJ 999, 1033.

\(^{183}\) Questions of objective arbitrability arise when states reserve certain matters for the exclusive jurisdiction of their municipal courts. The principle of equality of creditors has been considered to form part of the ‘public policy’ of a country, namely France. As a result, French courts are not allowed to enforce an award which may affect the validity of this principle: see Cour de Cassation, *Société Saret v SBBM*, (1992) 38 Revue de l’Arbitrage 663. This position is refuted by some authors: CS Gibson, ‘Arbitration, Civilization and Public Policy: Seeking Counterpoise Between Arbitral Autonomy and the Public Policy Defense in View of Foreign Mandatory Public Law’ (2009) 113 Penn. St. L. Rev. 1227; S Bufford, ‘International Insolvency Law and International Arbitration: A Preliminary Perspective’ (Penn State Law, Legal Studies Research Paper No. 2-2015) 24.

\(^{184}\) Re Spectrum Info. Tech., Inc., 183 B.R. 360, 362 (Bankr. E.D.N.Y. 1995): ‘[T]he issue as to whether or not a bankruptcy court should allow a dispute to be resolved by an arbitration forum to which the parties agreed implicates the clash of two federal statutes’. 
To provide some guidance, in *McMahon* the Supreme Court overruled the precedent of *Zimmerman* and held that the party opposing arbitration should prove that the Congress would want the matter to be decided in a collective forum. In any case a presumption in favour of judicial remedies operates only with reference to substantive core insolvency matters. Despite this, the courts have long recognised that bankruptcy courts should be the sole forum to resolve all disputes concerning the debtor’s assets.

The solution has been criticised for lacking adequate guidance in “hard cases”, thus promoting legal uncertainty and litigation. Some scholars have therefore suggested that arbitration clauses should be treated as severable executory contracts, thus giving the office-holder the power to deny or enforce this clause over any type of claim.

Cross-border insolvency disputes usually end up being hard cases. In cross-border procedures the law of the centre of main interest (‘COMI’), which in the majority of cases is the place of incorporation, typically determines the rules

---


186 *Zimmerman v Continental Airlines, Inc.*, 712 F.2d 55 (3d Cir. 1983), according to which the enforcement of arbitration clauses in insolvency cases should have been determined by the “sound discretion” of the judge (at 59-60).

187 Substantive insolvency matters are all those issues that deal with the definition of the rights of the parties in the insolvency procedure. They are opposed to procedural insolvency rules, which deal with how these rights can be exercised in a formal or hybrid insolvency procedure. Substantive issues include – among others – the rules on ranking of claims and order of priorities in the insolvency process; directors’ liability and disqualification as well as on the appointment of insolvency practitioners; avoidance and adjustment actions.

188 Elscint, Inc. v First Wis. Fin. Corp. (Re Xonis, Inc.), 813 F.2d 127 (7th Cir. 1987), 131: ‘the bankruptcy jurisdiction is designed to provide a single forum for dealing with all claims to the bankrupt’s assets’; Re Matter of Imp. & Mini Car Parts, Ltd., Inc., 97 F.3d 1454 (7th Cir. 1996) at *1; Napleton Enterprises, Llc v Bahary, No. 15 C 3146, 2016 WL 792322 (N.D. Ill. Mar. 1, 2016) at *7.


190 There is a good amount of literature, albeit in varying depths, on the notion of ‘centre of main interest’ (‘COMI’). On this concept, see: Finch and Milman (n 96) 675-678; G McCormack, ‘COMI and Comity in UK and US Insolvency Law’ (2012) 128(1) L.Q.R. 140.

To determine a foreign debtor’s COMI, courts look to certain nonexclusive factors: location of debtor’s headquarters; location of those who actually manage the debtor; location of debtor’s primary assets; location of majority of debtor’s creditors or of majority of creditors who would be affected by case; and/or jurisdiction whose law would apply to most disputes.
applicable to the insolvency of the company and their interaction with arbitration. Therefore, the arbitrability of core insolvency issues largely depends on the law of the COMI legal system, i.e. the *lex concursus*.

There are however exceptions, such as when the insolvency procedure is triggered after the commencement of an arbitration procedure. This was the case in *Syska v Vivendi*, where the arbitral tribunals in the U.K. and Switzerland were asked to rule on their competence.

When *Elektrim* filed for bankruptcy in Poland, the appointed supervisor (Mr. Syska) tried to dismiss the arbitration procedures on the basis that art. 142 of the Polish bankruptcy law renders void all arbitration agreements when a party files for bankruptcy protection and that art. 4.2(e) of the European Insolvency Regulation ('EIR') (now art. 7.2(e) EUIR Recast) requires that the effect of the opening of insolvency proceedings on current contracts is determined by the law of the State of the opening of proceedings (*lex concursus*).

While the Swiss court agreed with the proposed rationale, their English colleagues relied on art. 15 EIR (art. 18 EUIR Recast), which provides that the effects of insolvency proceedings on pending proceedings (including arbitrations) shall be governed by the law of the Member State where the lawsuit (rectius, proceeding) was pending. That law was English law, which does not feature any automatic stay or *vis attractiva* of the arbitral dispute to

---

191 Nevertheless, complications arise in respect of companies which are subject to insolvency proceedings outside their place of incorporation. See, for instance *Rubin* (n 173).

192 However, the majority of scholars observe that ‘the perceived wisdom in arbitration is that only pure or core bankruptcy issues will fall outside the scope of arbitral jurisdiction’: S Nadeau-Séguin, ‘When Bankruptcy and Arbitration Meet: A Look at Recent ICC Practice’ (2011) 5(1) D.R.I. 79, 92.


194 Jozef Syska (acting as administrator for Elektrim SA (in bankruptcy)) v Vivendi Universal SA [2009] EWCA Civ 677, [2009] 2 All E.R. (Comm) 891. For a comment, see: E Sjostrand, ‘Effects of Insolvency proceedings in the Context of the EC Insolvency Regulation’ (2009) 2(6) C.R. & I. 249 (noting the difference between a situation where arbitration proceedings were merely contemplated and one in which the proceedings were pending or had commenced); J Chuah, ‘Resolving Unresolved Relationship Problems – the Case of Cross Border Insolvency and Pending arbitrations’ (2011) 8(4) E.C.F.R. 423 (conducting a comparative analysis on the way in which different jurisdictions have addressed the conflicts arising from a lack of co-ordination between the law governing the insolvency procedure and the law applicable by virtue of the arbitration agreement); D Draguiev, ‘The Effect of Insolvency on Pending International Arbitration: What Is and What Should Not Be’ (2015) 32(5) J. Int. Arb. 511.
the insolvency court. Hence, they decided in favour of Vivendi: the arbitrators could issue an award on that dispute.

The decisions in McMahon and Syska v Vivendi allow the arbitrability of key insolvency matters. This approach is consistent with the pro-arbitration attitude of the general law, despite the fact that arbitration and insolvency law may ‘present a conflict of near polar extremes’. This pro-arbitration attitude led some authors to claim that it is possible to arbitrate core insolvency issues, provided that the parties are contractually and consensually entitled to do so.

It is now appropriate to investigate if the characteristics of an insolvency procedure (either formal or out-of-court) are compatible with the arbitration procedure.

Insolvency procedures are collective and binding on all parties, including dissenting ones. Therefore, in England the admission of the defendant into formal insolvency proceedings determines a moratorium over the ongoing arbitration proceeding against that party.

Is the stay on enforcement actions necessary to preserve the collective character of the insolvency procedure? Under U.S. law, the arbitration would not be automatically stayed if the debtor is trying to recover money from the defendant. Nothing in the law prevents the office-holder in England or the debtor in the U.S. to continue the arbitration proceeding if that is in the interest of the insolvent estate. Furthermore, some courts have claimed that they have

---

195 In the U.K., s.9(4) of the Arbitration Act 1996 provides that unless an arbitration agreement is ‘null and void, inoperative, or incapable of being performed’, the Court shall grant a stay of proceedings brought in respect of a matter which is subject to an arbitration agreement.

196 Fotochrome, Inc. v Copal Co, Ltd, 517 F.2d 512 (2d Cir 1975).

197 Gropper (n 174).

198 Core matters are rights that arise under the insolvency law or in the insolvency case. If they arise “under” the law, they have a substantive nature. Examples include the right to avoid a preference or a fraudulent transfer that would not otherwise exist under the general law. If a core matter arises “in” the insolvency case, it has primarily a procedural nature. This includes the right to file a petition to remove an office-holder.

199 Under s.43(6), Sch. B1 IA 1986, ‘No legal process (including legal proceedings, execution, distress and diligence) may be instituted or continued against the company or property of the company except (a) with the consent of the administrator, or (b) with the permission of the court’. S.130(2) IA 1986 applies a similar rule for liquidation. The judiciary clarified that “legal process” includes arbitration proceedings: see Bristol Airport Plc v Powdrill [1990] Ch. 744 (CA).
discretion to dismiss a winding up petition when the most prominent debt is disputed and the parties included in their contracts an arbitration clause.\textsuperscript{200}

However, if the claimant is trying to recover from the insolvent debtor, the latter enjoys the protection granted by the automatic stay\textsuperscript{201} or by the moratorium. This is because both countries apply the UNCITRAL Model law which prevents the commencement and continuation of individual proceedings against the debtor when foreign main proceedings are recognised under national law.\textsuperscript{202}

The consensual nature of arbitration makes this procedure unsuitable to achieve the best interest of all affected parties. Arbitration awards are binding only for the parties that signed an arbitration agreement. Several stakeholders in an insolvency procedure (such as tort claimants or governmental entities) could not give their consent in advance. It is equally doubtful that all stakeholders would agree \textit{ex-post}, after the commencement of the formal procedure.

This clearly emerged in a recent cross-border insolvency procedure. In the \textit{Nortel} saga,\textsuperscript{203} despite the urgency from the insolvency courts to refer to arbitration to solve competing claims between creditors, the parties have not acceded to do so.

This case evidences that the consensual nature of arbitration may present an insuperable obstacle for the consistent use of this mechanism in insolvency practice. Restrictions on party autonomy that stem from the collective nature of the insolvency procedure ‘are likely to be a source of potential conflict with any arbitration agreement or pending arbitration proceedings to which the insolvent party is connected’.\textsuperscript{204}

\textsuperscript{200}Eco Measure Market Exchange Ltd v Quantum Climate Services Ltd [2015] EWHC 1797 (Ch), [2015] BCC 877.
\textsuperscript{201}In case of cross-border procedures, the administrator of the insolvent estate should obtain the recognition of the domestic insolvency procedure pursuant to §.1515 11 U.S.C. After that, all pending proceedings in the U.S. - including arbitration proceedings - will be stayed by virtue of §.1520 and §.362 11 U.S.C.
\textsuperscript{202}Article 20 of the UNCITRAL Model Law. ‘Individual actions’ include arbitration: see UNCITRAL Guide, para 145.
\textsuperscript{203}Re Nortel Networks, Inc., 737 F.3d 265 (3d Cir. 2013).
\textsuperscript{204}W Kühn, ‘Arbitration and Insolvency’ (2011) 5(2) D.R.I. 203, 208.
This conclusion is reiterated in a dated International Chamber of Commerce ('ICC') case where the arbitrators concluded that, while the mere fact that one of the parties is subject to insolvency proceedings does not render the dispute non-arbitrable *per se*, the disputes *‘which have a direct link with the bankruptcy proceedings’* are excluded from the jurisdiction of the tribunal. \(^{205}\)

As mentioned at the beginning of this sub-section, the list of issues that affect the interaction between arbitration and insolvency is voluminous. Even if the matter was arbitrable, it is yet to be determined if the counterparty lost his or her capacity to arbitrate by entering into insolvency proceedings [subjective arbitrability]. \(^{206}\) Equally, it is to be investigated if the award would be recognised and enforced by all the states which ratified the *Convention on the Recognition and Enforcement of Arbitral Awards* (New York, 1958) ('New York Convention'), since the signatory countries may rely on the exceptions listed in art. V(2) (including the public policy exception) to prevent enforcement and recognition of the award. \(^{207}\)

This was the legal issue raised in *Victrix Steamship*, \(^{208}\) where the Second Circuit refused to enforce an award for damages rendered against an insolvent estate because it would *‘conflict with the strong public policy of ensuring equitable and orderly distribution of local assets of a foreign bankrupt’* \(^{209}\).

Suggesting that insolvency procedures could be decided by arbitration overlooks the fact that the basic principles of arbitration and insolvency law are barely reconcilable: party autonomy and consent of the parties on one hand, binding and collective enforcement of decisions on the other. \(^{210}\)

Arbitration can support insolvency proceedings, but it cannot replace this statutory collection procedure. Even if the mere fact that a core insolvency

\(^{205}\) ICC case No. 6697 (1990).

\(^{206}\) The prevailing school of thought argues that the capacity should be assessed at the time of the conclusion of the arbitration agreement. See: V Lazic, *Insolvency Proceedings and Commercial Arbitration* (Kluwer Law International: Alphen aan den Rijn 1999).

\(^{207}\) For a summary of the issues that tribunals have to address in insolvency-related cases: PK Wagner, ‘When International Insolvency Law Meets International Arbitration’ (2009) 3(1) D.R.I. 56.

\(^{208}\) *Victrix Steamship Co., SA v Salen Dry Cargo A.B.*, 825 F.2d 709 (2d Cir. 1987).

\(^{209}\) Ibid, 714.

\(^{210}\) Bufford (n 183) 2.
matter had been decided in arbitration proceedings is not, in itself, a valid
reason for denying recognition and enforcement to the resulting award, it is the
consensual nature of arbitration which prevents a widespread use of this
remedy to settle and administer cross-border insolvency cases. Arbitration
fails to represent a viable autonomy-based solution in cross-border insolvency
cases.

2.3 Marketization of Insolvency Law in Asset-Segregated Industries

Does systemic failure to meet payments ("insolvency") determine the need for
statutory rules in autonomous and generally de-regulated industries?

Asset-segregated industries are sectors of the economy where special rules
derogue from general contract law tenets on securities and sanctity of contract.
The reason for a discrete system of law lies in the ex-territorial nature of the
assets traded in these sectors. These industries include the financial and (to a
lesser extent) insurance sectors, the oil and mining industry as well as the
aviation and shipping industries.

Generally speaking, asset-segregated industries are characterised by a lesser
influence of the law and higher exposure to market forces. This exposure to the
market forces influenced the content and development of the law ("marketization"). As a result, market players may agree on and enforce among
themselves contractual solutions that disregard some of the statutory rules and
principles that govern not only contract, but also insolvency law.

Taking the financial and insurance industries as an example, both in England and in the United States, the regulators have introduced discrete statutory

---

211 Needless to say, the same considerations apply with reference to the use of arbitration in domestic cases. The fact that - to the best knowledge of the writer - no author has proposed to make use of this dispute resolution mechanism for purely domestic cases is telling of the difficulties that arise from gathering sufficient consensus among the creditors to follow this path.

212 An asset has an ex-territorial nature whenever its discipline is determined by a multitude of applicable laws either because of its ownership structure or because of its movements across the globe.

213 The rules which deal with the distress of financial institutions and insurance companies are largely derived from the E.U. law. In particular, the discipline is regulated by the Credit Institutions (Reorganisation and Winding Up) Regulations SI 2004/1045, the Insurers
remedies in case of financial distress. A consideration of the rescue and restructuring of financial institutions and insurance companies is beyond the scope of this research. The systemic importance of the financial sector makes the latter an inappropriate candidate for an extended analysis of the nature of its autonomy-based mechanisms. This is because the introduction of some of these autonomy-based remedies in the financial sector (such as the safe harbors mentioned in sub-section 2.2(a)(i)) may be justified by the need to protect this sector of the economy from systemic risks and domino effects in case of failure of one of its participants.

However, in recent years some law and economics scholars have conducted extensive empirical research in other de-regulated industries to determine the real need for insolvency rules in these areas. One of the industries is the shipping sector.

Beside the large availability of data, several other considerations made the shipping industry a perfect candidate for these studies. On the one hand, assets (i.e. vessels) frequently have a multi-territorial or ex-territorial nature, thus rendering the application of domestic insolvency rules particularly problematic, due to the preliminary need to solve a conflict of laws conundrum. On the other hand, the de-regulated nature of this branch of law resulted in the development of widely accepted - albeit partially domestically regulated - remedies for breach of contract. These include maritime liens and arrest procedures.

---


214 In the U.S., under the McCarran-Ferguson Act 15 U.S.C. ss.1011-1015, rehabilitation and/or liquidation of insurance companies are matters of state law. Substantial similarities exist among the procedures enacted by the states. Banks and thrift institutions are subject to a specialised insolvency regime under sections 11 and 13 of the Federal Deposit Insurance Act, if their deposits are insured by the Federal Deposit Insurance Corporation (‘FDIC’).


216 Maritime liens are special privileged claims upon sea-connected properties, which remain valid despite changes in the ownership of the vessel. The law of the ship’s nationality governs the existence and priority of maritime liens, but certain characteristics - such as their priority over non-maritime liens and the preponderance of the right of the most recent lienholder - are common, since they stem from the enforcement and recognition of the 1952 Convention on the Arrest of Seagoing Ships.

Maritime liens arise by operation of the law out of services rendered to, or injuries caused by, a maritime property. They do not require neither the prior consent of the debtor, nor to be filed or recorded for perfection, since they attach the rem simultaneously with the cause of action.
This sub-section addresses the main arguments advocated by these commentators: (1) insolvency law remedies are more expensive and less efficient than industry-specific ones; and (2) TCP issues do not arise in these sectors because of the peculiar nature of both the players and the rules applicable to these industries. The overall goal of this sub-section is to investigate if autonomy-based approaches can be justified at least with reference to asset-segregated industries.

2.3(a) The Nature of Autonomy-Based Mechanisms

Commentators who advocate for autonomy-based mechanisms in de-regulated, asset-specific industries claim that they are more efficient - both economically and procedurally - than insolvency ones. The case seems particularly persuasive for the shipping industry, where the ex-territorial nature of the traded assets has determined a more tenuous link with insolvency rules.

In a particularly well documented paper by Franks, Sussman and Vig\textsuperscript{217} it was argued that there is no reason to rely on insolvency mechanisms if two conditions are met. The first is that creditors may, and frequently do make use of maritime remedies to deal with the distressed debtors. The second is that these mechanisms should not, and do not result in coordination failures, higher costs and fire sale discounts.

With reference to the first condition, these authors claim that ‘the rule of law has been established: it is largely private, decentralised, highly differentiated,

---

competitive, and adaptable' 218 This law is based upon the private mechanism of
the maritime lien (described in footnote 216), on the recognition of a
preferential treatment to the crew members,219 on the particular structure of
the industry220 and on the peculiarity of “double mortgage” contracts.
Not all of these observations, however, should go unquestioned.
In particular, recent cases prove that shipping is far from being a sector in
which the rule of law has been established and where creditors have reasonable
expectations to enforce private remedies.
For instance, in the O.W. Bunker case, courts around the world reached
remarkably discordant conclusions on the common legal question of whether
physical suppliers of fuel bunkers were entitled to maritime liens for
necessaries over the supplied vessels.221
Other considerations suggest that autonomy-based remedies might not be of
immediate use in case of crisis. For instance, with reference to the crew
preference, its undisputed nature is known to the distressed debtor, as well as

218 Ibid 2.
219 Under maritime law, in all jurisdictions crew claims are made senior to any other claims,
including those of secured creditors. This results in the crew having a strong incentive in co-
operating with the creditors, when their employer is in arrears with their payments.
220 Similar to what happens in other commercial sectors such as real estate, and oil and mining,
operators are organized as holding companies, with each asset (e.g. vessel, building, mine or oil
well) owned separately by a different subsidiary. This allows creditors to double-mortgage both
the assets and the shares of the subsidiary, which means that they could repossess the
mortgaged asset without taking physical possession of it in a port and without the need of a
lengthy and expensive court procedure.
221 In England and Singapore, courts ruled that physical suppliers are not entitled to any
1034 with reference to the first jurisdiction, Precious Shipping Public Co Ltd v O.W. Bunker Far
East (Singapore) Pte Ltd [2015] 4 SLR 1229 [54] for the latter. On the other hand of the
spectrum, Canadian federal judges are inclined to recognize the validity of such a remedy:
Canpotex Shipping Servs. Ltd v Maritime Petrobulk Ltd 2015 F.C. 1108 (Can.). Finally, U.S. courts
still have to adopt a uniform position on the subject matter: while they generally dismiss
physical suppliers’ claims to a maritime lien, they adopt an ambivalent position over the
intermediary’s request for the same statutory protection: Barcliff, Llc v M/V Deep Blue, Imo No.
9215359, 2016 WL 5660934 (S.D. Al. Sept. 28, 2016) and Clearlake Shipping PTE Ltd v O.W.
Bunker (Switzerland) SA, 2017 WL 78514 (S.D. N.Y. January 9, 2017), where this remedy was
recognised, as opposed to ING Bank N.V. v M/E Temara, 2016 WL 6156320 (S.D. N.Y. October 21,
2016), where O.W. Bunker’s claim was dismissed.
For an analysis of the decisions in common law countries: E Vaccari, ‘OW Bunker: A Common
Law Perspective on Multilateral Co-operation in Insolvency-Related Cases’ (2017) 7 I.C.C.L.R.
245.
to the creditors. The crew employer, therefore, will do everything in its power to keep their payments flowing.

Should a delay be experienced, it does not necessary follow that the crew will agree on the requests of the other creditors. The debtor may promise payment upon delivery of the cargo, while the other creditors cannot ensure either a swift payment or a future job to the disgruntled workers.

In other words, a significant period of time may pass between when the debtor shows the first signs of distress and the moment in which contractual claimants and crew agree on autonomy-based solutions to address their joint problems. A period of time in which, on the other hand, insolvency remedies may be triggered by any one of these players.

Similar concerns affect other asset-segregated industries, such as the oil and mining sector. This is a highly de-regulated industry, where parties make heavy use of unincorporated joint ventures to purse common projects. Due to the nature of their relationships, the same parties rely on de-regulated contracts to define their duties and liabilities, as well as the consequences, should one of the parties breach them.

However, even if we limit our analysis to a single jurisdiction (i.e. the U.K.) traditionally renowned for the value and protection granted to the principles of freedom and sanctity of contract, some commentators, as well as part of the judiciary, question the enforceability of some clauses commonly included in these agreements that have the same effect of contracting out insolvency rules.

As shown in *Pan Ocean*, despite the recognition of the Korean rehabilitation proceedings as foreign main proceedings pursuant to the Cross-Border Insolvency Regulations 2006, the English court refrained itself from issuing an

---

222 Recently, courts have re-asserted that in the English system, parties are free to agree whatever terms they choose to undertake in their relationships and that they can do that in a document, by word of mouth or by conduct: *Globe Motors, Inc. v RTW Lucas Varity Electric Steering, Ltd* [2016] EWCA Civ 396, [2017] 1 All. E.R. (Comm) 601, Beatson LJ at [100].

223 For instance, in an article Aldersey-Williams (n 163) and other authors questioned whether the pro-contractual approach showed in recent decisions in *Cavendish v Makdessi* (n 121) and *Belmont Park* (n 113) would be sufficient to secure the enforceability of forfeiture provisions. Provisions that, among others, are included in model forms of joint operating agreements used in the oil and gas industry, and provided by established associations, such as 'Oil and Gas UK' (2009 form) and the 'Association of International Petroleum Negotiators' (2012 form).
injunction restraining Fibra from terminating the contract when the recognising
court (i.e. the English one) could not itself have made such an order (i.e.
invalidating the ipso facto clause) in its own domestic proceedings. In other
words, the relevant termination provisions being invalid "as a matter of Korean
law" was irrelevant: it was the English anti-deprivation principle, not any
Korean law rule, which should govern the validity of the termination
provisions.

As one commentator observed, '[t]he recent English cases on ipso facto clauses
confirm “how” English law will determine the validity of such clauses, but, for
cross-border transactions, it is unclear “when” English law should apply'.
This seriously jeopardizes the validity of Franks' claim that in cross-border shipping
cases 'the rule of law has been established'.

With reference to the latter condition and, in particular, to the alleged enhanced
economic efficiency of private mechanisms over insolvency law remedies, this
thesis does not refute their conclusions. It refutes, however, their relevance.

Franks, Sussman and Vig may have demonstrated that autonomy-based,
discrete remedies are at least as efficient as insolvency law procedures in
dealing with distressed debtors. Similar considerations apply to the
enforceability of ipso facto clauses in asset-segregated industries. However,
these observations are in themselves insufficient to claim that autonomy-based
remedies should be preferred over statutory ones. At best, they simply
demonstrate the need for more efficient insolvency procedures.

This sub-section has proved that, while the second condition generally
advocated by commentators to plead a case for autonomy-based solutions in

---

224 Re Pan Ocean Co. Ltd [2014] EWHC 2124 (Ch), [2014] Bus LR 1041. The applicant, the
administrator of a company which has filed for insolvency relief in South Korea, sought an order
to refrain the counter-party from terminating a contract which included an ipso facto clause and
was subject to English law. Such a clause would not have been enforceable under Korean law.
Distancing themselves from the U.S. approach in Re Condor Insurance Co. Ltd (2010) 601 F 3d
319, the court refused to issue such an order.

225 R Matthews, 'Tough Choices: Ipso Facto, the Anti-Deprivation Principle and Choice of Laws'

226 Ibid 62.
asset-segregated sectors of the economy may be valid, this is not necessarily the case. Even more problematic is the observation that autonomy-based mechanisms may not always be available to creditors.

Nevertheless, this lack of procedural or economic efficiency of these mechanisms over insolvency ones may not represent a major obstacle, if these commentators are right in claiming that in these industries there is no TCP problem.

2.3(b) The Lack of a TCP Problem

As highlighted in sub-section 1.3(a) and as it will be discussed further in section 5.4, TCP dilemmas occur whenever competing, contracting parties are unable to allocate their rights over the debtor and its assets in an orderly way, because the debtor's existing and potential assets are unable to cover the creditors’ existing and potential claims.

Some authors claim that in the maritime world, TCP problems do not arise. This is primarily because creditors have specific claims on the goods of the debtors and, upon default, they can repossess the goods and put into practice value-enhancing actions for the satisfaction of their claims.

To prove valid, such a statement should be statistically significant. At least with reference to the shipping industry, it is based on the widespread adoption of the “double mortgage” contract in commercial transactions.

If we assume, as many of these authors seem to do, that commercial transactions are bi-lateral in nature and that “double mortgage” contracts are the rule rather than the exception, we may observe that security-holders do benefit from a fast and effective repossession mechanism. Surely, there is little co-ordination failure between the secured creditor and the debtor. However, the relationships between creditors are much more complicated.

---

227 “Double mortgage” contracts can be entered into by holding companies, whose vessels are owned separately by a different supplier. This allows creditors to take a security interest not only over the vessel (which may also be recognised by operation of the law), but also over the shares of the subsidiary. As a result, upon default, the creditor is able to become the sole owner of the distressed debtor and sell the vessels for its satisfaction.
The collapse of *Eastwind Maritime Inc.* (‘Eastwind’) represents a thought-provoking case study as it featured a conflict between participants from different asset-segregated industries (i.e. the maritime industry and the financial sector).

*Eastwind* was a Marshall Islands domiciled company, which filed for liquidation (Chapter 7) alongside with more than fifty (50) affiliates in the Southern District of New York at the end of June 2009. The filing came a day after *Nordea Bank* (‘Nordea’) took over twelve (12) subsidiaries (each of which owned one vessel) and sold them to Samama’s *Draften Shipping*. It also followed a number of setbacks for *Eastwind*, including vessel arrests, lawsuits and the loss of a major management contract.

Proponents of autonomy-driven approaches might argue that this case did not feature any TCP problem. This is because the main creditor (*Nordea*) was able to appoint new directors for the entities for which it held a security line and sell their shares before a corporate bankruptcy procedure was triggered.

This narrative, however, overlooks the fact that *Nordea* was not the only creditor of these distressed subsidiaries. While the sale was in its own interest, all other creditors were left out-of-money (with the exception of crew members). Tax claimants, suppliers, shareholders and bondholders received nothing from this sale, to the point that *Nordea* had to pay $750k to settle a litigation with the trustee of the bankrupt holding company.

To sum up, rather than proving the absence of any TCP problems, *Eastwind* proves the modernity of this concept. It equally highlights the inability of autonomy-based remedies to consider the conflicting interests of other stakeholders in asset-segregated industries, thus paving the way for the use of a RCP notion that considers also their rights and expectations.

---

229 Franks and others (n 217).
2.4 Normative, Efficiency and Fairness Considerations

It is not infrequent that radical views are either generally praised and cheered or hosed down by a torrent of counter-arguments (or both, not necessarily in any specific order). As for the theories described in the previous sections, the latter approach has proven prevailing in the insolvency cohort. There is a burgeoning literature that tries to prove the autonomy of insolvency law and the need for mandatory rules with different degrees of success.

Parties have always included contractual clauses in their agreements aimed at regulating their relationships should one of them default on their obligations without the need to rely on insolvency law. The existence of statutory limits to their implementation, as well as the lack of uniform approaches at national and international level in the judiciary, may demonstrate that markets are incapable per se to address all the nuances of insolvency cases. Additionally, even the contracting parties do not fully trust their enforceability.\(^{230}\)

However, the theoretical proposals de-constructed in this chapter should not be dismissed simply because they have not been tested in practice\(^ {231}\) or because markets may be inefficient. Additionally, some of the criticisms may be excessive,\(^ {232}\) as mechanisms (such as standardization of clauses) could be deployed to address the most striking inequalities and issues.

From a normative standpoint, stay waivers and ipso facto clauses do not question the opportunity, scope and purpose of insolvency law; they simply affect the formation of the insolvency estate. When the opportunity to rely on statutory mechanisms is questioned (such as with recourse to arbitration), the consensual and private nature of the alternative, autonomy-based remedy makes it unsuitable for generalised application.

\(^{230}\) This, at least, is what the case laws mentioned in this section suggests with reference to insolvency procedures. Outside insolvency, however, these clauses retain their validity and enforceability. A circumstance, which explains their inclusion in standard forms and in negotiated agreements.

\(^{231}\) Even though the previous sub-sections proved that, when carve-outs and procedural remedies are translated into practice, several problems arise, thus suggesting that these theories are also inefficient when dealing with real-case scenarios.

\(^{232}\) Is it true that the majority of creditors, both in size and number, are frequently mis- or non-adjusting? Should we build a system around or for them, or should we reduce the chances of abuse in a system designed to achieve other purposes, e.g. maximise creditors’ return and the opportunity of viable but financially distressed companies to re-enter into the market?
With reference to asset-segregated industries, this chapter has proven that the discrete rules that govern their affairs are unable to acknowledge the issues that the cohort of creditors faces when their common debtor files for bankruptcy protection. These rules simply result in sidestepping insolvency practices and principles, such as the pari passu principle of distribution of assets among equally ranked creditors.

Historical arguments have also been made to counteract autonomy-based proposals. Some authors, for instance, observed that, when parties were unrestrained in the content of their contracts, they did not negotiate for insolvency remedies, thus prompting the legislator to adopt nation-wide remedies. These arguments, however, have a reverse side. Insolvency law has emerged from commercial practice and the first statutes simply replicated the procedures and practice of workout agreements.

More convincing, but still not entirely persuasive criticisms contested the validity of these theories on the basis of empirical unsoundness and their very specific focus. As Bufford put it, ‘it would be foolhardy to develop bankruptcy policy or to revise bankruptcy law based on such a thin slice of bankruptcy life’.

Autonomy-based alternatives may prove enticing for certain companies (e.g. publicly listed corporations) or industries (e.g. financial or maritime sectors), but this does not justify the general repeal of insolvency statutes.

From a pragmatic standpoint, the following considerations are based on the distinctive features of autonomy-based theories. All the above-mentioned visions have the following elements in common:

1) Faith in the Market (substantive efficiency). Corporations are either conceived as nexuses of contractual relationships where everything is negotiable (Adler) or functions whose membership is given to all the individuals who make company-specific investments (LoPucki). Markets

---

234 Among others: de Ruysscher (n 62).
235 Bufford (n 233) 840.
are sufficiently mature and efficient to maximise the value of the
distressed company and support their restructuring efforts;

2) *Contract Law is all that is needed.* Contracts entitle the creditors to take
type of control of the debtor on the basis of the hierarchy of priorities
recognised by the general law. There is no space for “priority claim
holders”, that is for claimants that enjoy a preferential treatment only in
insolvency and by reason of the financial distress of the debtor;

3) *Contractualism replaces Collectivism.* Autonomy-based procedures are
driven by the debtor under the supervision of the “in-money” creditors,
even if sometimes the assistance from courts or turnaround
professionals may be envisaged. Intervention from third parties is
restricted to cases where the incumbent management is not able to deal
with the prisoner’s dilemma or when it has lost any credibility to restore
value to the original levels;

4) *Procedural Efficiency.* Costs of consensus in autonomy-based procedures
are always lower than the direct and indirect costs associated with
mandatory rescue or liquidation procedures;\(^\text{236}\)

5) *Pre-determined Exit Strategies.* Irrespective of the mechanism
considered, all contractual parties have a reasonable expectation from
the onset of their negotiations that, in case of financial difficulties, a pre-
determined autonomy-based procedure will apply;

6) *Focus on “in-money” Creditors.* There is no need to recognise the same
rights and privileges to all claimants. Since contractual solutions require
consensus, it is only appropriate to demand approval solely to the
parties that have an interest in the procedure. When a creditor holds a
claim, whose residual value is even in case of a successful turnaround
zero or close to zero, this creditor can have no right to obstruct or
otherwise delay the autonomy-based process.

---

\(^{236}\) Direct costs include all the expenses associated with running a formal or hybrid insolvency
procedures, including administrative and professional fees, as well as negative externalities
associated with delay. Indirect costs include loss of customers, unfavourable payment terms,
key employees leaving the company, and similar negative externalities associated with the same
procedures.
These characteristics show that in a remarkable discordance with common wisdoms, autonomy-based remedies promote a high level of procedural efficiency. As seen before, sophisticated contractors do rely on *ipso facto* clauses, despite the conflicting rulings and approaches in the Anglo/American system. This faith in autonomy-based remedies means that mechanisms such as chameleon equity or option proposals could be implemented in a liquid market.

Just as the market participants do not have difficulties in understanding the proposed, autonomy-based mechanisms - on the contrary, they would probably find them of more immediate comprehension than existing legal structures governing insolvency procedures -, shareholders and contractual creditors are likely to structure their relations on the basis of the proposed autonomy-based mechanisms, especially in purely domestic cases. Entrepreneurialism and market integrity do not seem to be negatively affected by autonomy-based proposals.

Vulnerable stakeholders, however, might argue that there is no mechanism to deal with their concerns and claims, as debtors and contractual creditors are the only parties involved in the process. Judicial, civil or criminal remedies would be ineffective to address the claims of this group of stakeholders, since autonomy-based theories do not question the “principle of finality” of contract law. The company purchasing the assets of the debtor, merging with that, or otherwise emerging from rescue proceedings is not generally liable for the debts of the original entity. There will therefore always be a need for a law as an option for those stakeholders who did not enter into a contract with the debtor.237

The biggest hurdle to overcome for autonomy-based visions is their acceptability in light of the current legislative and cultural framework. A piecemeal implementation of these proposals may result in some countries refusing to enforce the effects of autonomy-based restructurings for public policy concerns. Equally, the discussion on the desirability of *ipso facto* clauses

---

has evidenced that many players have a lukewarm attitude towards autonomy-based remedies, since they are frequently perceived as the mechanism sophisticated parties use to achieve higher returns or additional protections at the expense of less sophisticated ones. Finally, theories which rely primarily on current management to turnaround the business (or liquidate it on the market) seem to ignore the circumstance that ‘most company problems are internally generated by management deficiencies’.238

Not surprisingly, society as a whole may complain about autonomy-based mechanisms since they do not maximise overall benefits. They are designed to maximise the return to the sophisticated stakeholders. The claims of vulnerable stakeholders and society at large are barely considered, and no safeguards are envisaged to address these concerns.

2.5 CONCLUDING REMARKS

For quite a long time the generally unchallenged position was that insolvency law should promote equity and fairness between claimants. This view has informed the evolution of statutory rules in this area of law, with the result that the existence of statutory mechanisms to deal with corporate and individual distress has never been seriously challenged. It was only when a young faculty member at Stanford Law School described insolvency law as the solution to a collective problem (i.e. the common pool problem) that the first cracks in the equity-and-justice granitic façade began to appear.

The starling characterization of insolvency law as a collective action mechanism opened the floodgates to serious critiques of its claimed autonomy from other areas of law, notably contract law. However, this chapter has proven that autonomy-based theories may not withstand comprehensive theoretical criticism. Their implementation raises concerns with reference to procedural fairness and acceptability from the society at large.

Additionally, several authors have proven that the existence of statutory insolvency mechanisms may help achieve one of the fundamental goals of no-insolvency approaches, i.e. to reduce the cost of capital. This is because funders may prove more willing to grant credit to businesses in jurisdictions and environments where they are aware of the rules, principles, mechanisms, remedies and risks that they face, should the borrowers default on their payments.

A statutory framework of insolvency law can contribute to enhance the legal predictability of the system. As a side effect, it can also promote autonomy-based, out-of-court workouts as both parties that are bargaining in the shadow of the law are fully aware of their rights in a formal insolvency scenario.

Despite that, autonomy-based theories shatter the conviction, shared by many proceduralist and principle-based scholars, that the only way to solve TCP situations raised by insolvency cases is by means of a regulatory intervention of the state. It is not always the case that institutional arrangements imposed by external authorities will prove more successful than autonomy-based solutions in promoting the interests of the participants to the insolvency procedure. There are circumstances in which the parties affected by the debtor’s corporate demise can autonomously act and implement decisions which are in the best interest of the majority of stakeholders.

The weak spot of these proposals is that they assert that regulation is neither needed nor necessary. Cases like British Eagle, Nortel, O.W. Bunker and Eastwind have proven that this assumption is erroneous. Regulation is needed, admittedly sometimes only as a last-resort ‘system of collectivized debt collection’, to deal with those cases in which participants act independently and are motivated by selfish and opportunistic aims. A legal framework without

---

241 TH Jackson, The Logic and Limits of Bankruptcy Law’ (2nd edn, Harvard University Press: Cambridge, MA, 2001) 7. Against: de Ruysscher (n 62) 22 (arguing that if insolvency was intended as a “means of last resort” it would focus only on fraud and expropriation of assets, thus preventing reorganisation and continuity of business).
specific procedural and substantive rules that deal with insolvency disputes may prove insufficient.

Insolvency theoretical frameworks (and rules) should not, however, assume that parties are always incapable of communicating and acting for the common good. Autonomy-based theories have the merit of re-asserting the centrality of the principle of party autonomy in the insolvency context. They have adduced that any theoretical framework of insolvency law (including those that deal with the limits of this area of law, including this study) should consider, protect and promote the autonomy of the stakeholders involved in the procedure.

Autonomy-based methods caution against the extensive disregard of private negotiations, especially in a business context. The following chapters investigate if other seminal approaches promote a procedurally fair and efficient system of rules that address when companies should file for insolvency.
CHAPTER 3 - THE LIMITS OF INSOLVENCY LAW IN PROCEDURALIST FRAMEWORKS

«Bankruptcy [law] reflect the kind of contract that creditors would agree to if they were able to negotiate with each other before extending credit»\(^1\)

3.1 INTRODUCTION

The analysis of neo-libertarian theories suggested that insolvency law should remain a discrete area of law. However, this does not imply that insolvency rules should be substantially dissimilar to contractual remedies. On the contrary, their scope could be restricted to procedural instructions aimed at binding parties and facilitating the solution of the common pool dispute by means of an agreement.

This view has been advocated in several works by scholars collectively known as “proceduralists”. Proceduralists or contractarians\(^2\) share the neo-libertarian market-oriented focus of the theories described in chapter two. However, they disagree with neo-libertarians on their call for transforming insolvency rules in private law remedies. They argue for a procedural approach to the subject, thus giving rise to the criticism of those who observe that this “procedure” would be *de facto* reduced to an “afterthought”, to a ‘*narrow and purely reactive*’ set of rules, which would have no need to be separate from general, private law.\(^3\)

---


\(^2\) As Baird defines those academics (as himself) who advocate for a proceduralist approach to insolvency law and resist inclusion of separate (re)distributive goals which, on the contrary, are advocated by “traditionalists” - see DG Baird, ‘Bankruptcy’s Uncontested Axioms’ (1998) 108 Yale L.J. 573. Other contributors to this line of thinking include MG Shanker, ‘The Abuse and Use of Federal Bankruptcy Power’ (Fall 1975) 26(3) Case W. Res. L. Rev. 3 (arguing that rules valid only in front of bankruptcy courts are a tension-creating situation); TH Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain’ (1982) 91 Yale L.J. 857 (arguing that insolvency law should deal only with inter-creditor questions on the basis of the creditors’ bargain model).

2012: Detroit, Michigan.  

At the beginning of 2012 Detroit, the largest city of Michigan with a population of nearly 700,000 people, found itself the brink of collapse. Decades of industrial decline, economic downturn, social and racial strife, financial mismanagement, municipal disarray, and political corruption brought the city on the verge of a liquidity crisis.

Before taking the books in court, the city and the state looked for consensual solutions with creditors, first by means of a state fiscal oversight over the city expenses (April 2012), and then by the appointment of Jones Day restructuring attorney Kevyn Orr as the city’s emergency manager (hereinafter, EM) on 14 March 2013. The unsuccessful outcome of this attempted “haircut” on Detroit’s debt has resulted in the most controversial municipal bankruptcy of recent times.

---

4 For this portion of the thesis, the author relied on the research that he conducted at earlier stages of his doctoral studies and that resulted in the publication of the following article: E Vaccari, ‘Municipal Bankruptcy Law: A Solution Which Should Not Become a Problem’ (2017) 5 NIBLeJ 02. Part of the wording is taken from that paper.

5 In its heydays in the 50s, Detroit was the hometown of more than 1.8 million people. Source: <http://historydetroit.com/statistics/> accessed: 17 September 2018.

6 Michigan and Detroit industries have always heavily relied on the auto sector. However, the oil crisis of the 70s and the emergence of Japanese and Korean automakers in the U.S. car market found the “Big Threes” (GM, Ford and Chrysler) ill-prepared to meet these new challenges. Automation of the industry meant that fewer workers were needed in factories, while the neglected municipal teaching system was incapable of educating skilled workers.

7 Michigan backtracked a revenue-sharing agreement negotiated with the city in 1998. Furthermore, the 2008 financial crisis also affected the money that state and federal lawmakers could devote to city budgets.

8 While many commentators blame mayor Coleman Young for the city’s economic collapse, a great deal of responsibility is to be charged also on mayor Kwame Kilpatrick, and not simply for the corruption scandals that resulted in his twenty-eight-year conviction in a federal prison. See below sub-section 5.2(d).

9 In 2012, city’s violent crime rate was five times higher than national average, police took on average thirty minutes to arrive on the scene of a high-priority call and only 39 out of 344 murders were solved in 2011. In addition, 40% of the city streetlights were not working and a study conducted in 2014 estimated that in Detroit area there were at least 84,000 blighted or vacant structures: N Bomey, Detroit Resurrected: To Bankruptcy and Back (W.W. Norton & Co., Inc.: New York, 2016).


Detroit filed for Chapter 9 in the US Bankruptcy Court of the Eastern District of Michigan on 18 July 2013 at 4:06 p.m.\(^\text{12}\) However, the city was declared “eligible” for bankruptcy only on 3 December 2013.\(^\text{13}\) It was this second ruling, which paved the way for real negotiations between the creditors and the city. With the support of a mediator (Chief Judge Gerald Rosen), EM’s staff negotiated with major creditors over a reduction of the outstanding liabilities.

Detroit had debt in excess of $18 billion. While a portion was secured, the majority was not. Among unsecured creditors, the most problematic positions - for different reasons - were those of pension and healthcare liabilities,\(^\text{14}\) and those of bondholders (primarily, UBS and Merrill Lynch) and their insurers (primarily, Syncora and FGIC). While ranking at the same level,\(^\text{15}\) bankruptcy officials tried (and managed) to secure a significantly better treatment for the retirement funds:\(^\text{16}\) in the battle between citizens and bondholders, the former fared remarkably better.\(^\text{17}\)


\(^{14}\) The city was required to distribute payments to some funds, to ensure that retirees’ monthly benefits were paid, and their health expenses covered. By the time Detroit filed for bankruptcy, it experienced a shortfall towards these creditors equal to $9.2 billion (i.e. nine times the city’s annual core budget). Source: Boney (n 9) 48.

\(^{15}\) Chapter 9 grants senior status to debts secured by the pledge of specific revenues (e.g. the water and sewer system bonds secured by utility bill payments).

\(^{16}\) According to an agreement signed in April 2014 and then approved by their members, police officers and firefighters - due to the better conditions of their retirement funds - did not experience cuts to their monthly pensions, but only in the annual cost-of-living-adjustment (COLA) increases. General municipal pensioners agreed to a 4.5% cut in their monthly payments, and the elimination of COLA increases. Health care cuts were drastic, but nothing in comparison to what the bondholder insurers agreed on: 13 cents on the dollar in cash, plus the opportunity to develop existing properties in metro area.

\(^{17}\) While this work is critical on that outcome, not all commentators appear to be equally troubled. For instance, Gillette argued that bondholders should bear the greater losses because they are better placed to monitor the city’s behaviour over its citizens and because they can demand ex ante compensation for their loans [C Gillette, ‘Bondholders and Financially Stressed Municipalities’ (2012) 39 Fordham Urb. L.J. 639]. Schragger concurs by claiming that since economic crises have a political nature, it makes sense for courts or legislatures to prioritize citizens over creditors [RC Schragger, ‘Citizens Versus Bondholders’ (2012) Fordham Urb. L.J. 787, 803]. Despite how persuasive the arguments, in the author’s opinion these comments present a fundamental flaw: law or contracts, not praiseworthiness, should determine creditors’ ranking. Also, according to Goode [RM Goode, Principles of Corporate Insolvency Law (4th edn, Sweet & Maxwell: London, 2011)], equality of creditors is one of the pivotal principles of bankruptcy law and it should not be easily displaced.
The final plan of adjustment - subject to state’s oversight -, included a significant financial support from the “Great Bargain”, as well as minor contributions from the state budget. This was approved by all classes of creditors and confirmed by Rhodes J. on 7 November 2014.

The plan’s goals were achieved at the expense of some of the most fundamental axioms of insolvency law: respect for pre-insolvency relative rights and the principle of rateable distribution among similarly placed creditors. The politically-informed nature of the governance prevailed over the procedural constraints of the Code. Proceduralist theories suggest that this should never be the case and that their understanding of the purpose and limits of insolvency law would have resulted in an entirely divergent outcome.

After having discussed the main suggestions and arguments from proceduralist theorists (section 2), this chapter de-constructs the main proceduralist theories to investigate their normative validity, as well as their compatibility with the pragmatic benchmarks laid out in sub-section 1.3(c). Similar to chapter two, this section does not provide a full assessment of proceduralist theories as it is concerned with highlighting the features of these conceptualisations that are relevant for the debate on the limits of insolvency law. The overall purpose of this chapter is, accordingly, to determine if and to what extent these theories can help to define the limits of insolvency law.

3.2 Proceduralist Solutions in Insolvency Law

A comprehensive investigation of all proceduralist theories relating to insolvency law falls outside the scope of this thesis. To collect appropriate evidence for our de-constructivist analysis, the following section provides a glance at the pivotal characteristics of the most widely accepted ones to assess their normative value and their practical implications.

18 The “Great Bargain” is the colloquial term used to designate the contributions to pension funds made available by a series of foundations as part of a comprehensive settlement to preserve city-owned art at the Detroit Institute of Art for the benefit of the local residents and the region.

19 For a definition of a de-constructivist approach, see section 1.2, ftm 32.

20 For a general definition of proceduralist theories, see section 1.2, ftm 34.
At the end of this analysis it will become apparent that proceduralist solutions may fall short of providing a normative explanation of the insolvency corporate framework as they do not withstand the scrutiny of the procedurally fair and efficient criteria employed in this work. Nevertheless, proceduralists have shown that markets value a system of insolvency rules capable of promoting an efficient management and ensuring a predictable outcome of corporate rescue or liquidation cases. This finding will be taken into consideration by the author in chapters five and six, where he outlines his alternative conceptual framework.

[1] An understanding of insolvency law as being primarily procedural is supported by scholars (such as Shanker and Adler), who believe that rules valid only in front of bankruptcy courts are a tension-creating situation. If a problem is solved only in bankruptcy, they argue, ‘[t]hat ‘solution’ is a cure which is probably worse than the disease. Indeed, it can be hardly classified as a solution at all’.21

Highlighting the procedural nature of insolvency law results in restricting its scope to a last-resort mechanism.22 If insolvency law does not amend substantive rights, parties (debtors and creditors together) would be encouraged to reach an agreement outside of insolvency. At the same time, they would know that, should they fail to cooperate, any of them could always commence an insolvency procedure, which would preserve the ‘relative value of particular non-bankruptcy entitlements instead of the rights themselves’.23

In other words, whenever the TCP dilemma could not be solved with contractual agreements, any interested party could eventually trigger an insolvency procedure. Collectivity, the binding nature of insolvency and the

21 Shanker (n 2) 9.
22 Ibid 22: ‘The function of bankruptcy law is not to derogate from the general debtor-creditor law; rather, to support it. Bankruptcy’s unique function is to provide a forum of last resort’. Against, see Adler (n 3), who argued that ‘bankruptcy must resolve inconsistent obligations and may serve other functions, such as provisions of a fresh start to individuals, but bankruptcy need not provide a collection-action process’ (at 1698).
23 Jackson (n 1).
preservation of the *pari passu* principle would prevent any strategic use of insolvency remedies.

The idea behind this reasoning is that, if the insolvency system does not affect the rights recognised by general law, parties, left alone, would act in their collective best interest. They would negotiate a satisfactory, swift arrangement at the lowest cost.

The proponents of this line of thinking argue that sale of assets and business for market value eliminates for both large and MSMEs the need of reorganisation procedures such as Chapter 11. They contend that *‘Chapter 11 can play its traditional role only in environments in which specialized assets exist, where those assets must remain in a particular firm, where control rights are badly allocated, and where going concern sales are not possible’.*

They basically argue that the need for collective procedures may be restricted to periods of cyclical, economic downturns. However, it is not clear why the utility of a procedure should depend on the global economic context, rather than on the soundness of its foundations.

Additionally, practice, theoretical studies and comments from the proponents themselves undermine the validity of this conclusion and, hence, the overall soundness of the proposal. In particular, it is frequently acknowledged that corporations are nexuses of relationships, not simply collections of contracts. Their value is represented by the people who work for them as much as by their contracts for the sale or supply of goods. If all stakeholders are not equal, deviations from generally enforceable rules can be in the interests of all players, as in the case of *Detroit*.

Shanker and Adler’s vision addressed only allocative issues without providing guidance on how to assess the creditors’ conflicting rights and expectations.

---

25 Cases like *Nortel* (see sub-section 3.2(b)) and *Detroit* (see sub-section 5.4(c)), among others.
26 As Shuchman observed, purely “law and economics” methodologies tell us something about economics, but very little about the problems of bankruptcy: P Shuchman, ‘Theory and Reality in Bankruptcy: The Spherical Chicken’ (Autumn 1977) 41(4) Law & Contemp. Probs. 66.
27 Baird and Rasmussen (n 24).
[2] Other law and economics scholars such as Jackson,29 Baird30 and Scott31 [creditors’ bargain theory] also contended that insolvency law should deal with allocative disputes among creditors.

In other words, insolvency law’s central goal should be to collectivize the process by which a debtor’s assets are made available to its claimants whenever an (allocative) TCP problem emerged. It should be a derivative and facilitative system of rules, with very little interference on party autonomy.

Bankruptcy law is or should be the set of procedures that can come into play when multiple party withdrawal rights are triggered and the exercise of these rights by individual investors is costly and interferes with the deployment of the firm’s assets.32

These authors assume that, for the state-directed insolvency law procedure to exist, those with rights to the assets of a company should agree ex-ante, in the negotiation phase, on such a need. Parties would agree on limitations to their rights only if that resulted in a maximisation of the debtor’s assets. As a result, insolvency law should allocate rights among claimants to particular assets, but it should not interfere with distributional issues since it should aim at ex-post maximisation of the returns to creditors.33

To illustrate this point, Jackson discussed the options available to him and a Stanford professor in the theoretical case that their common debtor would fail to repay his debt and had insufficient assets to pay both of them. Jackson concluded that he and his Stanford colleague would agree ex-ante on a collective, pro rata distribution because it was impossible to devise an

32 Baird (n 30) 131.
33 Contractarian/creditors’ wealth maximisation theorists assume that the shareholders own the debtor (agency theory) and that the company is merely a ‘pool of assets’. Accordingly, when the company faces insolvency, the ownership shifts to the creditors, who are then entitled to grab and distribute its assets according to non-insolvency entitlements. The insolvency procedure should serve the owners’ interests, hence the interests of third parties (e.g. employees, suppliers, customers, and communities) should be considered only to the extent that they have a valid claim under non-insolvency law against the debtor.
alternative mechanism that made both him and the Stanford professor better off.\textsuperscript{34}

Nevertheless, while emphasizing the value of retaining out-of-insolvency rights, the proponents of this line of thinking recognize that there may be a ‘need to adjust non-bankruptcy attributes to unique bankruptcy procedures’.\textsuperscript{35} In other words, they recognize that non-insolvency rights could be amended by (insolvency) law to achieve the goals of the system.

Accordingly, the main deficiency of this line of thinking is that it fails to consider adequately (re)distributive issues.\textsuperscript{36} Not every relationship among creditors could be regulated according to rights recognized under the general law.\textsuperscript{37}

This is best illustrated by referring to cases in which insolvency laws have been exploited by one party to extract profit or avoid losses.\textsuperscript{38} This happened because those parties who made a strategic use of insolvency rules considered

\textsuperscript{34} Jackson (n 1) 30/31.
\textsuperscript{35} Jackson (n 29) 73; DG Baird, ‘Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren’ (1987) 54 U. Chi. L. Rev. 815, 823: ‘The only point Jackson and I make is that the priorities that exist under nonbankruptcy law should run parallel to priorities in bankruptcy. To the extent that these priorities generate bad distributional consequences, they should be changed in both settings’.

\textsuperscript{36} This concern was clearly expressed by E Warren in ‘Bankruptcy Policy’ (Summer 1987) 54(3) U. Chi. L. Rev. 775. Warren argued that bankruptcy should answer the question ‘How Shall the Losses be Distributed?’, but Baird - Baird (n 35) - replied that how losses should be borne is a question of general law.

\textsuperscript{37} Jackson, for instance, recognized that certain notions, such as that of “claim”, should be wide enough to include future tort claimants (e.g. asbestos claimants). He tried to nullify the risk of abusive use of insolvency law by arguing that limits to the determination of the claim are valid only if they exist outside insolvency.


See also Re Owens Corning, 419 F.3d 195 (3d Cir. 2005), 200, where it is acknowledged that some entities within the group were created to limit liability concerns with respect to asbestos. Similarly: Tronox, Inc. v Anadarko Petroleum Corp. (Re Tronox, Inc.) 450 B.R. 432 (Bankr. S.D.N.Y. 2011), which detailed how the company separated its oil and gas assets from the rest of the holdings to reduce its liability risks.

Other notorious cases include the insolvencies of \textit{Continental Airlines} (see section 6.2) and \textit{Wilson Foods}, where Chapter 11 was used to break labour contracts with a unionized workforce. On the contrary, in the insolvency cases of \textit{Manville Corp.} and \textit{A.H. Robins} (see above sub-section 1.1(a)), Chapter 11 was used to control mass tort damages.
the insolvency framework as a powerful and efficient mechanism to solve contractual or tort, rather than insolvency or common pool issues.\textsuperscript{39}

It follows that if the legislation fails to even consider the possibility that (re)distributive issues might arise because of the insolvency of a debtor, certain debtors would have an incentive to use the statutory provisions in a strategic way and the courts would lack appropriate remedies to counteract this misuse of the law.

\textbf{[3]} Building on these concerns, some authors tried to mitigate the most striking consequences of the creditors’ bargain heuristic\textsuperscript{40} by conceiving yardsticks that would make risk-sharing acceptable.\textsuperscript{41}

These scholars argued that the creditors’ bargain heuristic, while powerful and illuminating, was only partially successful because it projected a single vision of insolvency. Their ‘\textit{analytic and thematic clarity is eroded by the authors’ aversion to the declarative sentence and the proliferation of conceptually simplistic and distracting problems’}.\textsuperscript{42}

Accordingly, they attempted to harmonize individual (maximisation of insolvent debtors’ assets) and common (distributional equality among claimants) goals. A far from unproblematic purpose, since ‘\textit{any re-distributional effects of bankruptcy reduce the relative attractiveness of security to creditors’}.\textsuperscript{43}


\textsuperscript{40} In Jackson’s words, insolvency law is ‘a system designed to mirror the agreement one would expect the creditors to form among themselves were they to negotiate such an agreement from an ex-ante position’ [Jackson (n 2) 860].

\textsuperscript{41} RE Scott, ‘Through Bankruptcy with the Creditors’ Bargain Heuristic’ (Spring 1986) 53(2) U. Chi. L. Rev. 690. The author argues that risk-sharing (and, as a consequence, statutory distributive rules) could be justified whenever it has the potential of increasing the value of the company as a going concern, compared to the value of the assets in case of a liquidation sale. Similarities with the law of admiralty suggest when it was possible to depart from pre-bankruptcy entitlements. See also: Jackson and Scott (n 31).

\textsuperscript{42} Ibid 693.

\textsuperscript{43} Ibid 707.
In order to achieve both goals without disregarding the creditors’ bargain heuristic, these scholars advocated for introducing the **common disaster vision** in insolvency law.

The “common disaster vision” is based upon the “general average rule” conceived in the field of the law of admiralty. Its premise is that the managers of a company in financial distress share a lot of similarities with the captain of a ship facing a shipwreck. Like the captain, the manager is the agent of all parties participating in the venture. When the perilous situation arises, it is in the interest of all participants that the captain/manager takes all interests equally into account.

Similarities with the law of admiralty suggest when it is possible to depart from pre-bankruptcy entitlements. This should occur when: (1) an imminent common danger exists; (2) part of the cargo or the company must be jettisoned to attempt saving the remainder; and (3) the attempt to avoid the common peril should look - from an *ex-ante* perspective - more likely than not to succeed.\(^4^4\)

Under this perspective (later supported even by the proponents of the original version of the creditors’ bargain model),\(^4^5\) risk sharing and general average contribution were justified in insolvency only if they ‘improve[d] the prospects for a successful reorganization and increase[d] the value of the enterprise whenever going-concern value exceeds the value of a piecemeal liquidation’.\(^4^6\)

In order to support this heuristic, “common disaster” scholars observe that insolvency law has never purported to grant absolute recognition to pre-bankruptcy entitlements. On the contrary, insolvency law should only ensure respect of substantial state-created rights to the extent they did not conflict with federal policy and equitable principles. Furthermore, the risk-sharing model helps to explain the rationale of those insolvency rules that depart from purely procedural practice.

---

\(^4^4\) This vision is justified by reference to the principle of general average, conceived in the field of the law of admiralty. According to it, when the ship is on the brink of disaster (shipwreck), the captain ceases being the main purveyor of the employer’s priorities and tries to adopt the best possible course of actions to save the boat, the goods and the life at stake (or at least as much as possible of them).

\(^4^5\) Jackson and Scott (n 31).

\(^4^6\) Scott (n 41) 704.
In theory, the common disaster conceptualisation provides a richer and more textured framework for the *ex-ante* bargain. Unfortunately, substantial difficulties mar any attempts to accommodate maximisation and distributional goals in insolvency while following this approach.\(^{47}\) The definition of the precise moment in which the captain/manager should start considering a wider variety of interests is highly disputable and could lead to judicial litigation. Additionally, the assumption that captains/managers should not act from the beginning in the interest of all stakeholders has been challenged by corporate governance scholarship.\(^{48}\)

Should the reader find these criticisms unpersuasive, it is worth observing that the revised creditors’ bargain heuristic actually supports one of the key features of this thesis, i.e. the need for insolvency laws to address common pool issues (albeit in their traditional form) that are both allocative and (re)distributive in nature.\(^{49}\) This may lead to the conclusion that proceduralist visions (at least in the common disaster iteration) have the potential to determine the dividing line between contract and insolvency law.

The next sections therefore investigate if the practical implementation of proceduralist tenets in domestic and cross-border cases produces procedurally fair and efficient outcomes. Should this be correct, then the thesis’ quest for a dividing line between contract and insolvency law could be considered concluded. Unless, of course, principle-based theories produce equally fair and efficient outcomes and address the potential shortcomings of proceduralist conceptualisations.

### 3.2(a) Procedure-Based Insolvencies

To preserve the sanctity of contracts and restrict to the highest possible extent the cases in which the law created rights valid only in the insolvency context, proceduralists argue that insolvency law should aim at auctioning the estate or

\(^{47}\) Jackson and Scott (n 31) 202.
\(^{48}\) This matter is debated extensively in section 4.3 of this thesis.
\(^{49}\) See above sub-section 1.3(a).
its assets and the APR should be strictly enforced.\(^{50}\) In any case, insolvency law should not alter the bargain reached by the parties in solvent times or the reliance on laws that are valid outside insolvency.

Two recent judicial decisions on each side of the Atlantic seem to support the view that insolvency rules should not alter the rights recognised to the parties by the general law, and the parties’ reliance on them. It has also been argued that their implications may go beyond the international context of the cases, thus potentially affecting the interplay between contract and insolvency rules in domestic cases.\(^{51}\) These cases are *Bakhshiyeva* in London and *Sun Edison* in New York.

In *Bakhshiyeva*\(^{52}\) the court was required to determine if the recognition of foreign insolvency proceedings could prevent the creditors from exercising their rights under an English law contract if these rights were contrary to the terms of the insolvency proceeding approved by a (foreign) court. The

---


\(^{51}\) JL Westbrook, ‘The End of Bankruptcy’ *Credit Slip* (29 May 2018) <http://www.creditslips.org/creditslips/2018/05/the-end-of-bankruptcy-.html?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+creditslips%2Ffeed+%28Credit+Slips%29> accessed 17 September 2018. The argument does not seem persuasive to the author of this paper. The possibility to exercise substantive rights that are in contrast with the content of the insolvency procedure has not been portrayed as a general rule. It is subject to the limits set out in *Antony Gibbs & Sons v Societe Industrielle et Commerciale des Metaux* [1890] 25 Q.B.D. 399 (CA). *Gibbs* applies only if English law rights are affected by a foreign procedure and the creditors have not submitted to that jurisdiction. This exception could not be invoked in a purely domestic case.

court relied on *Gibbs* to conclude that a debt governed by English law could not be discharged by foreign insolvency proceedings unless the debtor submitted to the foreign insolvency proceedings. This is because, as evidenced in *Pan Ocean*, *Rubin* and *Agrokor*, the UNCITRAL Model Law and the CBIR 2006 are concerned with procedural matters and could not affect the existence, exercise or enforcement of substantive rights. As a result, the choice of law in a contract could trump the collective and substantive nature of the (foreign) insolvency proceedings.

In *SunEdison* the plaintiff (SMP) was a debtor under Korean bankruptcy law (since May 2016) while the defendant (SunEdison) was an entity subject to a Chapter 11 proceeding in the U.S. (since April 2016).

In 2011, the parties entered into a supply and license agreement (‘SLA’) which contained an *ipsa facto* clause that permitted either party to terminate the contract if the other filed for bankruptcy or became unable to pay its debts as they became due. The SLA was governed by New York and U.S. federal law. Under Korean law (the law governing the SMP’s insolvency procedure) the *ipsa facto* provision would be unenforceable, while under New York law the clause was enforceable.

*SunEdison* sent a termination notice to SMP in March 2017. The Korean procedure was recognised as a foreign main proceeding under Chapter 15 of the U.S. Code after SunEdison issued the termination notice to SMP (15 June 2017).

---

53 *Gibbs* (n 51). See: IF Fletcher, *The Law of Insolvency* (5th edn Sweet & Maxwell, London 2017) 961 at [30-061]. The same author has criticised the rule as ‘*insular and xenophobic in the extreme, and is plainly guilty of maintaining dual standards with regard to the principle of universality in bankruptcy*’ (923-924 at [29-067]).
56 *Re Agrokor DD* [2017] EWHC 2791 (Ch), [2018] Bus. L.R. 64 [115].
57 *OJSC* (n 52) [137], citing Morgan J in *Pan Ocean* (n 54) at [111].
59 If the debtor (SMP) had entered into an insolvency procedure, §365(e)(1) applies. According to the federal law, termination is prevented if justified solely on an *ipsa facto* clause which relies on the inability to pay the debts as they fall due or the commencement of an insolvency procedure by the debtor.
60 *Re SMP Ltd.*, Case No. 17–11192 (Bankr. S.D.N.Y. 2017) (SMB). Outside insolvency scenarios, *ipsa facto* clauses are enforceable under New York law absent fraud, collusion or overreaching: *Murray Realty Co. v Regal Shoe Co.*, 265 N.Y. 332, 193 N.E. 164, 165 (1934); *W.F.M. Rest., Inc. v
If SunEdison’s termination was valid, SMP could no longer use the intellectual property, which had been in the meanwhile bought by GLC. This would have maximised the assets of the American debtor while impoverishing the prospects of the reorganising Korean entity.\textsuperscript{61} If, however, SunEdison was limited to rejecting the SLA, SMP could continue to use SunEdison’s intellectual property without its consent.\textsuperscript{62}

Similarly to Bakhshiyeva, Bernstein J concluded that the choice of law made by sophisticated commercial parties should have been upheld. As a result, the judge applied a New York substantive contract rule and not the Korean substantive insolvency provision to determine the validity of the termination notice as this was subject to New York and not Korean law.

Bakhshiyeva and SunEdison show that judges are willing to adhere to proceduralists’ tenets and disregard any attempt to modify insolvency rights negotiated by the parties in solvent times.

The next sections discuss some cases with no or little (re)distributive implications\textsuperscript{63} and report on auction-based procedures with (re)distributive issues.\textsuperscript{64} Attention is paid to the current understanding of the APR.\textsuperscript{65} This rule is meant to protect the substantive entitlements negotiated by the parties outside a formal insolvency procedure. If proceduralist theories are implemented in the Anglo-American insolvency framework, there should be few deviations from this rule both in the law and practice.

\textbf{Sub-section 3.2(b)} investigates the proceduralist mechanisms in cross-border insolvencies (i.e. cross-border insolvency agreements or ’CBIAs’) to determine to what extent they represent a comprehensive solution to cross-border corporate distress. \textbf{Section 3.3} highlights the defining characteristics of proceduralist approaches in insolvency law and determines their compatibility


\textsuperscript{62} Westbrook (n 51).

\textsuperscript{63} Sub-section 3.2(a)(i).

\textsuperscript{64} Sub-section 3.2(a)(ii).

\textsuperscript{65} Sub-section 3.2(a)(iii).
with the benchmarks introduced in sub-section 1.3(c) before drawing some concluding remarks for this chapter.

3.2(a)(i) Auction-Based Insolvencies without (Re)Distributive Implications

As explained in the previous section, the existence of some factors such as a small group of controlling creditors, working markets and lack of company-specific assets tend to favour sales of single items, estates and businesses over complex and expensive statutory reorganisation procedures.

If these assumptions were true, market rules should inform insolvency practice and prove sufficient to preserve the going-concern surplus of the distressed debtor. Baird made this point by comparing the insolvency case of an asset-heavy modern telecommunication technology (Global Crossing)66 with the 19th century cases that involved railway companies. While in both cases the companies defaulted over the repayments of loans for the construction of a (tele)communication network, Baird observed that Global Crossing reorganisation plan within a Chapter 11 procedure was essentially a sale to the best bidder. As a result, he concluded that:

- Creditors of insolvent businesses no longer needed a substitute for a market sale, since the ability to sell both small and large corporations as a going concern eliminates the need for a collective forum;
- Chapter 11 was no longer a substitute to a sale, but the forum where these sales took place.67

However, the rapid sale of asset-heavy companies is not the only option in today’s insolvency arena, as the Abengoa case suggests. That company first filed for insolvency protection in November 2015. Under Baird’s theory the preferable solution would have been a sale of the profitable assets in satisfaction of the creditors.

---

67 Baird and Rasmussen (n 24) 753: ‘Chapter 11 can play its traditional role only in environments in which specialized assets exist, where those assets must remain in a particular firm, where control rights are badly allocated, and where going concern sales are not possible’; DG Baird, ‘The New Face of Chapter 11’ (2004) 12 Am. Bankr. Inst. L. Rev. 69, 71.
This course of action would have been wise and appropriate, especially considering that at the end of 2015 the consequences of the 2008-2009 financial crisis were lessening. In other words, there was a liquid market and there were potential investors for the company’s profitable assets, including Abengoa’s New York-listed subsidiary that owned and ran water and power plants in the U.S. Also, it might be argued that this should have been the preferable course of action, considering the number (in the thousands) of creditors, the cross-border nature of the business and the high number of employees (in excess of 24,000).

Nevertheless, the Spanish practitioners and advisers, supported by their American and English colleagues, opted for a consensual debt-for-equity swap. Under the agreement, 70 per cent of the pre-existing debt was converted into 40 per cent of Abengoa’s new share capital, current shareholders retained around 5 per cent of the shares in the new company and additional funds were secured for the future.

For the purposes of this thesis, it is sufficient to observe that the conditions of the deal marked a significant improvement over the creditors’ expectations in a sale-oriented procedure. According to the available data in the negotiated debt-for-equity agreement, existing creditors faced a 97 per cent haircut on their loans. By preserving and turning around the existing business, its synergies and economies of scale and the company’s expertise in renewable energy technology, the creditors who consented to the swap faced “only” a 70 per cent haircut.

---

68 Abengoa’s failure was managed by means of two Spanish “homologaciones” - which have been recognised around the world as the main procedures since the company was incorporated in Spain - an English CVA and a U.S. Chapter 11.

69 According to Global Turnaround (March 2017, issue 206), under the terms of the deal agreed in May 2016 and published at the beginning of 2017, Abengoa will receive 1.17 billion euro in funds made up of fresh investment as well as the rollover of existing credit facilities, while another 1.2 billion euro of new money will come from non-bank, private equity funds.

70 Abengoa has committed itself to a more ‘focused’ approach. Since the beginning of the procedure, the company sold its non-core stakes, some photovoltaic plants in Spain and a wind farm in Uruguay. Additionally, the rescue plan specifies that Abengoa will concentrate its business on designing, building and servicing renewable energy plants for outside owners.
Similar considerations may be unfolded with reference to the *Agrokor* crisis.\(^{71}\) *Agrokor* is clearly a case where the business was sound. The financial distress was the result of the rapid growth of the company and its exponential increase in liabilities. Failure to refinance some of its notes at the end of 2014 resulted in the holding company being unable to repay its debts as they fell due.

Since *Agrokor* was a company with substantial assets, under Baird’s narrative creditors would have been better off if the company entered into an auction-based insolvency procedure. However, this course of action would have resulted in the termination of all of the ongoing executory contracts with existing suppliers. Additionally, the default on the outstanding promissory notes would have determined the crisis and probably the distress of many of them, with the result that the going-concern value of the company (i.e. its network of contracts) would have been lost.

While the case is still ongoing, it appeared from the beginning that the main creditors (i.e. the lending institutions) were not willing to push the company into liquidation. They agreed on a standstill and on new money injections. Only when it became clear that the need for more radical restructuring could not be consented in an informal workout, the creditors sought the support of the Croatian government. As a result, the legislator adopted the *Law for the Extraordinary Administration for Companies with Systemic Importance for the Republic of Croatia*\(^ {72}\) (dubbed as “Lex Agrokor”).

This law introduced a new insolvency procedure for large companies in Croatia. It provided a workable moratorium on creditors’ actions, resulted in the appointment of an emergency management commissioner upon petition of a company that met the eligibility criteria and aimed at rescuing the distressed business. Additionally, it provided protection for new financing.

While it is not demonstrated that the *Abengoa* and *Agrokor* debt-for-equity swaps and turnaround plans will succeed, these cases prove that rescue

---

\(^{71}\) *Agrokor* was a private group of companies which run its business primarily in Croatia. The company had a turnover of $6 billion, 15 per cent of Croatia’s GDP. Despite being incorporated in the Croatian state, it directly employed 60,000 people in Croatia and in other Balkan countries such as Slovenia, Bosnia and Serbia.

\(^{72}\) Official Gazette of the Republic of Croatia nr. 32/2017, 6 April 2017.
procedures can be used to preserve the going-concern value of distressed debtors. These proceedings can ameliorate the allocative issues in cross-border cases and promote (re)distributive policies, even for the benefit of the old equity-holders.

Formal, procedural insolvency mechanisms may prove insufficient or ill-suited to achieve the same results. These considerations do not apply only to large corporations. Take, for instance, the case of a “human capital firm” in which the company and the person running it are indistinguishable. Proceduralist theorists would argue that there is equally no need to undertake a procedure designed to rescue the company. However, it is difficult to see how an auction-based procedure could maximise the value of a company that has no marketable asset.

The goal of a proceduralist system should be to facilitate the distressed debtor to leave an unsuccessful entrepreneurial experience behind and start afresh, possibly in the same field. A person who has been an electrician or a travel agent for all their lives is likely to continue to work in the same field, provided that there is still a market for its expertise and skills.

Because proceduralists assume that what debtors need is either to wind-up a company or to sell the profitable portion of their business for the satisfaction of their creditors, insolvency law should be primarily procedural. However, if these entrepreneurs want to start afresh, they may benefit from the retention of the network of suppliers and clients that they developed in their previous, unsuccessful business experience.

While rescuing these businesses may raise concerns over “phoenix trading”, it also offers some continuity for both suppliers and employees and – when restricted to MSMEs – it raises minimum competition concerns. It is not

---

73 Baird (n 67) 87.
74 Ibid. The author reached this conclusion after having studied the data from ninety-nine Chapter 11 cases filed in 1999 in the Bankruptcy Court for the Northern District of Illinois, Eastern Division.
75 According to a briefing paper edited by Lorraine Conway for the House of Commons, Phoenix Trading and Liability of Directors (No. CPB 4083, 28 March 2017), phoenix trading occurs when ‘the assets of an insolvent business are re-acquired (often at less than their full value) by its former directors (or closely connected parties) who then set-up a new company involved in the same or similar business’, 3.
surprising, therefore, that legislators did not prevent this practice altogether. On the contrary, they only opted to introduce procedural and substantive safeguards – sometimes by means of soft law instruments – for the sales of businesses in pre-pack insolvencies.\footnote{For instance, in England s.216 IA 1986 aims at protecting the public from being misled into dealing with the new business which operated in the old premises and with the same or a similar name than the failed company. Additionally, despite being applicable on a voluntary basis, insolvency practitioners usually follow the guidelines included in the SIP 16, which provides some additional checks and controls in pre-pack procedures.}

Leaving aside the frequently voiced concern that auctions are incapable of generating accurate value for distressed corporations,\footnote{However, some authors observed that '[c]ompetition leads to decent (though not perfect) pricing [and that] in any contest of real prices (in auctions) against hypothetical prices (in courts), real prices will be more accurate': FH Easterbrook, 'Is Corporate Bankruptcy Efficient?' (1990) 27 J. Financ. Econ. 411, 413.} a concluding remark might be that the evolution of the industry and the financial sector puts some pressure on “traditional” statutory rescue mechanisms. However, as highlighted by other commentators, this circumstance does not ‘signal the end of its old uses, that corporate reorganizations no longer exist’.\footnote{AM Dickerson, 'The Many Faces of Chapter 11: A Reply to Professor Baird' (2004) 12 Am. Bankr. Inst. L. Rev. 109, 109.}

This sub-section has demonstrated that the use of procedural remedies underestimates the complexities of business practice and ignores the (re)distributive implications that arise from business failure. It is to be determined, however, if procedural remedies designed to cope with (re)distributive issues are capable of providing satisfactory and comprehensive solutions to corporate failures. This will be the purpose of the following sub-section.

\subsection*{3.2(a)(ii) Auction-Based Insolvencies with (Re)Distributive Implications}

Can parties use formal bankruptcy procedures that do not affect the nature of their contractual rights to address (re)distributive issues? This theory, advocated by Shanker and Adler (section 3.2) has been recently tested in the Chrysler case.\footnote{By common account, Chrysler has been an exceptional case, hence it might be inappropriate to draw general conclusions on the validity of procedural remedies from this case: see, among others, MJ Roe and Joo-Hee Chung, 'How the Chrysler Reorganization Differed from Prior Practice' (2013) 5(2) J. Legal Analysis 399.}
When Chrysler faced liquidation at the end of 2008, the U.S. government clarified that it would have backed a rescue of the company only if its management was able to conceive a long-term solution with reasonable probability of success.  

Unlike the Agrokor (2017) or Parmalat (2005) cases, there was no support in Capitol Hill for a bail-out or legislative intervention tailored to the needs of the automotive industry. Additionally, the government stated that any new funds would have been granted at market rate. The government agreed to act as a reluctant lender only due to the dire state of the U.S. financial system, which was dealing with the systemic consequences of the collapses of Lehman Brothers, Fannie Mae and Freddie Mac.

In this context, it appeared from as early as the beginning of 2009 that Chrysler had only two options: 1) a Chapter 7 liquidation of its assets; or 2) a §363(b) sale of all or substantially all the company under Chapter 11 of the U.S. Bankruptcy Code. A lengthy Chapter 11 reorganisation procedure would not have been feasible due to two main reasons: lack of funds and the opinion –

---

This author, however, shares Baird’s view that this perception is wrong. Chrysler (and GM) reorganisations were not significantly affected by the government’s intervention as they followed a pattern substantially similar to other large reorganisations occurred in recent years: BA Berringer, “‘It’s All just a Little Bit of History Repeating’: An Examination of Chrysler and GM Bankruptcies and their Implications for Future Chapter 11 Reorganizations’ (2010) 7 N.Y.U. J. L. & Bus. 361 (arguing at 363 that Chrysler is part of an established line of cases that date back to nineteen century equity receiverships where influential creditors and managers take control of the procedure, and the government is unable to protect the interests of less powerful creditors); DG Baird, ‘Car Trouble’ (John M. Olin Program in Law and Economics Working Paper No. 551, 2011); DG Baird, ‘Lessons from the Automobile Reorganizations’ (2012) 4(1) J. Legal Analysis 271.

On the same line of thinking, see also: SJ Lubben, ‘No Big Deal: The GM and Chrysler cases in Context’ (2009) 83(4) Am. Bankr. L.J. 531 (maintaining that ‘the bankruptcy academics’ criticism of the automotive bankruptcy cases does not stand up to careful scrutiny’, at 547); ER Morrison, ‘Chrysler, GM, and the Future of Chapter 11’ (Columbia University School of Law, Working Paper No. 365, 2009), arguing that GM and Chrysler are ‘cautionary tales about Chapter 11, not about government intervention’, at 1.

80 The Obama Administration’s valuations were supported by the findings and work of the Automotive Task Force, an ad hoc group of United States cabinet-level and other officials that was formed in February 2009 to deal with the financial bailout of automakers Chrysler and GM.

81 §363(b) 11 U.S.C. authorizes a debtor to sell any or all its assets shortly after the filing for insolvency. Upon request of the debtor, the court shall grant approval after notice and a hearing. Usually, the debtor files for insolvency after having agreed (i.e. pre-negotiated) the conditions for the sale of the company or substantially all of its assets to a “stalking horse”. The court’s approval usually includes the terms and conditions for presenting competing bids. The issues raised by §363(b) sales are the same as pre-package reorganisations: lack of transparency and risk of abusive behaviour by the leading creditors and the existing management. However, they are generally praised as a fast, efficient and reasonably inexpensive mechanism to restructure a distressed business.
shared by the majority of commentators – that *Chrysler* was too small and too U.S.-centred to survive as an autonomous automaker.82

In the United States, thanks to the strict observance of the APR (see below sub-section 3.2(a)(iii)) and to the procedural nature of §363(b) sales, the *Chrysler* old stakeholders should have figured out with reasonable certainty the outcome of the insolvency procedure during the pre-insolvency negotiation phase. Creditors should have predicted that, if a buyer was found, consideration would have been paid and distributed in satisfaction of the old creditors and pursuant to the APR. The capital structure of the new company would have mirrored this agreement, with its ownership being distributed to the buyer and the institutional creditors of the old company. While it would not had been possible to determine in advance the debt-to-equity ratio, the stakeholders expected that no voting and ownership rights would have been recognised to existing shareholders as they were “out of money”.83 *Chrysler* therefore was a perfect case to test if stakeholders considered the procedural remedies provided by the law as adequate and if they relied on them to sort out their (re)distributive issues.

Procedural rules, however, largely ignore the side effects that their implementation has on the communities and on certain categories of unsecured creditors such as employees, pension and health funds.

However, for a company like *Chrysler* to survive, it was essential to retain a motivated, efficient and cost-effective (albeit leaner) workforce as well as a network of dealers. If the payments towards the “strategic” employees and dealers were not kept current, the company would have lost all of its going concern value.

82 Against: DA Skeel, Jr., ‘Competing Narratives in Corporate Bankruptcy: Debtor in Control vs. No Time to Spare’ (2009) Mich. St. L. Rev. 1187, according to whom *Chrysler* and in particular *General Motors* were obvious candidates for a debtor-in-control treatment, as opposed to the *Lehman Brothers* case (which, in the opinion of the author, was a ‘true’ no-time-to-spare case).
83 At the time, *Chrysler* was controlled by the private investment company Cerberus Capital Management which, along with other investors, purchased a majority stake in 2007. It was not a family-run company and there were little reasons to suggest that either the preservation of the current management or the recognition of a minority share to the current owners would have increased the chances of success of the ‘rescued’ company.
As a result of these conflicting interests and the inability of the law to force parties to agree on an acceptable solution outside a formal insolvency mechanism, Chrysler filed for Chapter 11 protection on 30 April 2009, after having negotiated a memorandum of agreement with a potential bidder, Fiat S.p.A.

Due to the circumstances of the case, the Bankruptcy Court of the Southern District of New York was willing to recognise restrictive covenants against competing bids. As a result, some of the assets of the old Chrysler were sold to a newco for $2 billion, a remarkably low figure for the number of properties, IP rights and trademarks that were being transferred. More strikingly, however, the newco was not formed by the new bidder and the old creditors, as a “traditional” debt-for-equity swap would have suggested. On the contrary, new Chrysler agreed to assume $5.3 billion on trade debt (thus preferring these unsecured creditors to secured ones) and to recognise a 55 per cent share of the newco, as well as a $4.6 billion note to Chrysler retirees for their healthcare needs.

84 Re Chrysler Llc, 405 B.R. 84 (Bankr. S.D.N.Y. 2009).
85 One of the issues in Chrysler (and GM) bankruptcy cases was whether they presented illegal sub rosa plans, i.e. de facto rescue plans designed to scheme around the statutory protections afforded to creditors pursuant to s.1129 of the Bankruptcy Code. This claim has been rejected by the courts, and it has been extensively debated in other articles: R Brubaker, ‘The Chrysler and GM Sales: § 363 Plans of Reorganization?’ (Sept. 2009) 20 Bankr. L. Letter No. 9 (who concluded that it was not a sub rosa plan); Lubben (n 79) (equally against the sub rosa theory); BE Adler, ‘A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors’ (2010) 18 Am. Bankr. Inst. L. Rev. 305; M Roe and DA Skeel, Jr., ‘Assessing the Chrysler Bankruptcy’ (2010) 108 Mich. L. Rev. 727 (both in favour of the sub rosa explanation). This debate however falls outside the scope of this thesis.

86 For a more critical explanation of the strict covenants, see Adler (n 85) according to whom ‘[t]he sale restrictions served the government’s desire to assure continuation of the company and to protect the union’s interest, but it is not apparent that the sale was designed to maximise the return to the bankruptcy estate’, at 308. Unfortunately, this statement is not supported by evidence. Additionally, while it may be true that the sale was not designed to maximise the return to the estate, other commentators argued that it was designed to enhance the return to all stakeholders and to minimise the impact on the communities and the society at large: Skeel (n 82); AJ Warburton, ‘Understanding the Bankruptcies of Chrysler and General Motors: A Primer’ (2009) 60 Syracuse L. Rev. 531; R Brubaker and CJ Tabb, ‘Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM’ (2010) 5 U. Ill. L. Rev. 1375; SMD Solomon, ‘Uncomfortable Embrace: Federal Corporate Ownership in the Midst of the Financial Crisis’ (2011) 95 Minn. L. Rev. 1733; K Korres, ‘Bankrupting Bankruptcy: Circumventing Chapter 11 Protections Through Manipulation of the Business Justification Standard in § 363 Asset Sales, and a Refined Standard to Safeguard Against Abuse’ (2011) 63 Fla. L. Rev. 959; M Kahan and EB Rock, ‘When the Government is the Controlling Stakeholder’ (2011) Faculty Scholarship Paper 316 <https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=1315&context=faculty_scholarship> accessed 17 September 2018.
benefits. In other words, ‘a judge approved a transfer of a debtor’s assets to favoured creditors under circumstances where holders of other claims were denied basic safeguards’. The Chrysler case therefore proves that procedural remedies are neither apt to force parties to negotiate out-of-court restructurings, nor sufficient in themselves to address the (re)distributive issues arising in these cases. Some commentators observed that the Chrysler (and GM) cases ‘foretell [...] the literal death of the fundamental distributive principles that are the essence of bankruptcy law and that have been the bedrock of bankruptcy reorganizations for at least a century’. The case of Detroit reported at the beginning of this chapter is another example of this trend.

A creditor-driven liquidation would have potentially resulted in marginally higher returns for secured creditors, but only at a high price for the U.S. economy, its industry and workers.

Chapter 11 proposals may fail to guide the choice of the parties affected by the debtor’s insolvency. Nevertheless, deviations from proceduralist tenets have been encountered in practice because these theories fail to properly consider the most relevant interests of the parties affected by the debtor’s insolvency.

---

87 Roe Skeel (n 85) 733.
88 Adler (n 85) arguing that the sale of Chrysler was irregular and inconsistent with the principles that undergird the U.S. Bankruptcy Code.
89 Brubaker and Tabb (n 86) 1376. The authors, in particular, criticised the implications of the GM insolvency procedure. Against this analysis: Berringer (n 79).
90 According to the Automotive Task Force, the costs of liquidating the automakers would have been greater than providing assistance (at autonomy-based terms). See SL Rattner, Overhaul: An Insider Account of the Obama Administration’s Emergency Rescue of the Auto Industry (HMH Publishing Company: Boston, 2010).
91 This same conclusion has prompted some authors to propose amendments to §363(b) sales to avoid what they define the “ice cube bluff”, i.e. the false or exaggerated claim that the company is on the brink of dissolution and that it needs a fire sale to rescue its business - see MB Jacoby and EJ Janger, ‘Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy’ (2014) Yale L.J. 862.
3.2(a)(iii) More on Proceduralist Insolvencies

Beside substantially liquid markets and competitive (and cheap) auctions, procedural-based solutions to financial and economic distress require a strict observance of the absolute priority rule (‘APR’).\(^2\) Under its application, insolvency practitioners or debtors-in-possession (‘DIP’) are prevented from distributing money to a class of lower-priority creditors or shareholders before higher-priority classes are paid in full.

Stringent compliance with the APR at best does not encourage the participation from shareholders, who have usually nothing to gain from the insolvency procedure. At worst, it may result in blocking or delaying practices aimed at obtaining some consideration from the other stakeholders.

As a result, pre-pack sales, debt-for-equity swaps and schemes of arrangement are usually employed to secure shareholders’ cooperation, which is sometimes required to ensure the success of the turnaround.\(^3\) The rescue of the British Energy Group in 2004 proves the advantages in proceeding with such a scheme, as well as the

---

\(^2\) The APR prevents direct or indirect distribution of proceeds to junior claimants if seniors are not fully paid. In the United States, if was first recognized by the Supreme Court in Case v Los Angeles Lumber Products Co. Ltd., 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939), when it was held that such a rule is a corollary of any "fair and equitable" plan. Congress in 1978 incorporated the notion in the U.S. Code. As for today, §.1129(b)(2)(B)(ii) precludes a holder of a junior claim or interest, such as an existing equity holder, from receiving any distribution under a non-consensual Chapter 11 plan on account of its claim or interest, unless all objecting senior creditors are paid in full.

\(^3\) Not only shareholders’ support may ensure that goodwill is preserved and costs and time of the procedure are reduced to a minimum. Shareholders may be key suppliers, part of the existing management team, or key employees. Additionally, they may be among the few people willing to invest in the ailing business. Accordingly, ensuring their cooperation is in the interest of all parties involved in the turnaround process.

---

**THE CASE OF BRITISH ENERGY**

British Energy, the then largest electricity generation company in the U.K., entered into financial difficulties in 2002 due to a slump in wholesale energy prices, a failure to obtain relaxations on the Climate Change Levy and renegotiations of its back-end fuel costs with BNFL, as well as issues with a number of its reactors.

At that time, the company approached the government for financial aid. However, the government conditioned its support to the agreement on a consensual rescue plan.

To secure the approval from bondholders, creditors and shareholders, the company negotiated a “Creditor Restructuring Agreement” which granted to existing creditors 97.5% of shares in the restructured company. However, to secure old shareholders’ approval, they were to receive 2.5% of the issued share capital in the new company, with warrants to subscribe for further new shares equal to 5%. This despite senior creditors’ contributions had not been paid in full.
propensity of English players to accept a breach to the absolute priority principle if that appears for the good of the company or the business.

However, not even in the United States is servile adherence to the absolute priority standard recognized either by the law\textsuperscript{94} or by the judiciary.\textsuperscript{95} Serious criticisms have been raised to its most rigid interpretation in the academic context. Some scholars demonstrated that it may be in the interest of bondholders themselves to sidestep a rigid application of this rule.\textsuperscript{96}

As for the law, in the United States proponents of a reorganisation plan are required to honour the APR only with respect to classes that voted against the plan.\textsuperscript{97} Furthermore, the judiciary has recently approved “rescue” plans where this obligation has been displaced (\textit{Chrysler}: see above 3.2(a)(ii)). Finally, empirical evidence demonstrates that - on certain occasions - senior creditors agreed on reorganisation plans, which included more beneficial payments to junior creditors than the strict observance of the APR would have implied. This is because the creditors had the legitimate impression that courts would have approved the reorganisation plan despite their opposition (\textit{Detroit}: see below 5.4(c)).

Detrimental for the absolute priority paradigm is the widespread recognition of ‘new-value’ exceptions, a judicially developed exemption to the APR paradigm.

\textsuperscript{94} Substantially all insolvency systems recognize a preferential treatment to selected creditors only during formal insolvency proceedings.

\textsuperscript{95} For instance, in \textit{Re Global Garden Products Italy S.p.A.} [2016] EWHC 1884 (Ch), [2017] BCC 637 Snowden J sanctioned a scheme of arrangement - which is not even, technically, a formal insolvency procedure - for an Italian incorporated and domiciled company where only 76.34\% by value of all scheme creditors entitled to vote approved the plan. This despite the objection of dissenting creditors, according to whom the circumstance that some creditors received either “work fees” or “co-ordination fees” should have recommended their inclusion in a different class. The Court revisited the issue of consent fees or other inducements to creditors to vote in favour of a scheme and confirmed that, provided that such fees are disclosed, offered to all relevant creditors and not so large as to influence a vote in a particular manner, there is nothing objectionable in them: \textit{Re Public-Joint Stock Company Commercial Bank “PrivatBank”} [2015] EWHC 3299, [2015] WL 6966229 followed. In this case, co-ordination fees were set at €22,500/month.

\textsuperscript{96} Daigle and Maloney demonstrated that such a solution would mitigate some of the agency costs, in particular when the assets of the distressed company are particularly “malleable”. Deviation from a strict interpretation of the APR would give bondholders the opportunity to share some of the benefits that would otherwise be privately assumed by the shareholders before filing for insolvency protection: KH Daigle and MT Maloney, ‘Residual Claims in Bankruptcy: An Agency Theory Explanation’ (Apr. 1994) 37(1) J.L & Econ.157.

\textsuperscript{97} 11 U.S.C., §.1129(b).
In the U.S., for instance, debtor’s shareholders are permitted to retain an interest in the newco even though senior creditors (essentially, all creditors) are not paid in full and even if one class of them has voted against the plan.

The thresholds for the recognition of these new-value exceptions are extremely narrow. In *Bonner Mall*, the 9th Circuit held that, for the old equity holders to retain a share in the new company, five requirements had to be met. Particularly, the added value shall be ‘1) new, 2) substantial, 3) money or money’s worth, 4) necessary for a successful reorganization and 5) reasonably equivalent to the value or interest received’.

The Supreme Court adopted a similar conclusion in *Ahlers* and it expanded it in *203 North LaSalle*. In both cases, the Supreme Court rejected the debtor’s request for the recognition of the new value exception. However, it further specified the requirements needed to judge in favour of the existence of such an exception. In other words, if the debtor promises to contribute with something else than simple labour and if other parties are given the opportunity to contribute, such an exception may apply.

Bankruptcy courts, however, have adopted a cautious approach in recognizing new-value exceptions. For instance, in *Re Castleton Plaza LP*, the 7th Circuit reversed a first instance decision and held that where an insider proposed a new-value exception (because all the shares of the reorganised company would have been allocated to the wife of the debtor), competitive bidding through an auction process was essential. In *NNN Parkway* the bankruptcy court of the Central District of California held that courts must evaluate on a case-by-case basis whether there has been sufficient “market testing” of the new value that equity holders propose to contribute in exchange for retention of their interests.

---

98 *Bonner Mall Partnership v U.S. Bancorp Mortgage Co. (Re Bonner Mall Partnership)*, 2 F.3d 899, 911 (9th Cir. 1993).
100 *Bank of America National Trust Savings Association v 203 North LaSalle Street Partnership*, 119 S.Ct. 1411 (1999), where Justice Souter held that debtor’s pre-bankruptcy equity holders could not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in reorganised entity if other senior creditors were not allowed to compete for that equity or to propose competing reorganisation plans.
101 *Re Castleton Plaza, LP*, 707 F.3d 821 (7th Cir. 2013).
in the reorganised Chapter 11 debtor. Finally, in *Iridium*\textsuperscript{103} the 2\textsuperscript{nd} Circuit recognised that one of its most fundamental duties was to assess whether a pre-plan settlement's distribution plan complied with the Bankruptcy Code's priority scheme. Nevertheless, to consider whether the settlement is “fair and equitable”, the court, in its discretion, can endorse a settlement that does not comply in some minor respects with the priority rule where the remaining factors weigh heavily in favour of approving a settlement.

Similarly, in cases where the exception had been recognised (such as *Red Mountain*\textsuperscript{104}), the bankruptcy court carried out an extensive factual investigation on the circumstances of the case and the *real and tangible* existence of these criteria.

In the recent decision in *Czyzewski v. Jevic Holding Corp.*\textsuperscript{105} the Supreme Court, despite reversing the lower court decisions to approve a rescue plan that was not fully compliant with the APR, reinstated that courts have the discretion under §.349(b) 11 U.S.C. to make such orders *for cause*, i.e. to protect reliance interests.\textsuperscript{106} Other reasons include preserving the debtor as a going concern, to ensure that the disfavoured creditors are better off, to promote the possibility of a confirmable plan, or to help restore the *status quo ante*.

The reliance on the APR in debtor-friendly

---

\textsuperscript{103} *Re Iridium Operating, Llc*, 478 F.3d 452 (2d. Cir. 2007).


\textsuperscript{106} The Supreme Court ruled against the validity of the rescue plan as approved by the lower courts because it resulted in general end-of-case distributions that would be impermissible in a Chapter 11 plan or a Chapter 7 liquidation. The Supreme Court reasoned that the parties did not prove the existence of a rare case exception, which would have allowed the court to disregard priority in structured dismissals for “sufficient reasons”.

---

*Jevic* file for Chapter 11 after having been purchased in a leverage buyout. The case was dismissed under §.1112(b). While the dismissal should have restored the *status quo ante*, courts can depart from this rule for cause (§.349(b), structured dismissal).

---

*Czyzewski v Jevic Holding Corp.*

*Jevic*’s drivers have been awarded a judgment for violation of state and federal *Worker Adjustment and Retraining Notification (WARN)* Act. Part of that judgment counted as a priority claim. However, the structured dismissal proposed by the debtor and approved by the bankruptcy court and the 3\textsuperscript{rd} Circuit left the drivers entirely out of money, while lower-priority general unsecured creditors would have been paid.

The Supreme Court reversed the afore-mentioned decision for their failure to apply the APR.
jurisdictions gives secured lenders - especially in single asset real estate cases - significant leverage to maximise recoveries. It also protects general unsecured creditors from pre-pack plans agreed by a portion of (usually secured and sophisticated) creditors and the directors of the ailing company, whenever they would result in reducing the return to which they would be entitled in either a liquidation or a formal rescue procedure. Hence, the rule is generally being followed.

Nevertheless, the recent decisions on the scope and admissibility of exceptions to the APR, as well as the recent trends in §363(b) sales described in sub-section 3.2(a)(ii) represent remarkable developments. It appears, therefore that procedural, auction-based solutions continue to play a role primarily in those formal proceedings where allocative issues are primarily at stake.

In England, parties favour negotiated solutions over proceduralist approaches to rescue. It seems therefore that, both in England and the U.S., courts are keen on approving turnaround deals which include limited exceptions to statutory priority rules if this appeared to be in the best interest of the stakeholders as a whole.

3.2(b) Procedural Coordination in Cross-Border Insolvencies

To overcome the territorial constraints imposed by domestic insolvency rules, parties developed cross-border insolvency protocols ('CBIPs').

Conceived before the enactment of the UNCITRAL Model Law, this ad hoc approach involves negotiating an agreement that must be approved by all courts having jurisdiction over the debtor and its assets in order to coordinate the concurrent cases commenced under domestic procedures. This agreement would also allocate some, but not all, authority over issues between the courts involved in the cross-border case.107 One of the first significant cases that successfully implemented a CBIP was the Maxwell Communications Corporation ('M.C.C.') insolvency procedure in the late Nineties.108

M.C.C. was a British based and incorporated company. Its principal creditors were British institutional lenders, but the majority of its assets were in the United States, in the form of several subsidiary companies. When the company sought for insolvency protection, an administration was opened in England and a Chapter 11 procedure in the U.S.

Because of the allocative issues raised by this case, the U.S. bankruptcy judge appointed an examiner (Richard Gitlin) with the duty to cooperate with the English administrators.

The American examiner and the English administrators cooperated in accordance with a document called the ‘Protocol’. This allowed the parties to come up with a comprehensive distribution plan, rather than carving up assets for the satisfaction of local creditors. The Protocol succeeded in reducing delays and duplications of efforts and the distribution plan was approved by the vast majority of the creditors,109 despite differences in the statutory priorities recognized by the applicable insolvency laws. It is not surprising, therefore, that commentators largely praised the results of this case110 and that the scheme has been subsequently adopted in procedures with comparable characteristics.

This success story seems to suggest that, at least with reference to cross-border cases involving mainly sophisticated creditors and allocative TCP problems, parties are better placed than the legislator to guide the insolvency process. Proceduralist solutions subject to international guidelines111 may therefore represent appropriate mechanisms to deal with corporate distress.

---

109 In the U.S., the plan was approved by 99.3% in number and 99.98% in value of unsecured creditors, while in England holders of 99.3% in number and 99.7% in amount of the claims voted to accept the scheme.


111 IF Fletcher and B Wessels, Transnational Insolvency: Global Principles for Cooperation in International Insolvency Cases. Report to ALI (30 March 2012), edited by the American Law Institute and the International Insolvency Institute.
Additionally, this *ad hoc* approach is not new. The first of such approaches dates back to 1302, when Pope Boniface VIII intervened to compel parties to an ordinary distribution of assets in the *Ammanati* affair\(^ {112}\) (described in the box).

Other cases further confirmed this conclusion,\(^ {113}\) but there have also been significant exceptions. In the *Felixstowe* case,\(^ {114}\) for instance, at the request of an English creditor, the English court refused to transfer the assets of the debtor to the United States, where a Chapter 11 procedure had been commenced.

While in an academic commentary, Lord Hoffman tried to single out the *Felixstowe* case on the basis that no insolvency proceedings were opened in the secondary jurisdiction (England),\(^ {115}\) in more recent times there has been no shortage of cross-border procedures where the *ad hoc* cooperation approach has proven wanting, even if parties were asked to deal primarily with allocative issues (see the *O.W. Bunker* affair, described in sub-sections 2.3(a) and 5.3(d)).

---


\(^ {113}\) Among others: *Re Axona International Credit & Commerce Ltd*, 88 BR 597 (Bankr. S.D. N.Y. 1988) - the liquidation case involving the U.S. assets of Axona, which was simultaneously being wound up in Hong Kong; *Re Olympia & York Devs. Ltd* [1993] 12 O.R.3d 500 - the world’s largest privately-held real estate developer, filed for insolvency protection in Canada, the U.S. and England in May 1992; *L.J. Hooker Corporation*, Inc., a real estate and mortgage broker maintaining offices in Tampa, Orlando and Miami, Florida which filed for bankruptcy protection (Chapter 11) in the Southern District of New York on 8 February 1990; and the *Bank of Credit and Commerce International* case.


\(^ {115}\) Hence the impossibility of ensuring adequate protection to English creditors: Hoffman (n 110) 2517.
The most notorious of these cases is *Nortel Networks Ltd*. In January 2009, following the insolvency of the parent company in Canada, all its subsidiaries filed for insolvency protection in the United States, United Kingdom and France. Because of the different rights recognised under commercial and insolvency law to some of the claimants, several issues emerged on the allocation and distribution of the proceeds from the sale of the insolvent estate.

Parties in the *Nortel* international litigation were mainly sophisticated, institutional lenders. Because of the gridlock in court litigation, in June 2011, Justice Geoffrey B. Morawetz of the Ontario Superior Court and Hon. Kevin Gross of the U.S. Bankruptcy Court of Delaware ordered parties to seek mediation regarding the division of Nortel’s assets.

The first mediation - under the supervision of Hon. Warren K. Winkler, Chief Justice of Ontario - lasted between April 2012 and January 2013, with no tangible result. Two further rounds of mediation were equally unsuccessful. Only on 12 October 2016 (seven years and a half after the first filing), parties managed to reach an agreement to divide up the $7.3 billion raised from liquidating the failed telecoms company, until then held in a “lockbox”. A result that was facilitated by the decision of the American and Canadian judge to authorize a cross-border trial to resolve competing claims to the same property. Duration aside, such an agreement was very costly paid: professional fees globally for the *Nortel* case have exceeded $2 billion, according to recent estimates.

---

116 *Re Nortel Networks, Inc.*, 2009 CarswellOnt 236. While being incorporated in Canada, the parent company and some of its subsidiaries first filed for Chapter 11 in the United States to benefit from the automatic stay. They then brought an application in front of the Ontario court pursuant to s.18.6 of Companies’ Creditors Arrangement Act demanding the recognition of the Chapter 11 case as a “foreign proceeding”. This would have given effect in Canada to the automatic stay of proceedings granted to Chapter 11 applicants. The application was granted on 14 January 2009.

117 Major claimants were U.S., Canadian and E.M.E.A. estates, U.S. bondholders, U.S. and Canadian unsecured creditors’ committees, U.K. pension interests and Canadian trustee.


120 *Global Turnaround*: October 2016, Issue 201.
Once again, these cases prove that, even in cross-border cases which involve mainly sophisticated parties and raise primarily allocative issues, the existence of a proceduralist system with widely accepted global principles for cooperation is not sufficient in itself to ensure that parties act in their collective best interest.

3.3 **Normative, Efficiency and Fairness Considerations**

This section evaluates the desirability of proceduralist approaches in insolvency by testing their theoretical soundness and their compatibility with the pragmatic benchmarks adopted in this study.

From a normative standpoint, major concerns have been voiced about the fact that proceduralist visions seem to assume that insolvency law is primarily a debt collection mechanism for the benefit of contractual creditors. Equally, the claim that creditors’ wealth maximisation is or should be the only legitimate goal of insolvency is contentious. Such an approach would fail to consider the claims of a wide variety of stakeholders impacted by the failure of the debtor\(^{121}\) and which are examined below in sub-section 4.3(c).

From a pragmatic standpoint, it is first necessary to determine the distinctive features of proceduralist solutions in insolvency law:

1. **Faith in the Procedure.** Insolvency procedures are determined *ex-ante* and written in the law. Whenever an insolvency procedure is triggered, the role of the judiciary is simply to supervise the process, not to facilitate the achievement of a particular goal. It is up to the parties in interest to draft a rescue or liquidation plan on the basis of their pre-insolvency entitlements. Courts and other professionals with supervisory powers

---

\(^{121}\) For a summary of the most controversial theoretical criticisms raised by proceduralist theories in general, and creditors’ wealth maximisation visions in particular: Warren (n 36); DR Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1992) 71 Tex. L. Rev. 541. In particular, Korobkin challenged these visions for their inability to recognise non-economic value aspects such as moral, political, social and personal considerations: DR Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 Col. L. Rev. 717, 762.
should refrain from intervening directly in the process. Their role is to check that the law is respected and that procedures are not abused;

2. Contractual Rules Rule. Several proceduralist authors (Shanker, Adler, Jackson, Baird) argued that rules that are valid only in insolvency can create tension. This is because they could give parties a perverse incentive to push their debtors into insolvency, for instance by recognising a priority status or management powers that would not have been recognised outside insolvency. To promote the chances of maximising creditors’ returns, the relative value of pre-insolvency rights should not be affected. If the distribution hierarchy in place before the opening of any insolvency proceedings was changed by insolvency rules, ‘the exchange of values that took place before the insolvency proceeding (e.g. the interest rate charged by the lender for the loan) would lose its foundation’.\textsuperscript{122} The creditor would be forced to renounce to the agreed benefit (e.g. priority or securitization of assets) without compensation for the reduced return on his investment;

3. Collectivity and Compulsory Nature of Insolvency. The enforcement of a collectivist approach is the pre-emptive condition for parties to agree on freezing or postponing their individual collection rights. According to the Cork Report, any proceedings are collective whenever parties cannot rely on individual remedies to enforce their claims.\textsuperscript{123} The proceduralist understanding of the concept of collectivity may prove difficult in its application in rescue proceedings, where the main concern is to ensure that the interests of the general body of creditors take precedence over the individual rights of some of the claimants.\textsuperscript{124}

The compulsory nature of insolvency law is a natural consequence of its collective attitude, since ‘to allow a debtor to contract with a creditor to


avoid participating in the bankruptcy proceeding would destroy the advantages of a collective system';

4. **Efficiency as Procedural and Substantive Goal.** Proceduralist remedies in insolvency are intrinsically procedural and substantively efficient because they represent the optimal mechanism to maximise creditors’ returns. Legislators are constantly challenged to test the efficiency of the existing rules;

5. **Pre-determined Exit Strategies.** Before the commencement of the case, all contractual parties have a reasonable expectation that, in case of financial difficulties, a pre-determined procedure will apply and that their contractual rights will be preserved;

6. **Equality Among Creditors.** Relationships among creditors are governed only by their pre-insolvency entitlements. As a result, junior creditors cannot possibly expect a partial or full payment of their claims if senior and secured creditors have not been paid in full (APR).

In light of these characteristics, it is therefore possible to assess if procedural-based remedies in insolvency are procedurally efficient and fair.

When it comes to **procedural efficiency**, similarly to what happens for autonomy-based alternatives to insolvency law, there is no explicit “barrier to entry”. This circumstance may favour strategic filings, especially by companies who are saddled with tort or extra-contractual liabilities and want to rescue or reorganise their business.

Mechanisms to prevent an abusive or strategic use of insolvency remedies are not **per se** incompatible with a proceduralist understanding of insolvency law. However, this would imply that judges are recognised discretionary and evaluative powers to assess the abusive or legitimate nature of the filing. This is likely to increase complexity, litigation and costs. Furthermore, such an assumption about the role of the judges is incompatible with one of the pillars of proceduralist theories. Hence it is likely that strategic or abusive use of insolvency law will not be curbed with the adoption of proceduralist stances.

---

125 Jackson (n 1) 17.
With reference to the other aspect of procedural efficiency, i.e. the treatment of parties in insolvency, proceduralist approaches seem straightforward and clear. Pre-insolvency entitlements are paramount: claimants take part in the rescue process or share the proceeds in the distribution phase only if they are not completely out of cash.

This apparently unambiguous picture is frequently ignored in practice. In considering the actuality and enforceability of the APR in insolvency cases, this thesis has proven that adherence to this paradigm can be detrimental to promoting the best possible return for creditors. However, parties and judges would be left without clear guidance on the best course of action if and when two of the fundamental pillars of proceduralist solutions (i.e. maximisation of creditors’ return and preservation of pre-insolvency entitlements) were to be in conflict. A case-by-case approach could not realistically be considered an acceptable solution to address a systemic shortcoming of this vision.

Moving to the analysis of procedural fairness, the de-constructivist approach has highlighted that protection of entrepreneurialism, shareholders’ return, market integrity and creditors’ expectations represent paramount concerns of the proceduralist understanding of insolvency law. As observed in the previous paragraphs, real case scenarios may force stakeholders to disregard part of the principles upon which these visions are based on, thus questioning their theoretical soundness.

In line with the premises of the proceduralist visions, the claims of vulnerable stakeholders are frequently ignored. However, proceduralist visions may also fail to achieve equality among contractual claimants, since some insiders may take advantage of undisclosed information and reduce their liabilities towards the debtor.

Finally, when it comes to the acceptability of proceduralist solutions, the most significant obstacle is represented by the need to disregard or otherwise severely restrict one of the pillars of current insolvency practice: the promotion of the rescue of viable businesses.
While nothing in the proposed frameworks suggests that proceduralist remedies should not be used to rescue viable companies or businesses, these proceedings are ill-designed to achieve rescue outcomes. Even when the insolvency case is reduced to a fire-sale of the business, it may be necessary to recognise additional protection and consideration to certain categories of out-of-money creditors whose participation is essential for the success of the turnaround efforts. Purely proceduralist mechanisms, however, would fail to accept the legality of these solutions, because they would be seen as infringing on the pillars upon which these visions of insolvency law are based.

3.4 CONCLUDING REMARKS

It is no coincidence that in recent times some of the successful auctions occurred under the hat of procedural and substantive insolvency protection.

If the above-mentioned insolvency cases were simply about swapping debt for equity or selling potentially profitable assets, it would be possible to concur with the proponents of a proceduralist approach to insolvency law. Under that taxonomy, insolvency law would not add anything to already viable and efficient private remedies and should simply determine the framework under which these sales should occur.

However, the examples discussed in this chapter demonstrate that not all complexities can be dealt with the support of a proceduralist framework. Parties have deliberately chosen insolvency law to perform these “sales” because it would allow them to restructure not simply their books, but also their relations with suppliers, traders and competitors. In other words, it is thanks to the substantive reorganisation and the renegotiation powers recognized in the insolvency arena that the relevant stakeholders either accomplished a “fire sale” of their assets and business or agreed on the distribution of the insolvency proceeds.

Finally, it is worth keeping in mind that while auctions are an efficient insolvency procedure capable - in themselves - of achieving ex-post efficiency,
they may not necessarily achieve revenue efficiency, i.e. the attempt to maximise the proceeds to the creditors from the insolvency procedure.\textsuperscript{126}

So far, practice has proven that - despite the use of innovative mechanisms, such as pre-pack sales - insolvency law performs a function that cannot be accomplished by other branches of law. Insolvency law is not simply about protecting contractual rights,\textsuperscript{127} therefore it cannot be restricted to a set of procedural rules that minimize bureaucratic costs and maximise the allocation of proceeds among claimants.

This chapter has also proven that proceduralist theories may not withstand comprehensive normative criticism. Furthermore, their implementation raises concerns with reference to procedural efficiency and fairness and their acceptability by society at large.

At the same time, the value of proceduralist approaches should not be dismissed. Proceduralist thinking and the cases mentioned in this chapter highlight that markets value a system of insolvency rules capable of promoting an efficient management and ensuring a predictable outcome of corporate rescue or liquidation cases.

The following chapter investigates if principle-informed approaches can address some of the criticisms highlighted in this chapter with reference to procedural-based remedies in insolvency, while promoting the values that procedural and autonomy-based theorists have advocated.


\textsuperscript{127} For instance, with reference to the U.S. Chapter 11, during the debate which led to the enactment of the 1978 Act, it was observed that ‘[t]he purpose of a business reorganization case, unlike a liquidation case, is to restructure its finances so that it may continue to operate, provide employees with jobs, pay its creditors, and produce return for its stockholders’ H.R. Rep. No. 598, at 607 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.
**CHAPTER 4 - THE LIMITS OF INSOLVENCY LAW IN PRINCIPLE-BASED FRAMEWORKS**

«If thou lend money to any of My people, even to the poor with thee, thou shalt not be to him as a creditor; neither shall ye lay upon him interest» [Exodus 22:24 (25)]

«Let no debt remain outstanding, except the continuing debt to love one another, for whoever loves others has fulfilled the law» [Romans 13:8]

4.1 INTRODUCTION

The previous chapter has introduced the proceduralist conceptualisations on the scope and purpose of insolvency law. It maintained that the major contribution of these theories to the discussion on the limits of insolvency law has been to reinstate the centrality of legal predictability in the insolvency debate.

At the same time, proceduralist theories argued for restricting the scope of insolvency law to the protection of contractual rights, in line with the economic libertarian and neo-classical\(^1\) tradition. As a result, they failed to withstand normative criticism\(^2\) based on the criteria of procedural efficiency and fairness. The idea that liquidation contributes to making the economic system more efficient by expelling from the market unviable businesses has never been seriously plausible.\(^3\)

The recognition that substantive insolvency policies could not rely only on procedural tenets brought some commentators to conceive principle-based theories. These commentators - collectively known as *traditionalists* or

---


\(^2\) Chapter three has argued that the theoretical underpinnings of proceduralist models fail to withstand a value-bereft scrutiny.

communitarians⁴ - argue that insolvency law should pursue an autonomous set of rules and principles, capable of treating with fairness and justice the honest but unfortunate debtors who are no longer capable of paying their debts as they fall due. Multi-value visions⁵ have been encouraged by those scholars who tried to incorporate communitarian approaches and distributive rationales. This progressive group of scholars, who played a significant influence in shaping U.S. corporate insolvency law,⁶ argue that the role of corporate insolvency law should be to steer away creditors from sale and distribution of assets to a “new bargain”.⁷ Their arguments gave rise to what this thesis calls “principle-based theories”⁸

This chapter is concerned with the de-constructing⁹ the main principle-based theories to assess the guidance that these theories can provide to determine when insolvency rules should replace the general law of contract to determine the substantive and procedural rights of claimants against companies in distress.

20 April 2010: U.S. Exclusive Economic Zone, Gulf of Mexico.

On that day, the Deepwater Horizon, a 10-year-old drilling rig owned by Transocean and chartered to British Petroleum (‘BP’), exploded and sank. This major incident resulted in the loss of life of eleven people working on the drill and on the largest spill of oil in the history of marine oil drilling operations.¹⁰ It

⁸ For a general definition of principle-based theories, see above section 1.2, ftn 35.
⁹ See footnote 32, chapter one.
is estimated that around 4.9 million barrels of oil flowed from the rig site over the 87 days that it took to cap the Macondo well (15 July 2010).\textsuperscript{11}

The Gulf of Mexico disaster affected several thousands of people and communities who relied on fishing, tourism and oil-related activities for their livelihood. It also caused health-related problems to those involved in the clean-up efforts or living on the nearby coast. It resulted in an environmental disaster of biblical proportions. The investigation conducted by U.S. authorities on its causes found that \textit{BP} was the ultimate even if not the only entity responsible for the explosion and oil spill. \textit{BP} was therefore forced to contribute to the clean-up costs and to compensate all those parties who suffered damages from this tragedy.

\textit{BP} first created a $20 billion trust fund known as “Gulf Coast Claims Facility” (‘GCCF’) which was later replaced by a court supervised settlement-programme (‘CSSP’). According to the latest available figures released by the company,\textsuperscript{12} the overall cost paid by \textit{BP} in relation to the \textit{Deepwater Horizon} disaster should top $65 billion.\textsuperscript{13}

The company managed to pay this disbursement, thanks in part to the rise in the crude price of oil per barrel. However, what would have happened if the company failed on one or more of these payments? Could the price of the disaster be imposed on the company’s pre-2010 creditors on the basis of some moral valuations such as the prominence of environmental and health considerations over contractually or statutory-based rights and interests?

Principle-based theorists argue that insolvency law should not be immune from social, environmental and health considerations. Accordingly, the principle-based legal literature produced a great variety of principles, due to the diversity of theoretical positions on the purpose of this area of law (as evidenced in


Similar to chapters two and three, this section does not provide a full assessment of principle-based theories as it is concerned with highlighting the features of these conceptualisations that are relevant for the debate on the limits of insolvency law.

This chapter addresses the problem of weighting principles, i.e. the issue of recognising prominence to one principle over another in case of conflict (section 4.3). It demonstrates that whenever we “weight” a principle, we are in reality assessing the preponderance of the controlling interests, which that principle purports to promote. By referring to corporate governance theories, it also suggests that principles should protect and promote the interests of residual-risk takers, a notion employed to describe a wide category of stakeholders with conflicting expectations.

It therefore contends that the main benefit of principle-based theories does not lie in the definition of contentious legal principles. It does lie in shifting the focus of the normative debate to the recognition of rights (section 4.4).

Principle-based and corporate governance theorists recognise that a wide array of stakeholders has controlling rights over the distressed corporation. Any sound statutory system of insolvency rules should be based upon these premises and consider that the decision on when to file for insolvency should respect or at least acknowledge the prevailing controlling interests at the time of the filing.

**4.2 Principle-Based Solutions in Insolvency Law**

Elizabeth Warren is one of the leading experts of principle-based theorists. A couple of decades ago, she asked: ‘Why have a bankruptcy system? What function is it designed to serve? To argue whether it is costly, whether it is failing, or whether it should be reshaped, amended or scrapped, some joinder over what the system is designed to do is essential’.14

---

The current democratic senator justified its existence by reason of its purposes: enhancing and distributing value, internalizing the costs of failure to the parties dealing with the debtor and creating reliance on private monitoring. The theoretical delineation of these purposes follows from the criticism of proceduralist approaches and the identification of the “autonomous pillars” that supported the insolvency framework. A belief shared by many other communitarian and multi-value scholars.

These academics equally criticise no-insolvency scholarship for its lack of persuasiveness when translated into practice.\textsuperscript{15} They contend that as we live in an imperfect world,\textsuperscript{16} any theory conceived in a perfect market – zero transaction cost (PM-ZTC)\textsuperscript{17} environment should first prove to work “in practice” to be acceptable.

The author is sympathetic with these socio-legal approaches to legal research. A comprehensive investigation of all principle-based or principle-informed theories of insolvency law falls outside the scope of this thesis. Nevertheless, to collect appropriate evidence for our de-constructivist analysis, the following section provides a comprehensive glance at the different standpoints that have been taken on the matter.

Principle-based theories can be divided in four categories: \textit{pragmatism, contractarianism, eclectism, and team building}.\textsuperscript{[1]}

\textbf{[1] Pragmatist theories} are models in which principles are employed to determine predictive outcomes for hard cases. Pragmatist scholars do not share a common theoretical background among themselves, even if the majority of

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{15} Particularly persuasive is E Warren and JL Westbrook’s article ‘Contracting Out of Bankruptcy: An Empirical Intervention’ (2005) 118(4) Harv. L. Rev. 1197. The authors contended and proved that, to justify their reasoning, “contractualists” assume relatively small cohorts of claimants, who are able to negotiate an insolvency regime with a debtor or to adjust the prices or other contractual terms of their contracts to reflect the applicable bankruptcy regime. However, they argued that reality proves that there are many more claimants in insolvency cases, the vast majority of which unable to adjust their risks depending on the applicable procedure. Furthermore, even if they were able to do it, other inefficiencies and higher costs would result.
\item \textsuperscript{16} Warren (n 14).
\item \textsuperscript{17} LM LoPucki, ‘Strange Visions in a Strange World: A Reply to Professors Baird and Rosenzweig’ (Oct. 1992) 92(1) Mich. L. Rev. 79.
\end{itemize}
\end{footnotesize}
them seem to be influenced by the goals - albeit not necessarily the values - of law and economics models. In other words, these theorists evaluate insolvency law and corporate reorganisation in economic terms and propose the recognition and promotion of a system of principles capable of enhancing the (economic) efficiency of the statutory framework.

Scholars like Bork and practitioners like Moss recognise that even if (the) law is not what judges say, the judiciary plays an all-powerful role in determining the outcome of hard cases.

Pragmatist scholars believe that an ex-ante systematisation of insolvency principles may help the judiciary to reach uniform decisions in similar domestic or cross-border disputes. For the purpose of systematising principles and promoting predictability, pragmatists assume that insolvency laws should aim at increasing the return to statutorily-recognised claimants or facilitating the allocation of capital in the economy to the best use.

Unlike law and economics theorists, these scholars do not restrict the group of potential claimants to contractual creditors. Nevertheless, their list of principles is certainly narrower than those included by the theorists described below sub [2] - [4].

At the same time, the proposed conceptualisation based on all pervasive principles and guiding rules promotes predictability, uniformity and maximisation of return. One of the most remarkable and praiseworthy aspects of the pragmatist conceptualisation is its intention to provide guidance in hard

---

21 This is a commonly but improperly used phrase to refer to the positivist understanding of the law: HLA Hart, The Concept of Law (3rd edn, Clarendon Law Series: Oxford, 2012).
22 The notion of “hard case” is usually employed to refer to judicial or arbitral procedures in which the procedural or substantive law applicable to the facts is obscure or incomplete.
cases. Its members promote and sustain convergence-seeking and harmonisation-building projects, such as the Asian Principle of Restructuring Project\textsuperscript{24} and several other European projects.\textsuperscript{25}

Principle-based analysis is used to identify correlations between laws from different jurisdictions, fill a legislative gap or guide the solution of conflicts of principles. These studies promote convergence of philosophies and approaches, which in turn should result in enhanced predictability in hard cases and higher returns to claimants.

The main shortcoming of pragmatist theories is their inability to address some of the issues that they aim to overcome. Principles do not have the authority of hard laws. Despite their systemisation, they remain controversial: conflicts arise frequently and courts may apply some of these principles in a bolder or more conservative way.\textsuperscript{26} Harmonization generally results in soft law instruments, such as the proposed EC Directive on preventive restructuring mechanisms.\textsuperscript{27} Finally, to really succeed and become the pervasive framework of insolvency law, principle-based theories should be capable of determining \textit{ex ante} the goals that the insolvency and rescue framework should pursue. Such commonality of views has yet to be achieved.

\begin{footnotesize}
\textsuperscript{24}This project was launched by the Asian Business Law Institute (‘ABLI’) in cooperation with the International Insolvency Institute (‘III’) to facilitate the convergence of insolvency laws by identifying common standards (i.e. principles) applicable in domestic and cross-border cases.

\textsuperscript{25}One of the most recent is the initiative coordinated by the Conference on European Restructuring and Insolvency Law to improve rescue and insolvency laws in Europe. For more information, see: http://www.ceri.eu/.


\end{footnotesize}
Contractarians alongside with eclecticists and team builders, could be broadly classified as representatives of the “enterprise and forum” camp, as they argue that insolvency rules should protect more than economic interests.

The principal advocate of contractarian views has been Korobkin. In his works, he argues that insolvency law should address not simply the economic, but also the financial issues of the distressed corporation. More generally, contractarians believe that insolvency law should not be understood as a maximiser of economic outcomes, but as ‘a system for rendering richer, more informed decisions in response to financial distress’.

This change in perspective is justified by the idea that insolvency law represents the by-product of a bargain struck by all of the parties, whose interests might be affected by a company’s decline, behind a veil of ignorance. As a result, it is guided by principles that ‘prescribe limits on how [the] law should alter the rights, authority, and practical leverage of persons in financial distress’.

The first principle they would choose is “inclusivity”. This seems rather counter-intuitive: to enhance the chances of quick and efficient recovery or distribution might be preferable to consider only the interests of those who have proprietary rights against the debtor’s assets. However, in Korobkin’s theory the parties that are involved in the theory-building exercise do not have knowledge if they would be secured lenders, employees or tort claimants in the hypothetical case of the debtors’ failure.

---

28 The notion is borrowed by B Xie, Comparative Insolvency Law: The Pre-pack Approach in Corporate Rescue (EE Publishing: Cheltenham, 2016) 8.
29 Korobkin (n 4).
30 Korobkin (n 5) 787.
32 In Korobkin’s words, these are the principles ‘that persons would agree to under conditions that are appropriate for choosing principles to govern relationships in that context’ (Korobkin (n 4) 627).
33 Ibid.
34 Ibid 572.
35 This is the position contended by Baird and Jackson: DG Baird and TH Jackson, ‘Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy’ (1984) 51 U. Chi. L. Rev. 97, 100.
36 Korobkin (n 4) 570.
As a result, these parties support solutions which assure that, ‘whatever the position or positions they individually occupy, they [would] have the ability to promote the aims that are important to them’. In other words, the participants in the theory-building exercise would extend the right to join and influence the outcome of the insolvency procedure beyond the bearers of property rights against the debtor’s assets.

The second principle is “rational planning”. Korobkin draws from Rawl’s studies that it is rational for an individual faced with conflicting aims to plan specifically for the present and delay any commitment for the future. In insolvency scenarios, parties pursue conflicting objectives. In insolvency there is, therefore, the need to plan strategies that promote as many aims as possible or – when it is not possible to achieve all of them – at least those aims that are most important. In Korobkin’s view, the principle of rational planning addresses ‘the character of financial distress as a complex problem’. It encourages the parties to follow rational guidelines to identify the most rational long-term plan.

In sharp contrast with pragmatists, contractarians have been subject to extensive criticism with reference to the practical implications of their theories. In fact, unlike pragmatists, contractarians do not seek to categorise principles in an effort to support the judiciary, practitioners and businesses in the definition of (hard) cases. They conceive the mentioned legal principles as ‘an authoritative standpoint that can be used to evaluate the fundamental fairness of specific bankruptcy (i.e. corporate insolvency) rules or practices’, as elements capable of offering critical guidance to legislative reforms.

---

37 Ibid 574.
39 Korobkin (n 4) 581.
40 Ibid 584.
41 Finch and Milman (n 5) 34-35; Xie (n 28) 13.
42 As Vanessa Finch observes, ‘[t]he device of the veil […] does not in itself explain, in a convincing fashion, important distributional issues, such as how to judge trade-offs between fairness or justice and wealth creation’: Finch and Milman (n 5) 35.
43 Korobkin (n 4) 627.
44 More in general on that point, see DR Korobkin, ‘The Role of Normative Theory in Bankruptcy Debates’ (1996) 82 Iowa L. Rev. 75, where the author claims that both theoretical and non-theoretical approaches to the study of corporate insolvency law are needed to properly and exhaustively address insolvency questions.
It is intriguing to observe, however, that both contractarians and pragmatists share a common conjecture: corporations are not simply nexuses of contracts, but organisations aimed at protecting a multiplicity of interests from a variety of stakeholders. In particular, Korobkin observes that corporate insolvency practices create ‘a kind of community, consisting of all participants in the debtor’s financial distress, who express the diverse human values that inform their perspectives’.45

The principles that guide insolvency should be coherent and promote the interests of those who “make” the companies. As this work points out, such assumption is also shared by eclectic and team builder theorists.

[3] The focus on multiplicity rather than categorization of interests becomes even more marked with eclecticists.46 These thinkers, who include scholars like Warren and - to a lesser extent - Finch, assert that insolvency is that section of the law that deals with the systemic failure of the debtor.

According to these theorists, the rationales of this area of law differ from any other part of the law due to the uniqueness of the problems raised by insolvency. In their view, the central policy justification of insolvency law is to cope with default in an integrated system.47 Insolvency law should be concerned with (re)distributing the debtor’s losses among a number of different actors.

As the purpose of the theoretical debate is to identify these actors, it is hardly possible to provide ex-ante consistent answers to questions such as how to reallocate the resources and how to solve conflicts between (re)distributive goals.48

To define the standards of the insolvency system, eclecticists are willing to consider a broader range of interests than contractarians. If Korobkin continued to adopt a statutory-informed approach in the identification of those who have legally enforceable rights towards the insolvent estate/debtor, this is no longer

45 Korobkin (n 5) 787.
46 K Gross, Failure and Forgiveness: Rebalancing the Bankruptcy System (Yale University Press: New Haven and London, 1997); Warren (n 5); Warren (n 14).
47 Warren (n 5) 778.
48 Xie (n 28) 17.
or not always the case for eclecticists. The latter tend to emphasize the interests of the community alongside those legally recognised by the law. It has been argued that aspects of this approach were adopted in the Cork Committee’s statement of aims, thus indirectly guiding the evolution and content of English insolvency law.

Central tenets for eclecticists are the rejection of allocative efficiency as the sole criterion to define insolvency law policy and the attempt to comprehensively define the competing goals that underlay the system. In Warren’s words, they try to articulate ‘the normative goals of the system that scholars, practitioners, judges and legislators can share’. In reality, the definition of these goals has a wider influence, as it affects a large number of actors in the corporate field (including directors, shareholders, consumers, suppliers, etc.).

Like contractarians and - as it will be shown - team builders, multiple value/eclecticist theories might fail to give practical guidance in a complex, real-life corporate environment, as the list of policy goals is open-textured. However, providing certainty in hard cases does not present their primary purpose. Their studies are designed to enhance the awareness of the competing, (re)-distributive goals of the insolvency system.

This should lead in their view to the retention of those insolvency proceedings which prioritize reorganisation and rescue over liquidation.

If pragmatists try to convey guidance for judicial conundrums, eclecticists try to list the competing goals of the insolvency system and its guiding principles/standards. These goals are designed to recognise and enforce the conflicting interests of the insolvency stakeholders. Unfortunately, their

---

50 Warren (n 14) 338.
51 Ibid 339.
52 Warren (n 5) 813: ‘I readily admit that I do not offer a single rule that will resolve all disputes. Instead, I call attention to the difficult distributional issues in bankruptcy’.
53 Warren (n 14) 340.
54 Warren (n 5) 795-6.
categorisation lacks in determinacy because of the variety of interests they are willing to consider.\textsuperscript{56}

[4] **Team Builders** could be defined as those theorists who follow the lead and studies on the production theory of the corporation by Blair and Stout.\textsuperscript{57} They try to provide theoretical support and operational guidance on the use of the (re)distributive goals identified by eclecticists. In particular, they link the statutory enforceability of eclecticist goals to the bearers of a controlling interest in the distressed company. Unsurprisingly, they reject the traditional, neo-classical and libertarian economic view that companies are owned by and solely for the interests of shareholders.

The first and most notorious scholar to apply these corporate governance theories to insolvency law has been LoPucki.\textsuperscript{58} He asserts that the team production contract conceived by Blair and Stout continues in force during insolvency reorganisation proceedings, ‘as team members intended that result at the time they contracted’.\textsuperscript{59}

The corporate governance studies upon which LoPucki’s theory is based provide evidence of what eclecticists and contractarians have envisaged: corporations are jointly controlled by and managed in the interests of all those who make company-specific investments, the so-called “risk bearers”.\textsuperscript{60} These are not necessarily the stockholders or the creditors. In the majority of cases, risk bearers favour the preservation of the going concern value of the distressed company over liquidation, hence the principles of this area of law should – according to this theoretical approach – yield to this goal.

For the purpose of improving the success rate of insolvency reorganisations, team builders suggest shifting cases to more experienced judges, as well as paying more attention to the appointment of creditors’ committees and the

\textsuperscript{56} Finch and Milman (n 5) 37; BS Schermer, ‘Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy’ (1994) 72 Wash. U.L.Q. 1049, 1051.
\textsuperscript{59} Ibid 754.
\textsuperscript{60} This notion is further explained below in sub-section 4.3(c).
definition of pre-negotiated plans. They also support measures to facilitate DIP loans and mergers,\(^{61}\) while they criticise going-concern “fire” sales as they usually yield only a fraction of the residual value of the distressed company.\(^{62}\) Finally, they condemn the complicity of some complacent courts,\(^{63}\) which fail to fulfil their obligation to check if DIPs and professional players are acting in the best interests of the stakeholders.\(^{64}\)

These views have been criticised for prioritizing non-legally enforceable entitlements over legally enforceable ones. Nevertheless, these concerns might be overstated as variations in the order of priorities occur frequently in practice. For instance, it has been empirically proven that deviations from the absolute priority rule (‘APR’) are recurrent.\(^{65}\) Recognising that interest holders have a right to a share in the reorganised company despite the absence of legally enforceable entitlements is a relatively small step forward.

Other normative criticisms rely on behavioural considerations. For instance, LoPucki himself is sceptical about whether the theory could work in practice, as its success depends on the actions of the directors. Could the same directors that brought the company to failure be trusted to take the right decisions for the interests of the residual risk bearers?\(^{66}\)

---


\(^{64}\) LoPucki and Doherty (n 62) 45.

\(^{65}\) See this thesis (sub-section 3.2(a)(iii)) and LM LoPucki and WC Whitford, ‘Bargaining over Equity’s Share in the Bankruptcy Reorganisation of Large, Publicly Held Companies’ (1990) 139(1) U. Pa. L. Rev. 125.

\(^{66}\) In LoPucki’s words, ‘The [team production] theory is based on a wholesale grant of unfettered power to directors. My inclination is to think that will not work. Power corrupts, and absolute power corrupts absolutely’: LoPucki (n 58) 778.
However, in the author’s view, the primary reason for concern is that this theory fails to prove one of its central tenets, i.e. the preference of corporate reorganisation over liquidation when the decision process includes a larger and more varied number of stakeholders. Additionally, this theory has been conceived only with reference to reorganisation proceedings, but fairness and systemic considerations call for the recognition of the same interests also in liquidation or fire sale procedures of distressed corporations.

This theory tries to make a better, more faithful account of reality: distressed companies are no longer controlled by shareholders, but they cannot equally be run in the sole interest of contractual creditors. At the same time, it underestimates the complexities of real practice.

Contractual creditors have different views, priorities and interests. For instance, an investor who puts into practice a loan-to-own or loan-to-govern strategy on the eve of the company’s insolvency has significantly dissimilar priorities to a long-established supplier. The former wants to squeeze what good is left for their own profit, the latter is interested in minimising losses and, where possible, retaining a profitable relationship with the reorganised company. How can these positions be reconciled? Similarly, the more we extend the list of interested parties, the more their interests diverge.

To argue that corporate reorganisation is not a governmental imposition, but ‘a contract term by which creditors and shareholders agree to subordinate their legal rights to the preservation of the going concern’ is to ignore that the basic requirement for having a contract of any kind is the intention to create legal relations among signatories. Such unanimity can hardly be achieved in the context of an insolvency procedure.

Different standpoints have been taken on the goals of corporate insolvency law, the legally and non-legally enforceable interests that should be protected, and

---

67 Brady v Brady [1989] AC 755 (HL) 777-778 (arguing that the interests of creditors such as employees may be in conflict with the priorities and expectations of financial, short-term investors); S Paterson, ‘The Paradox of Alignment: Agency Problems and Debt Restructuring’ (2016) EBOR L. Rev. 497.
68 LoPucki (n 58) 743.
consequently the principles that should govern insolvency law. Despite the uniqueness of the theoretical views, the theories considered in this section share a common pattern: the recognition of (re)distributive goals beyond maximisation of the procedural efficiency.

The case for looking beyond policies uniquely designed to enhance allocative efficiency has been made. Insolvency law emerges as a forum, where all interests affected by business failure are considered, under a procedure governed by principles designed to protect and promote the expectations of the affected parties. New questions need to be answered: What interests and rights should be voiced? What principles should preside over insolvency law?

Before addressing the substantive issue of the identification and definition of these guiding principles, the pragmatic approach of this thesis suggests the opportunity to check if principle-based models could work in practice. The next sub-paragraph is dedicated to this task.

4.2(a) Could a Principle-Based Approach Shape Insolvency Law?

Principle-based theories may be promising on paper, but they may fail to provide tangible solutions to insolvency-related issues. To determine to what extent (if any) principles can and should shape the content of insolvency law, it is appropriate to look at projects based on pragmatic ideals. One of them was promoted by the Conference on European Restructuring and Insolvency Law (‘CERIL’).\textsuperscript{69} It focused on transactions avoidance rules from various European jurisdictions. Its purpose was to examine and compare the existing rules on the basis of the underlying (domestic and European) policies and principles.\textsuperscript{70}

The CERIL study was premised on the fact that national insolvency laws typically contain rules on avoidance transactions. Whenever these rules come into consideration, the parties in a potential dispute may have conflicting views

\textsuperscript{69} CERIL is an independent non-profit, non-partisan, self-supporting organisation of approximately 75 lawyers and insolvency practitioners, law professors and (insolvency) judges committed to the improvement of restructuring and insolvency laws and practices in the European Union and in its Member States and their operation.

\textsuperscript{70} Reference to this study seems appropriate, as the research was conducted by “pragmatist” theorists, whose aim is to develop principle-based models capable of explaining the reality, improving the \textit{status quo} and lead the evolution of the law.
and interests. According to the final report on the study,\(^{71}\) these conflicts derive from a contrast between two general principles.

On the one hand, insolvency claimants demand reliance on the principle of equal treatment of creditors (the so called *pari passu* rule), which however operates only whenever insolvency proceedings have started. On the other hand, it is argued that the expectations of the parties in a commercial transaction should be upheld by reason of the principle of the protection of trust.

The problem of transactions avoidance is also exacerbated by the lack of harmonisation of the insolvency laws among the European countries covered by this study, as similar “legitimate expectations” are protected in distinct ways. Generally speaking, the power of the person in charge of the insolvency procedure to challenge the validity of pre-insolvency transactions may depend on a variety of factors, such as the timing or nature\(^ {72}\) of the transaction and the subjective status of the parties in the transaction.

The report concludes that the law of preferences mirrors the underlying principles in most countries, but this conclusion is questionable. In fact, this remark has been possible by the reliance on rather elastic definitions of the underlying principles. Rather contradictorily, although roughly one third of the report (§§.17-30) is dedicated to the description of the diverging solutions adopted by national legislators with reference to the same issue, the authors impliedly suggested that roughly all the national laws on transactions avoidance rules are informed by the same principles.

As noted by Wessel (who acted as CERIL’s chairperson),

> *it seems promising to apply a principle-based approach to national insolvency laws. Carving out the fundamental commonalities instead of stressing the differences in details by focussing on the underlying*


\(^{72}\) For instance, under some laws it is not possible to challenge a transaction where a creditor has taken performance rather than received it. The creditor performs rather than receives a transaction when, among others, he or she obtains partial or full satisfaction for his claim after an individual enforcement action.
principles and their reflection in national insolvency rules supports all efforts to understand and – eventually – harmonise insolvency laws.\textsuperscript{73}

These promising conclusions should again not be overstated.

First, the study investigated only a narrow area of national transaction avoidance laws, i.e. those insolvency rules that apply to formal liquidation proceedings. These are the least contentious rules in the area, as a process of gradual approximation of existing procedures has been in place for a rather long period of time. It is expected that more dissimilar results would be observed if the investigation was extended to the treatment of transaction avoidance rules subject to general law.

However, even if the investigation continued to be restricted to insolvency issues, more contradictory results would be observed if the analysis included the treatment of transactions commenced or concluded before formal rescue proceedings, i.e. in informal workouts or quasi-formal proceedings.

As a result, further studies need to be undertaken to ascertain if a principle-based approach would work in relation to the entire scope of insolvency law.

Second, even with reference to the jurisdictions analysed in the study, the researchers observed that the law of preferences does not mirror the underlying principles in all of the countries, with notable exceptions being England and Wales, and Spain. They also recognised that some other principles, such as the principle of predictability (legal certainty) and of optimal realisation of the debtor’s assets, needed to be considered to explain some avoidance norms.\textsuperscript{74}

The authors characterise this issue as a problem of “weighting principles”.\textsuperscript{75} They argue that it is not problematic if the substantive law does not mirror the strict implementation of the guiding principles in the area, as this means that


other, more sectorial and detailed principles prevail over more general ones. They introduce us to a hierarchy of principles, in the same way as we are used to classify our sources of law from more general and prescriptive to more specific and less authoritative ones.

This explanation cannot be accepted. In particular, the adoption of such changeable paradigms would run counter to the achievement of the objective of procedural efficiency, which the thesis assumes as one of its paradigms.

For instance, CERIL authors have no problem to admit that the principle of optimal realisation of debtor's assets could modify the general insolvency rules dictated by the principles of equal treatment of creditors and protection of trust. In this case, a secondary, specific principle would trump the primary, more general ones. However, the same principle of optimal realisation is considered by the same authors as the guiding general principle when it comes to the definition of the rules that govern a liquidation procedure.

This ambivalent hierarchical status of principles has no equivalent for laws. A secondary administrative source cannot derogate from a primary statutory precept, unless within the limits determined by the statute itself. Hierarchies cannot be turned around. Why should this be possible for principles?

Finally, CERIL authors appear to share the implicit belief that principle-based theories could play a role in determining the substantive content of insolvency law, while they may have a less persuasive effect with reference to the definition of “procedural details” and “legal consequences”. Such a conclusion is particularly problematic with reference to a sector of the law which is primarily procedural in nature.

4.2(b) Preliminary Findings

What principle-based theorists have in common is an organisational - sometimes hierarchical - view of legal principles aimed at promoting and protecting a wide variety of interests.

---

76 Bork (n 74) 3.
Unlike neo-libertarians, they do not see the company simply as a nexus of contracts where shareholders, as the ultimate risk-takers, have bargained with the managers to act in the protection of their interests. Unlike new institutionalists, they do not see the company only as a mechanism to promote pareto-efficiency and as an organisational alternative to the market to lower the costs of market transactions.

Principle-based theorists envision the company as organisations where the directors must consider the power relations among all their members before deciding the company’s policies. They promote the introduction of mechanisms aimed at considering the interests of all the controlling risk-takers of the corporation into law.

Insolvency law should promote and protect the multiplicity of interests of the controlling risk-takers of the distressed company. However, principle-based theories alone fail to provide clear guidance in the definition of procedural and substantive issues of insolvency law.

As principles have a more marked attitude than laws, their implementation often falls on the company directors. What is left to be determined is how to weigh these principles (section 4.3) in light of the controlling claims (i.e. the interests) that each stakeholder has towards the company.

4.3 THE PROBLEM OF WEIGHTING PRINCIPLES

The Deepwater Horizon disaster showed the importance of considering conflicting interests. If the price of crude oil had fallen below $50 per barrel, the same disaster would have pushed parties to classify these principles in categories of decreasing importance in the ensuing corporate insolvency case.


How should principles be “weighted”? Who should decide if the rights of secured creditors should prevail over the health and environmental concerns of large communities? What reasons should be used to justify any restriction to some of the fundamental principles (sanctity of contract and right to health) underpinning the Anglo-American legal systems?

One of the most prominent scholars who studied these issues is Dworkin. In his studies, he concluded that unlike rules, which apply in all-or-nothing scenarios depending upon whether the facts fit within the legal definition, principles have a dimension of weight or importance. On one hand, principles are capable of being aggregated when they reach the same policy/result. On the other, whenever there is a contrast, it is necessary for one principle to prevail over (i.e. outweigh) the other. However, the scholar also concluded that ‘generally we cannot demonstrate the authority or weight of a particular principle’.80

Current practice in the jurisdictions considered in this study seems to confirm this conclusion. In sub-section 3.2(a)(iii), this thesis has observed that strict observance of the APR is increasingly undermined in an attempt to foster the rescue of viable businesses.

Similar considerations are also valid with reference to several of the other pillars of insolvency law. For instance, the principle of collectivity can be statutorily derogated from by secured creditors.81 Under both U.S. and English insolvency law,82 a lien remains attached to its collateral even after the beginning of the insolvency procedure and it can be enforced against the insolvent estate even if the debtor cannot be sued for any deficiency.

These exceptions are well known and their scope, extent and relevance have been extensively studied.83 In general, principle-based theorists have tried to justify the legitimacy of these waivers of the enforcement of general principles

---

79 Dworkin (n 75) 27.
80 Ibid 37 (emphasis as in the original version).
by demonstrating that other principles should be applied and that those - apparently conflicting - principles had to be preferred due to the circumstances of the case.

This justification or the alternative explanation that we are dealing with “exceptional cases” are not entirely satisfactory. They result in making the outcome of the procedure dependent upon subjective valuations. A valuation which, moreover, is dependent upon time and territorial-restricted horizons.

It is, however, equally conceivable that the conflict is among the rights of the stakeholders rather than between the procedural and substantive principles that underpin the law.

To assume that such a conflict of rights and interests may occur, it is however necessary to recognise that insolvency law could and should serve more than one interest at a time. If it is assumed - as some proceduralists do - that insolvency law is simply designed to maximise the return to contractual claimants and that these claimants are a rather homogeneous group, it is hardly possible to make sense of the principle-based conflicts.

The economic argument advanced by neo-classical scholars and financial economists maintains that once the company/debtor is solvent, decisions should be taken in the interests of the equity-holders, as they are the only parties that have contracted for a share in the net proceeds of the enterprise. Once the debtor is insolvent, the residual rights to its assets would pass to its contractual creditors. As a result, directors should act only in the creditors’ interests84 and avoid excessive risk-taking,85 which becomes more likely when

the value of stockholders' investment falls to zero and creditors will consequently bear most of the potential losses.\(^{86}\)

This “property conception of the corporation”\(^{87}\) has been supported by the “Chicago School” of law and economics.\(^{88}\) The assets of the corporation are the property only of its residual claimants: no legal obligation should be recognised under the law of contract towards any other stakeholder. This view conforms closely with the attitude of many proceduralist theorists.

Principle-based theorists, however, recognise that insolvency law serves more than one interest, as distinct stakeholders can claim controlling rights and independent expectations.\(^{89}\) By arguing that corporations must serve a larger social purpose beyond maximising the return for shareholders, they recognise that both corporate and insolvency laws should voice the concerns (and rights) of other stakeholders. They fail, however, to provide a normative justification for the recognition of these rights.

The next sub-sections will try to determine if the perception of principle-based theorists is true, what interests should be considered by this branch of the law and whether existing insolvency statutes protect these interests both in theory and in practice. The focus will be on legal rights recognised to contracting parties that are enforceable in insolvency procedures.

\(^{86}\) WW Bratton, Jr., ‘Corporate Debt Relationships: Legal Theory in a Time of Restructuring’ (1989) Duke L.J. 92, 165 (stating that highly leveraged corporations are likely to result in stockholder opportunistic conduct); V Brudney, ‘Corporate Bondholders and Debtor


\(^{88}\) Easterbrook and Fischel (n 77), who argued that shareholders have the moral and legal standing to be treated as owners.

\(^{89}\) This position is backed by other studies of corporate lawyers, scholars and economists: PF Drucker, ‘Reckoning with the Pension Fund Revolution’ (1991) 69 Harv. Bus. Rev. 106 (arguing that corporations exist to create wealth for the society).
In the insolvency context, it is imperative to distinguish between personal and proprietary interests. This is not the place for an extensive analysis of this topic. Nevertheless, it is submitted that only a clear perception of the fundamental principles of ownership and control over the insolvent company and its assets can provide reliable guidance when conflicts of interests arise.

A claimant has a **personal interest** when he or she can claim that right or interest only against the other party (or parties) to the contract.\(^9^0\) A claimant who has a personal right cannot enforce it in the defendant’s insolvency and cannot rely on the remedy of specific performance, even if there have been cases where courts have enforced these rights in insolvency.

Personal rights have been enforced in insolvency in many instances, including in *Re Newdigate Colliery*,\(^9^1\) where the court refused to allow the receiver to disregard the existing contracts for the sale of goods. Even if this decision prevented the receiver from selling the coal at a higher price, the court justified its ruling with the need to take into consideration ‘the interests of everybody concerned, and not to advance the interests of one of the persons concerned at the expense of the other’.\(^9^2\)

A claimant has a **proprietary interest** when the right or interest in relation to an asset is available against persons generally\(^9^3\) even if – depending on the nature of the proprietary right – there might be third parties against whom enforceability is precluded.

Proprietary rights can be over land, goods or intangibles, outright or by way of security. They can also be obtained by agreement (e.g. retention of title clauses), by operation of the law or through the operation of equity,\(^9^4\) which means that

---

\(^9^1\) *Re Newdigate Colliery* [1912] 1 Ch 468.
\(^9^2\) Ibid 478.
\(^9^3\) Calnan (n 90) 44.

---


the origin of some of them may be non-consensual. However, courts are reluctant to impose proprietary interests where it is “equitable” to do so, particularly in insolvency.95

The distinction between personal and proprietary rights would be largely academic if it was not for insolvency.96 Upon insolvency, only the assets owned by the company are available for distribution, sale or alternative use in a rescue procedure.

The owner of a proprietary interest is not affected by the principle of pari passu distribution,97 as established by cases that date back at least three hundred years.98 This is because proprietary claimants are awarded a constructive trust over a particular asset which, in the event of the constructive trustee’s insolvency, is not available for distribution among creditors.99

This claimant could rely on the remedy of specific performance, even if exceptions have been introduced by the law to prevent a race to the assets when the debtor filed for a formal insolvency procedure.100 In other words, proprietary interests enable the owner to take the protected assets outside the scope of insolvency proceedings.101 Nevertheless, when a claimant is entitled to

97 FH Lawson, Remedies of English Law (2nd edn, Butterworths: London, 1980) 149; Calnan (n 90) 19. Exceptions apply, for instance if the insolvent company acquired goods through fraud, misrepresentation or other vitiating factors: Re Eastgate [1905] 1 KB 465; Tilley v Bowman Ltd [1910] 1 KB 745. For a list of other exceptions, see: Goode (n 96) 13.
98 Burdett v Willett (1708) 2 Vern 638; Ex parte Dumas (1754) 1 Atk 232, 233-4.
99 S.283(3)(a) and (5) IA 1986.
100 The automatic stay in the U.S. and the moratorium in England suspend (but do not extinguish) the right of the holder of a proprietary interest to become the owner of the secured asset and sell it in satisfaction of his or her claim. Equally, both systems include transaction avoidance rules that may void the existence of property and proprietary rights. Finally, in England, if the proprietary interest concerned is presented by a floating charge, unsecured creditors may be entitled to a portion of the proceeds arising from the sale of the secured assets (s.176A of IA 1986 as introduced by the Insolvency Act 1986 (Prescribed Part) Order 2003). Floating charges can also, under certain circumstances, be voided: s.245 IA 1986.
101 Calnan (n 90) 39.
a proprietary, rather than a merely personal right, it presents one of the ‘perennial problems of the law of restitution’.\textsuperscript{102}

A proprietary interest can be secured. A security interest is a legal right granted by a debtor to a creditor over the debtor’s property (usually referred to as the collateral) which enables the creditor to have recourse to the property if the debtor defaults in making payment or otherwise performing the secured obligations.

The distinction between personal and proprietary rights does not lie in their nature (possession, property, alienation, etc.) but in the enforceability of the right against parties that have not entered into the original contract.\textsuperscript{103}

Besides that, claimants may have interests and expectations that can hardly be qualified as either personal or proprietary. Take for instance the case of a community where a polluting company continued to operate for several years. If the responsibility of the company had been ascertained in a court, the public authority (state or local community) may have personal or proprietary rights against the polluter.\textsuperscript{104} The local community, i.e. those who live in proximity of the company, may not have such rights. Additionally, the expectations of this community may be conflicting: while all of its members may expect that the

\textsuperscript{102} Calnan (n 95) 1.
\textsuperscript{103} Calnan (n 90) 44. The distinction may prove challenging in certain cases, such as leases of goods, licenses of land and charter-parties of ships, as explained in pages 49-55 of that volume.

company stops polluting and cleans the polluted land, some of its members may hope for the closure of the polluting facility while others – generally those whose livelihood depends on it – may wish for less draconian outcomes. With the sole exception of tort claims for pollution-related illnesses, absent any change in the regulations, the members of this community do not have any rights against the company, at least not as a collective body.

This is not the only case where the law fails to give proper, discrete consideration and remedies to the rights of certain parties. Another example is represented by the position of employees. These claimants have a legal right to be paid their wages for the duration of the formal insolvency procedure and – to a more limited extent – for the period that leads to the filing. Similar protection is granted to their pension benefits. However, as it will be explained in sub-section 4.3(c), the company-specific nature of their investment is rarely appreciated by the law.

Finally, as evidenced in Re Newdigate Colliery,\textsuperscript{105} this thesis argues that the insolvency system should not feature mechanisms that have the effect of advancing the interests of one person at the expense of the other without the existence of overarching justifications for doing so.

These considerations lead the author to suggest that for the purpose of determining whether the company should file for insolvency and the proper course of action once the procedure has opened, the law should introduce the new concept of risk bearer interests.

Risk bearer interests should be understood as rights enforceable against any persons generally (similarly to proprietary interests) that would not, however, give the owner - i.e. any of the subjects listed in sub-section 4.3(c) - the power to take assets outside the scope of insolvency proceedings (similarly to personal interests). Like personal rights, risk bearer entitlements would not need registration, should be proven in insolvency and confer on the owner the right to a dividend and to affect the course of actions taken in insolvency.

\textsuperscript{105} Newdigate (n 91).
Risk bearer interests should not be understood as rights that are created in insolvency. In insolvency procedures, these rights should become apparent and be expressly mentioned to justify the decisions taken as part of the procedure. Under the ordinary course of business, it is assumed that directors should equally consider these interests in determining the company’s policy. However, risk bearer right holders would not have autonomous legal remedies outside insolvency, as this would expand the duties of directors and might increase the risk of conflict among the company’s constituencies.

In other words, the position of a holder of risk bearer rights would be similar to the position of a floating charge holder before crystallization or that of a beneficiary under a trust. In the case of a floating charge holder, it is only when crystallization occurs that the beneficiary has an immediate, specific and proprietary interest in the company's individual assets. In the case of a beneficiary under a trust, the beneficiary's interests over particular assets fasten only when the trustee’s management powers come to an end. Equally, the holders of risk bearer interests can exercise the rights connected to their position only after the opening of a formal or hybrid insolvency procedure. Additionally, their claims would not affect the position of bona fide purchasers because risk bearer claimants acquire only an equitable, not a proprietary interest over the debtor’s assets.

As risk bearer interests would not be rights over assets, they would give to their owners - the risk bearers defined in sub-section 4.3(c) - the right to influence the timing of the filing and the outcome of the procedure in a way that best promotes their collective position. Risk bearer interests do not give the beneficiaries the power to unduly affect the rights recognised to other claimants, especially secured ones.

Where insolvency filings result in a quick maximisation of the debtor's assets, risk bearer interests would not affect the rights of proprietary claimants unless securities have been fraudulently obtained or the filings strategically designed to promote the interests of certain creditors at the expense of others. However, even in cases where insolvency procedures are designed to re-allocate capital to those best able to use it, the relative value of the secured creditor's pre-insolvency entitlement would not be affected. In these cases, enforceability of proprietary rights might be postponed and secured creditors might be forced to accept alternative collaterals or debt-for-equity swaps.

The risk bearer concept would sit alongside personal and proprietary interests and would neither modify the substantive nature of proprietary and personal rights nor the order of priorities. Secured creditors could still expect to grab the secured assets and sell them for the satisfaction of their claim but, if the timing of the sale would conflict with the risk bearer interests of other claimants and these interests prevailed (in number and/or magnitude) over those of the secured creditor, the sale could be postponed. In jurisdictions where the procedure is run by independent parties such as insolvency practitioners, this decision to postpone the sale may not even need the preliminary approval of the court.

In cases where proprietary and risk bearer interests conflicted, there would be a need to carry out a balance of equities exercise to assess the positions of the owners of these rights. To assess the position of each claimant and – as a consequence – the primacy of certain rights over others, this thesis suggests that office-holders should rely on the concept of rent introduced in sub-section 3(c) of this chapter, ftn 219. The outcome of this decision, which could be validated by the panel described in sub-section 6.4(d), should not be second-guessed by the judiciary except in cases of fraud or unconscionable decisions.

This new categorisation might not dispel uncertainties. Nevertheless, it should overcome one of the most contentious issues of judicial practice in common law.
systems, i.e. the recognition of proprietary remedies to personal claimants in accordance to the maxim that ‘equity deems as done what ought to be done’.\textsuperscript{108}

It is also suggested that courts should make use of a more principled approach than current practice to facilitate the identification of the prerogatives of the interest bearers. In fact, deontologically, it is possible to justify the existence of legally enforceable rights on moral or teleological grounds.\textsuperscript{109} In England in particular, the protection of rights (including, in the future, risk bearer claims) against mis-appropriators is justifiable less in term of moral desert and more in utilitarian terms.\textsuperscript{110} In other words, the claimant’s (i.e. creditor) right is protected to the extent that he or she can prove that the actions of the respondent (i.e. debtor) have undermined the owner’s patrimony. This represents a significant evidentiary challenge for risk bearer claimants and this approach should be reconsidered if the legislator agrees on the recognition of risk bearer interests in insolvency.

Why should a new category of rights be introduced to the law? Whenever a personal concern meets a certain threshold, the legislator and the judiciary have always been willing to sanction its breach by means of the introduction of legal or equitable remedies. As sub-section 4.3(c) will demonstrate, there are normative reasons to argue that certain stakeholders deserve additional protection.

It is first pertinent, however, to investigate if risk bearer rights are indirectly recognised by the law and the judiciary in near-insolvency scenarios or insolvency cases. This analysis will be carried out in the following sub-section.


\textsuperscript{109} Rawls (n 38) 24-30; C Fried, \textit{Right and Wrong} (Harvard University Press: Cambridge, MA, 1978) 9.

4.3(b) What Interests Are Relevant in Corporate and Insolvency Practice?

To determine if risk bearer rights are somehow and to what extent considered by those who run the companies, this sub-section investigates the duties of directors and office-holders under general corporate and insolvency law (and practice).

On the one hand, if principle-based theories are reflected in the law (and practice), it is expected that consideration is given to the interest of a large number of stakeholders. On the other hand, if proceduralist approaches have a prevailing informative effect over the current legislation (and practice), a substantial similarity in the interests protected by company and insolvency law should emerge, with the shareholders’ and creditors’ interests being preponderant.

4.3(b)(i) Directors’ Duties in Solvent Times

To understand the duty of directors under English law, it is appropriate to start the analysis from the Companies Act 2006 (‘CA 2006’). However, the provisions included in this Act do not represent by any means an exhaustive list of directors’ duties.111

General statutory duties are listed primarily in ss.171 to 181 CA 2006. This law amended the previous status quo by introducing new provisions based on the equitable principles relating to fiduciary duties and the common law of negligence.112 The purpose of this act has not only been to clarify the duties, but also to make the law more accessible and predictable.113

---

111 Some scholars have also questioned the structure and content of the duties in CA 2006 arguing that directors – and particularly those of SMEs – are ‘given an incomplete picture of the law, particularly in relation to remedies’: P Hood, ‘Directors’ Duties Under the Companies Act 2006: Clarity or Confusion?’ (2013) 13(1) J. Corp. L. Stud. 1, 47. A more comprehensive catalogue of directors’ duties emerges after having considered other sources such as the IA 1986, the Corporate Directors Disqualification Act 1986 (‘CDDA 1986’), the Enterprise Act 2002 (‘EA 2002’) and the Small Business, Enterprise and Employment Act 2015 (‘SBEEA 2015’). For a comprehensive analysis of the rights and duties of English directors under the general and corporate insolvency law, see: M Bruce, Rights and Duties of Directors 2016 (Bloomsbury Professional: London, 2016).

112 The equitable nature of these duties is further proven by the fact that the remedies for breach of any of them are the same as would apply if the corresponding equitable principle or common law rule applied. These include rescission (but not voidance) of the transaction, return of property, equitable compensation and confiscation of the profits, even if the company has
Key duties include the obligation to act within powers (s.171), to exercise independent judgment (s.173), to exercise reasonable care, diligence and skill (s.174) and to exercise independent judgment (ss.175-177). A fundamental principle of common law reinstated in s.170(1) CA 2006 is that directors’ duties are owed to the company as a whole, not to individual members.

For the purpose of this work, a key provision is s.172(1) CA 2006, which introduces the duty to act bona fide in the interests of the company. This has often been described as a core duty for English directors. According to this norm:


114 Known as “proper purpose rule”, it is well established since Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 (PC).

115 As stated before, many duties are imposed elsewhere in the legislation and are not covered in this thesis due to their specialist nature.

116 Percival v Wright [1902] 2 Ch 421 (Ch) and Peskin v Anderson [2000] BCC 1110 (Ch), 1111 where Neuberger J (as he then was) held that ‘[t]o hold that directors have a general fiduciary duty to shareholders would place an unfair, unrealistic and uncertain burden on directors and would present them frequently with conflicting duties between the company and the shareholders’. Particular fiduciary duties to shareholders are dependent on establishing and proving the existence of a “special factual relationship” between the directors and the shareholders. For a case comment, see D Arsalidou, ‘Directors’ Fiduciary Duties to Shareholders: the Platt and Peskin Cases’ (2002) 23(2) Comp. Law. 61. More recently, in Sharp v Blank [2015] EWHC 3219 (Ch), [2016] 1 P. & C.R. DG16 the court reinstated this conclusion by holding that directors have a duty to provide information but do not owe wider fiduciary duties because no special relationship exist between the directors and the company’s creditors and because the directors have not undertaken to act for the shareholders in any more extended sense.

[a] director of a company must act in the way he considers, in **good faith**, would be most likely to promote the **success of the company** for the benefit of its members as a whole (emphasis added).

This section is based on the equitable fiduciary\textsuperscript{118} duty formulated - in combination with the duty to act within powers - by Lord Greene MR in *Smith and Fawcett*.\textsuperscript{119} The pivotal elements are substantially two: (1) the need to act in good faith; and (2) the promotion of the success of the company as a whole.\textsuperscript{120}

The legislator has focused its attention particularly on the second of these elements and provided an illustrative list of interests that directors should keep in mind to promote the long-term success of the whole company.\textsuperscript{121} These include the interests of the creditors,\textsuperscript{122} employees,\textsuperscript{123} shareholders,\textsuperscript{124} HMRC,\textsuperscript{125} suppliers,\textsuperscript{126} customers and others, the community and the

\begin{flushleft}
\textsuperscript{118} The fiduciary nature of the duty is confirmed in several judgments. See, among others: *Regentcrest Plc (in liq.) v Cohen* [2001] 2 BCLC 80; *Extrasure Travel Insurances Ltd v Scattergood* [2002] EWHC 3093 (Ch), [2003] 1 BCLC 266; *Re Southern Counties Fresh Foods Ltd* [2008] EWCH 2810 (Ch), [2008] WL 4923175; *Apex Global Management Ltd v FL Call Ltd* [2015] EWHC 3269 (Ch), 2015 WL 6757849 [45] – [47].

\textsuperscript{119} *Re Smith and Fawcett Ltd* [1942] Ch 304 (CA).

\textsuperscript{120} The content of this duty had been encapsulated in several decisions and commentaries. See, among others: *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch. 407 (CA); *Dorchester Finance Co. Ltd v Stebbing* [1989] BCLC 498 (Ch); V Finch, ‘Company Directors: Who Cares about Skill and Care?’ (1992) 55 M.L.R. 179.

\textsuperscript{121} The specific reference to the long-term success of the company and the lack of any reference to the short-term perspective mark significant attempts to go beyond traditional short-termism views. The Parliament has been supportive of this trend by amending the government’s proposal – published in the White Paper ‘Company Law Reform’ (Cm 6456, 2005) – to require directors to consider ‘the likely consequences (short and long term) of the actions open to the director’.

\textsuperscript{122} Among others: *Lonrho Ltd v Shell Petroleum Co. Ltd* [1982] AC 173 (HL); *Ball v Hughes* [2017] EWHC 3228 (Ch), [2018] 1 BCLC 58; *Re Bowe Watts Cargso Ltd (in liq.)* [2017] EWHC 7879 (Ch), [2017] WL 06326756. As it will be evidenced in the following section, the interests of the creditors significantly intrude in the scenario and limit the directors’ autonomy whenever the company approaches a distressed situation.

\textsuperscript{123} Among others: *Hutton v West Cork Railway Co.* [1883] 23 Ch D 654 (CA).

\textsuperscript{124} Among others: *Allen v Hyatt* [1914] 30 TLR 444; *Re OS3 Distribution Ltd* [2017] EWHC 2621 (Ch), [2017] WL 04818747.

\textsuperscript{125} *Raithatha v Baig* [2017] EWHC 2059 (Ch), [2017] WL 04526672, where the court held that the company’s directors had breached their duty to exercise reasonable care and skill in failing to register the company for VAT and consequently to collect in VAT.

\textsuperscript{126} *Re William C Leitch Bros Ltd (No. 1)* [1932] 2 Ch 71 (Ch), where the court punished the behaviour of the company’s directors for inducing a supplier to deliver goods while they were aware that the company had no or little prospect to pay for the supply. Furthermore, in *R v Grantham (Paul Reginald)* [1984] QB 675 (CA) the Court of Appeal found that an intent to defraud is established on proof of an intention dishonestly to prejudice the creditors in
environment, and even the reputation for high standards of business conduct. In *LRH Services*\(^{127}\) the court held that

... the reference to the benefit of "the members as a whole" is not to cast the interests of members in contradistinction to those of the corporate entity, but to make clear that the directors must aim to provide, through the success of the company, benefits to all the members rather than any one group or class of them. This might require a balance to be struck if, for instance, different class rights mean that some policy choice might have a differential benefit as between classes.\(^{128}\)

Finally, s.172(3) CA 2006 clarifies that the pursuance of these interests is subject to any enactment or rule of law which requires the director to consider or act in the interests of the creditors of the company.

It seems, therefore that directors have to take into consideration a wide array of interests whenever they act on behalf of the company, as this duty operates prescriptively and requires active performance.\(^{129}\) This conclusion is seemingly further supported by the British government proposals for reform in the area. The Business, Energy and Industrial Strategic Committee recently launched an inquiry into “corporate governance”. Following the publication of the “Third Report of Session 2016-17”\(^{130}\), the government commented on some of the proposals.\(^{131}\) With reference to the duties listed in s.172 CA 2006, the government recommended the implementation of an approach designed to strengthen the voice of employees, customers and wider stakeholders in the companies’ life.

\(^{127}\) *LRH Services Ltd (in liq.) v Trew* [2018] EWHC 6000 (Ch), [2018] WL 01412414.

\(^{128}\) Ibid [29].

\(^{129}\) Langford (n 117) 221.


More recently, the government issued a consultation which aimed, *inter alia*, at exploring how directors make use of the expertise of professional advisers to promote the success of the company.\(^{132}\) The government was concerned that some directors may not be fully aware of their duties with regards to commissioning and using professional advice.

Respondents to that consultation argued that while directors have a good awareness of their duties, they may benefit from more training. They also observed that the market for independent board evaluations should be reviewed to ensure minimum standards.\(^ {133}\) Some also argued for stronger enforcement of directors’ duties.

The latter observation is important because it shows the existence in the market of a significant number of players that would be willing to force directors to consider the rights, interests and expectations of a wider variety of claimants.

The government seems supportive of this trend, as it recently laid down regulations to require all large companies in their annual reports to show how they have regard to the interests of employees, the consequences of their decisions in the long term and how they plan to improve business relationships with customers and suppliers.\(^ {134}\) As these requirements will take effect from January 2019, the government will assess the impact of this reform before considering further actions.

The position of the law and the government is therefore substantially supportive of extending not simply the range of interests that directors must consider when acting on behalf of the company, but also the availability of remedies should these duties be breached. However, the courts’ reluctance to second-guess the commercial decisions\(^ {135}\) taken by company directors – unless

---


\(^ {133}\) Ibid 24-25.

\(^ {134}\) Ibid 26.

\(^ {135}\) This is especially true in case of pre-packs: V Finch, ‘Pre-packaged Administration and the Construction of Propriety’ (2011) 11(1) J. Corp. L. Stud. 1, 18.
when marred by fraud – may have detrimentally affected the wide protection recognised under general law.

Despite directors’ duties qualification as “fiduciary”,136 courts have rarely sanctioned the detrimental use of directors’ powers and prerogatives,137 in part due to the lack of cases on the subject and the derivative nature of the action against the directors.138

Their interpretation would not in itself represent a major obstacle to the implementation of the legislative view on the matter, if only the notion of “the beneficiaries” of the statutory protection was wide and flexible enough to effectively safeguard those who have risk bearer interests in the company. Unfortunately, this long-established aversion to question managerial decisions has resulted in a diminished protection of the interests of all parties except for shareholders.

In fact, in Style139 the Chancery Division of the High Court denied a request from a minority shareholder to continue a derivative claim on behalf of the company against four of its directors. In rejecting this request, it is submitted that the court did not focus on verifying if the interests of the protected parties had been properly considered. If that were the case, the request should have been approved, as the court recognised that it was not sufficiently clear for the purposes of s.263(2)(a) CA 2006 that no director acting in accordance with s.172 would seek to continue the claim and that its quantum might not be

136 Common law requires directors to act in good faith in what they consider the best interest of the company - *Smith and Fawcett* (n 119) - and to use the powers conferred on them for a proper purpose. Alongside with this fiduciary obligation, directors are required to exercise whatever skill they possess and reasonable care (*Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 (Ch); *City Equitable* (n 120).

137 *Smith and Fawcett* (n 119) 306: directors must act ’bona fide in what they consider – not what a court may consider – is in the interest of the company’. See also: *Howard v Ampol* (n 114) 832: ’There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at’.

138 If duties are breached, the actions can be promoted by the board acting on behalf of the company (if the action is against only one of the directors) or by the shareholders (but still on behalf of the company). Keay observed that the introduction of public enforcement of directors’ duties is ’meritorious’ as it would promote the impression that the legal system ’takes breaches of company law duties and the rights of shareholders seriously’: A Keay, ’The Public Enforcement of Directors’ Duties: A Normative Inquiry’ (2014) 43 C.L.W.R. 89, 118.

139 *Brannigan v Style* [2016] EWHC 512 (Ch), [2016] WL 00386245.
insubstantial. The court’s rejection was based on different considerations, namely the slim chances of success and the potential costs.\textsuperscript{140}

The ruling in \textit{Style} was not an isolated one but the confirmation of an established trend in English case law. Courts have been reluctant to trump shareholders’ interests in favour of creditors’ claims, especially when it has not been proven that the company was hopelessly insolvent. As a result, in \textit{Sequana}\textsuperscript{141} the court held that even where a company had an estimated provision in respect of a long-term liability on its balance sheet, there was no justification for holding that the duty to protect creditors’ interests under s.172 CA 2006 applied for the whole period during which there was a risk that there might be insufficient assets to meet that liability. In the court’s view, if that were the case, the directors would have to take account of creditors’ rather than shareholders’ interests when running a business over an extended period of time.

Such a conclusion is however problematic. In the author’s view, despite that the facts of the case might not have justified a different solution, the court did not pay sufficient consideration to the objective of the law, which requires the directors to promote the success of the company for the benefit of its members as a whole.

The same light-touch approach emerged from the decision in \textit{Hedger v Adams}.\textsuperscript{142} In that case, the court held that a director was not in breach of his duties under CA 2006 when he transferred the assets of a company shortly before liquidation to another company that he controlled. The transfer was made for a deferred consideration and the second company later became insolvent. The court found that the directors acted while considering the creditors’ (but not the stakeholders’) interests.\textsuperscript{143} Yet, the court did not find any

\textsuperscript{140} Asplin J at [91] observes that ‘[i]n reality, it seems to me that such a director would conclude that pursuing the claim to a successful outcome would be extremely difficult and might not be cost effective and that the PEL would be in extreme difficulty in funding those proceedings’.

\textsuperscript{141} BTI 2014 Llc v Sequana SA [2016] EWHC 1686 (Ch); [2017] Bus. L.R. 82.

\textsuperscript{142} Hedger v Adams [2015] EWHC 2540 (Ch), [2016] BCC 390.

\textsuperscript{143} Ibid [38], \textit{Re HLC Environmental Projects Ltd} [2013] EWHC 2876 (Ch), [2014] BCC 337 followed.
breach of duty because the director had acted honestly and reasonably, having sought advice on how to proceed.

With reference to U.S. law, directors owe fiduciary duties to the corporation and its shareholders.\textsuperscript{144} Fiduciary duties of directors ordinarily include the duty of care and the duty of loyalty.\textsuperscript{145} The “duty of care” refers to the responsibility of a corporate fiduciary to exercise, in the performance of his or her tasks, the care that a reasonably prudent person would use under similar circumstances.\textsuperscript{146} The “duty of loyalty” derives from the prohibition against self-dealing that inheres in the fiduciary relationship and requires directors to act in the best interests of the corporation and its shareholders.\textsuperscript{147} The standard to prove a director’s breach of duty of care is “gross negligence”\textsuperscript{148} and in cases questioning the directors’ behaviour, courts have adopted a “reasonable man standard”.\textsuperscript{149}

\textsuperscript{144} Harff v Kerkonian, 324 A.2d 215 (Del. Ch. 1974), rev’d in part on other grounds, 347 A.2d 133 (Del. 1975); Aronson v Lewis, 473 A.2d 805, 811 (Del. 1984); Smith v Van Gorkom, 488 A.2d 858, 875-73 (Del. 1985); Revlon Inc. v MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986); Katz v Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986); Geyer v Ingersoll Publ’ns Co., 621 A.2d 784 (Del. Ch. 1992); Re Amcast Indus. Corp., 365 B.R. 91 (Bankr. S.D. Ohio 2007). See also the Model Business Corporation Act (2016 Revision) (9 Dec. 2017) § 8.30 according to which directors should carry out their duties in the interest of the corporation, i.e. ‘a frame of reference encompassing the shareholder body’ (at 182)


\textsuperscript{145} See also: United States v Byrum, 408 U.S. 125, 141 (1972); Revlon Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 179 (Del. 1986); Great Rivers Coop. v Farmland Indus., Inc., 198 F.3d 685, 701 (8th Cir. 1999). Blair (n 84) 57.

\textsuperscript{146} See also: Graham v Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); Gearhart Indus. Inc. v Smith Int’l Inc., 741 F.2d 707, 720 (5th Cir. 1984) (‘Unquestionably, under Texas law, a director as a fiduciary must exercise his unbiased or honest business judgment in pursuit of corporate interests’); Re Caremark Int’l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).


\textsuperscript{149} This standard basically assesses against the yardstick of the skill, diligence and care of a reasonably prudent person if the director acted in good faith and tried to reasonably pursue the best interest of the corporation: Blair (n 84) 57; AR Palmiter, ‘Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence’ (1989) 67 Tex. L. Rev. 1351.
Shareholders may rely on these fiduciary duties by promoting a derivative action against the directors and for the benefit of the corporation, with the result that recovery goes to the corporation. When it comes to the analysis of the position of other stakeholders, the autonomy-based and economic liberalist views shared by some parts of the judiciary means that courts have always been reluctant to accept that directors have duties other than towards the corporation and its stockholders. Creditors have no right to assert claims directly or derivatively against the directors for breach of fiduciary duties, not even in the zone of insolvency. Their rights are defined by the terms of their contracts (voluntary claimants) and by the applicable law (involuntary ones). The law only recognises the existence of an implied obligation of good faith alongside the established common law principle of fairness.

However, in the wave of corporate scandals that hit the country in the Eighties, many state legislators - beginning with Pennsylvania in 1983 - enacted provisions that forced directors to consider the interests and consequences of

---

150 Gadsden (n 147). See also: Danielewicz v Arnold, 137 Md. App. 601, 769 A.2d 274 (2001). In that case, the director's actions resulted in alleged breaches of fiduciary duties of loyalty, disclosure, and good faith and dilution of shareholder's majority interest in the corporation's stock. They also caused loss of control and general damages to the corporation. Nevertheless, an action for damages could be brought only in the name of the corporation itself acting through its directors, not by the shareholder in her individual capacity.


152 For a comprehensive analysis of the American position on the subject of directors' fiduciary duties to creditors: SL Schwarcz, 'Rethinking a Corporation's Obligations to Creditors' (1996) 17(3) Cardozo L. Rev. 647, 656 (stating that there is no appropriate basis, absent insolvency, to impose traditional fiduciary standards on what is essentially an arm's-length commercial relationship).

153 See, among others: Simons v Cogan, 549 A.2d 300 (Del. 1988) arguing that convertible debenture holders lack standing to bring a claim based on a breach of fiduciary duties; Metro. Life Ins. Co. v RJR Nabisco, Inc., 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989); Kham & Nate's Shoes No.2, Inc. v First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) according to which '[p]arties to a contract are not each other fiduciaries; they are not bound to treat [each other] with the same consideration reserved for their families'; Lorenz v CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993); United States v Jolly, 102 F.3d 46, 48 (2d Cir. 1996).


155 Among others: Harff (n 144) 222 (Del. Ch. 1974); Katz (n 144) 879.

156 Among others: Katz (n 144).


158 Among others: Neuman v Pike, 591 F.2d 191, 195 (2d Cir. 1979); Katz (n 144); Kham & Nate's Shoes (n 153).
their decisions on a wide variety of people, including employees, creditors, suppliers and communities in which the corporation had facilities.\textsuperscript{159}

This attitude was endorsed by the judiciary, even in states characterised by a strong pro-business mentality. For instance, in Delaware in \textit{Paramount}\textsuperscript{160} the court approved the decision of the directors of \textit{Time} to go ahead with a merger even if shareholders would have been better off with a sale to a takeover bidder willing to pay a significant premium over the stock market price.

The decision in \textit{Paramount} consolidated established case law. For instance, in \textit{Unocal}\textsuperscript{161} the Supreme Court of Delaware held that

\begin{quote}
[t]hough board of directors continued to owe due care and loyalty to a stockholder making a hostile tender offer for company's stock, in face of destructive threat which tender offer was perceived to pose, board had a supervening duty to protect the corporate enterprise, which included other shareholders, from threatened harm.\textsuperscript{162}
\end{quote}

Nevertheless, in order to establish a breach of fiduciary duties by a corporate director, plaintiffs must consider the “business judgment rule”.\textsuperscript{163} This rule provides that, in making business decisions, the directors of a corporation presumptively act on an informed basis, in good faith and in the honest belief that the action taken is in the best interests of the corporation. To overturn this presumption represents a near-Herculean task\textsuperscript{164} as courts will not interfere with directors’ decisions unless in case of fraud, bad faith, gross over-reaching or abuse of discretion.\textsuperscript{165}

\textsuperscript{159} As correctly observed by Mayson, French and Ryan, \textit{Company Law} (34\textsuperscript{th} edn OUP, Oxford 2017) 486, provisions of this kind, usually known as “other constituencies statutes”, where designed and implemented to create a barrier or an obstacle to hostile takeover bids, but their relevance goes beyond these cases.

\textsuperscript{160} \textit{Paramount Communications, Inc. v Time}, 571 A.2d 1140 (Del. Ch. 1990).

\textsuperscript{161} \textit{Unocal Corp. v Mesa Petroleum Co.}, 493 A.2d 946 (Del. 1985).

\textsuperscript{162} Ibid 948.

\textsuperscript{163} \textit{Aronson v Lewis} (n 144).

\textsuperscript{164} \textit{BH S & B Holdings} (n 148). For instance, in \textit{Re Midway Games Inc.}, 428 B.R. 303 (Bankr. D. Del. 2010), on reconsideration in part (19 March 2010) the Bankruptcy Court of Delaware held that directors did not breach their duties of loyalty and good faith by sustained or systematic failure of oversight.

\textsuperscript{165} Among others: \textit{Treadway Co. v Care Corp.}, 638 F.2d 357, 382 (2d Cir. 1980); \textit{Resolution Trust Corp.}, 830 F. Supp. 356 (Tex. 1989).
To sum up, while the law – more in England than in the U.S. – embraces the interests of a range of players that goes beyond the holders of personal and proprietary rights against the company, the light touch approach of the judiciary has strengthened the rights of shareholders and “traditional” creditors at the expense of risk bearer claimants.

4.3(b)(ii) Office-Holders’ Duties in Insolvent and Near-Insolvent Times

Do office-holders’ duties shift in insolvency, or in the proximity or likelihood of this event?\textsuperscript{166} If so, to what extent?

In the \textit{English tradition},\textsuperscript{167} s.172(3) CA 2006 holds that the duty to promote the success of the company is subject to limits, particularly ‘\textit{any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of the creditors of the company}’ (emphasis added).

As insolvency is one of these circumstances, it seems that the law promotes a shift in favour of a certain category of stakeholders (namely, the contractual claimants) in the \textit{proximity of insolvency},\textsuperscript{168} thus impliedly rejecting the claims of principle-based theorists.\textsuperscript{169}

In \textit{formal insolvency cases}, the general duties established in CA 2006 are complemented with specific provisions in IA 1986\textsuperscript{170} and CDDA 1986 that punish the behaviour of those directors and office-holders that have put

\textsuperscript{166} Proximity, vicinity of insolvency or twilight zone are all terms used to describe the situation ‘\textit{when the company is in financial distress and may well be moving from solvency towards and even into insolvency}’ (A Keay, ‘The Shifting of Directors’ Duties in the Vicinity of Insolvency’ (2015) 24 Int. Insol. Rev. 140, 141). UNCITRAL has defined it as the period ‘\textit{in which there is a deterioration of the company’s financial stability to the extent that insolvency has become imminent}’ (UNCITRAL Legislative Guide on Insolvency Law, ‘Part four: Directors’ Obligations in the Period Approaching Insolvency’ Working Group V, 43\textsuperscript{rd} session (New York, 15-19 April 2013 at para 22) <https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf> accessed 17 September 2018).

\textsuperscript{167} See generally: Finch and Milman (n 5) ch. 16 ‘Directors in Troubled Times’; IF Fletcher, \textit{The Law of Insolvency} (5\textsuperscript{th} edn, Sweet & Maxwell: London, 2017), ch. 27 ‘Liability of Directors and Others’.


\textsuperscript{169} The debate over the autonomous or derivative nature of this duty falls outside the scope of this work. On this issue, see: Finch and Milman (n 5) 585-587.

\textsuperscript{170} The majority of these provisions are included in Chapter X (s.206 to 229 and s.238 to 246), while s.246ZA and S.246ZB extend the scope of these provisions from winding-up to administration procedures.
personal concerns or those of selected (groups of) creditors over those of general claimants. At any rate, directors do not owe a duty individually to each creditor but collectively to the company or the creditors as a whole.\textsuperscript{171}

In the majority of these provisions, the legislator focused on protecting the interests of a specific group of stakeholders, namely the contractual claimants. Accordingly, s.207(2) IA 1986 states that a person is not guilty of the offence of fraud if he or she can prove that the transaction has not defrauded the company’s creditors. S.211 IA 1986 punishes with a fine or imprisonment (or both) those directors that have made false representations to creditors for the purpose of obtaining their consent to an agreement with reference to the company’s affairs or to the winding up. Similarly, the protection of creditors is paramount to the punishment of fraudulent (s.213 IA 1986) and wrongful (s.214 IA 1986) trading. Other rules (s.423 to 425 IA 1986) clarify that directors face criminal and civil liabilities whenever transactions are made at an undervalue and for the purpose of putting assets beyond the reach of creditors.

It seems therefore that in writing these rules, the English legislature assumed that the interest of the distressed company matched those of its contractual creditors. No space was reserved in the law for the claims of other stakeholders, even if specific protections and obligations apply to some categories of suppliers (ss.233 and 233A IA 1986).

\textsuperscript{171} \textit{Yukong Lines Ltd of Korea v Rendsburg Investment Corp. of Liberia (The Rialto)} [1998] BCC 870 (QB) 884 holding that the director ‘does not owe a fiduciary duty towards an individual creditor nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director of the company’.

\textbf{The Kinsela Case}

In January 1981 RK was in a situation of financial difficulty. To preserve the family business, directors leased the company premises to Mr. and Mrs. Kinsela for three years. The lease was on particularly favourable terms and allowed the to purchase part of the premises for a sum that was below their real market value.

Once the company entered into liquidation, the office-holders tried to challenge the validity of the agreement. The Court found in their favour, as it observed that the real intention of the directors was to put company’s assets beyond the reach of its creditors.

More importantly, the court held that while in a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company itself when questions of the duty of directors arise, in an insolvent company the interests of the creditors intrude.
The judiciary has adopted an approach that substantially mirrors the statutory position. More to the point, it can be argued that s.172(3) CA 2006 represents the statutory recognition of the established common law principle that directors in times of distress must consider the interests of the creditors when making decisions in the running of the company’s affairs.\textsuperscript{172}

In \textit{Nicholson}\textsuperscript{173} the court found that the interests of the company were to be equated with the interests of the shareholders in general except where the company was insolvent or of doubtful solvency or where the proposed act would be prejudicial to creditors. Following the influential Australian precedent in \textit{Kinsela},\textsuperscript{174} in \textit{Brady} the Court of Appeal held that ‘the interests of the company are in reality the interests of existing creditors alone’.\textsuperscript{175} In \textit{West Mercia Safetywear} the Court of Appeal held that the directors breached the duties imposed by the law because at a time of corporate distress they disregarded the interests of the general creditors of the insolvent company.\textsuperscript{176} According to some commentators, it was only with \textit{West Mercia Safetywear} that ‘the English courts approved overtly of the approach taken in Australia’.\textsuperscript{177}

This approach has not been consistently applied by English courts since the late Eighties.\textsuperscript{178} For instance, the House of Lord distinguished the Court of Appeal’s position in \textit{Brady}, as Lord Oliver of Aylmerton observed that “the interest of the

\textsuperscript{172} Keay (n 113) 444.

\textsuperscript{173} Nicholson v Permakraft (N.Z.) Ltd [1985] 1 NZLR 242 (CA).


\textsuperscript{175} Brady v Brady (n 67).

\textsuperscript{176} Liquidator of West Mercia Safetywear Ltd v Dodd [1988] 4 BCC 30 (CA) 33. For a comment on the case, see: LS Sealy, ‘Directors’ Duties: An Unnecessary Gloss’ (1988) 47(2) Camb. L.J. 175; V Finch, ‘Directors’ Duties Towards Creditors’ (1989) 10(1) Comp. Law. 23 (observing that the decision left unanswered the question of when the shifts of duties operate); D Marks, ‘Preference and Misfeasance: Is West Mercia an Unhelpful Guide?’ (1989) 2(1) Insol. Int. 1 (arguing that there is no real need to hold that creditors’ interests intrude in the duties of directors as wrongful trading provisions already protect creditors from directors’ abuses); D Petkovic, ‘Directors’ Duties and the Intrusion of Creditors’ Interests’ (1989) 4(4) J.I.B.L. 166 (arguing that while \textit{West Mercia Safetywear} heralded the importation into English case law of the ‘shift doctrine’, the parameters of the principle’s application remain uncertain).

\textsuperscript{177} Keay (n 166) 147.

\textsuperscript{178} For a list of cases that support the shift of directors’ duties in the proximity of insolvency, see: Keay (n 166) 149 (ftn. 50). More recently, see the decision in \textit{Re Capitol Films Ltd (in Administration)} [2010] EWHC 2240 (Ch), [2011] 2 BCLC 359 where the court held that the authorization of a transfer of assets without previous consideration of the interests of the company’s creditors can present a breach of the directors’ duties to the company.
“company” is a phrase which refers to a variety of opposing expectations, including those of the employees and future creditors.\textsuperscript{179} It would be wrong, in Aylmerton’s view, to simply look at the infringement of creditors’ expectations to assess if the threshold prescribed by the law has been met. As will emerge from the following chapters, the author is supportive of literature that challenges the view that shareholders and creditors are the only residual owners of the corporation.

Additionally, if the law fully embraced the creditor-oriented view, these parties should be given a standing to sue rogue corporate directors. However, this right is currently reserved primarily to insolvency office-holders. Also, the existence of such a shift in the directors’ duties would require an outright prohibition of any practice that might not result in the maximisation of the creditors’ interests. Many provisions – primarily those which permit a pre-orchestrated sale of distressed businesses to connected parties – sit at odds with the creditors’ maximisation assumption.

In the \textbf{U.S. tradition}, outside formal insolvency procedures, fiduciary duties are governed by state law. However, the opening of a corporate bankruptcy procedure under 11 U.S. Code means that duties and potential liabilities (such as for wrongful or fraudulent trading) are governed by federal common law rather than by the applicable state law.\textsuperscript{180}

\textsuperscript{179} \textit{Brady v Brady} (n 67) 777-778. The decision in \textit{Brady} was overruled by the House of Lords, but on this point their Lordships acknowledges that the interests of creditors had to be taken into consideration.

In insolvency situations, U.S. Bankruptcy Courts apply the “trust fund doctrine” (first introduced in *Wood*¹⁸¹) according to which directors of an insolvent company ‘no longer owe a duty to stockholders who no longer have any economic interest in the entity’.¹⁸² Therefore, since a person is able to establish the fact of insolvency (which may occur before the filing), the directors owe fiduciary duties to the creditors of the company only.¹⁸³

In near-insolvency situations, i.e. when the company is in the proximity of insolvency, the situation is far less clear. On one hand, directors are liable towards all the constituencies of the company (i.e. not only its creditors) for wrongly prolonging the life of their distressed companies,¹⁸⁴ albeit exceptions apply.¹⁸⁵

---

¹⁸¹ *Wood v Drummer* 30 F.Cas. 435 (No. 17944) (C.C. Me. 1824). The Delaware Supreme Court adopted the doctrine in *Bovay v H.M. Byllesby & Co.* 38 A.2d 808 (Del. 1944).


¹⁸³ *Geyer v Ingersoll* (n 144), 790. For an analysis of Geyer: SR McDonnel, ‘*Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors’ Burden from Shareholders to Creditors*’ (1994) 19 Del. J. Corp. L. 177. See also: *Re Scott Acquisition Corp.*, 344 B.R. 283 (Bankr. D. Del. 2006) (arguing that directors and officers of an insolvent wholly-owned subsidiary owe fiduciary duties to the subsidiary and its creditors); *Production Resources Group, Llc v NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004). In the literature: Varallo and Finkelstein (n 182) (arguing that strict application of the trust fund doctrine operates as a substantial disincentive for directors to consider alternative courses of action); de Barondes (n 85) 63.

¹⁸⁴ This situation is known as the tort of “deepening insolvency”. The concept first originated in *Re Investors Funding Corp.*, 523 F.Supp 533 (S.D.N.Y. 1980), while the term “deepening insolvency” was first used in *Schacht v Brown*, 711 F.2d 1343 (7th Cir. 1983). This principle has recently been re-affirmed in *Quadrant Structured Products Co. v Vertin*, 102 A.3d 155 (Del. Ch. May 4, 2015).

¹⁸⁵ See, for instance, *Amcast* (n 144), arguing that a claim asserted on behalf of creditors against corporation’s directors and officers for deepening insolvency, based upon fraudulent prolonging of corporation’s life or expansion of its debt beyond insolvency in manner resulting in further dissipation of assets, is not valid cause of action.

---

**The Credit Lyonnais Case**

In November 1990 Mr. Parretti acquired *MGM* in an LBO transaction but subsequently lost control of the company to *Credit Lyonnais* by reason of the clauses in a Corporate Governance Agreement signed by the parties.

To retain control of *MGM*, Parretti sought to dispose quickly and at undervalue of key *MGM* divisions. *MGM*’s creditors (including *Credit Lyonnais*) would have assumed most of the downside risk, while *MGM*’s shareholders (who had little equity in the company) would have received most of the upside benefit.

The chancellor found that Paretti’s actions breached its fiduciary duties as non-executive director of *MGM*. The Chancery Court of Delaware held that directors operating in the ‘zone of insolvency’ owed fiduciary duties to the ‘corporate enterprise’, which meant not only to equity-holders but also to creditors.

---

In November 1990 Mr. Parretti acquired *MGM* in an LBO transaction but subsequently lost control of the company to *Credit Lyonnais* by reason of the clauses in a Corporate Governance Agreement signed by the parties.

To retain control of *MGM*, Parretti sought to dispose quickly and at undervalue of key *MGM* divisions. *MGM*’s creditors (including *Credit Lyonnais*) would have assumed most of the downside risk, while *MGM*’s shareholders (who had little equity in the company) would have received most of the upside benefit.

The chancellor found that Paretti’s actions breached its fiduciary duties as non-executive director of *MGM*. The Chancery Court of Delaware held that directors operating in the ‘zone of insolvency’ owed fiduciary duties to the ‘corporate enterprise’, which meant not only to equity-holders but also to creditors.

---

In November 1990 Mr. Parretti acquired *MGM* in an LBO transaction but subsequently lost control of the company to *Credit Lyonnais* by reason of the clauses in a Corporate Governance Agreement signed by the parties.

To retain control of *MGM*, Parretti sought to dispose quickly and at undervalue of key *MGM* divisions. *MGM*’s creditors (including *Credit Lyonnais*) would have assumed most of the downside risk, while *MGM*’s shareholders (who had little equity in the company) would have received most of the upside benefit.

The chancellor found that Paretti’s actions breached its fiduciary duties as non-executive director of *MGM*. The Chancery Court of Delaware held that directors operating in the ‘zone of insolvency’ owed fiduciary duties to the ‘corporate enterprise’, which meant not only to equity-holders but also to creditors.
On the other, the case of Credit Lyonnais\textsuperscript{186} seemed to have introduced into American case law the English expansion of fiduciary duties to corporate creditors.\textsuperscript{187} In fact, in that ruling Chancellor Allen of the Delaware Court of Chancery held that ‘\textit{at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers (i.e. the shareholders) but owes its duty to the corporate enterprise (i.e. primarily the creditors)}’.\textsuperscript{188}

In Credit Lyonnais, Delaware commercial court extended the trust fund theory (according to which directors owe duties to creditors) from insolvency to the period where insolvency is close but not yet manifest.\textsuperscript{189}

While other courts have been supportive of this shift of fiduciary duties in the proximity of insolvency,\textsuperscript{190} this doctrine was harshly criticised by commentators\textsuperscript{191} and in other circuits.\textsuperscript{192} Its implementation has also proven

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{187} Prior to Credit Lyonnais there have been cases where courts suggested that insolvency determined a shift of the fiduciary duties from stockholders to creditors. See Davis v Woolf, 147 F.2d 629, 633 (4th Cir. 1945); Clarkson Co. Ltd v Shaheen, 660 F.2d 506, 512 (2d Cir. 1981); Am. Nat’l Bank v Mortgage Am. Corp. (Re Mortgage Am. Corp.), 714 F.2d 436, 464 (5th Cir. 1983); and Re Sharon Steel Corp., 871 F.2d 1217, 1228 (3d Cir. 1989).
\item \textsuperscript{188} Credit Lyonnais (n 186) 1155.
\item \textsuperscript{189} See also: Ed Peters Jewelry Co. v C&J Jewelry Co., 124 F.3d 252, 276 (1st Cir. 1997); Askanase v Fatjo, 130 F.3d 657, 666 (5th Cir. 1997).
\item \textsuperscript{190} See also: L Lin, ‘Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors’ (1993) 46 Vand. L. Rev. 1485 (characterizing the vicinity of insolvency as ‘ill-defined’); CR Morris, ‘Directors’ Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais’ (1993) 19 J. Corp. L. 61; RF Hartman, ‘Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?’ (1993) 50 Wash. & Lee L. Rev. 1761, 1766 (arguing that Credit Lyonnais leaves crucial questions unanswered while observing that this decision has provided the foundation for using situation-specific fiduciary duties to solve the problems raised by the financial model); McDonnel (n 183) 210 (stating that Credit Lyonnais left a myriad of questions unanswered); B Nicholson, ‘Recent Delaware Case Law Regarding Director’s Duties to Bondholders’ (1994) 19 Del. J. Corp. L. 573, 575 (viewing the vicinity of insolvency exception as ‘regrettably ambiguous in its timing and scope’); RKS Rao and others, ‘Fiduciary Duty à la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm’ (1996) 22 J. Corp. L. 53 (viewing the vicinity of insolvency as ‘broad and ambiguous’); de Barondes (n 85) (arguing that the shift of fiduciary duty harms primarily that set of creditors such as suppliers and non-adjusting claimants least capable of negotiating an alternative contractual resolution); AD Shaffer, ‘Corporate Fiduciary-Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About’ (2000) 8 Am.
\end{enumerate}
\end{footnotesize}
problematic for the same Delaware courts with the result that it was promptly abandoned. First, in *Trenwick* the Delaware commercial court held that directors' duties do not change as the company nears insolvency or becomes insolvent. Then in *Gheewalla* the Delaware Supreme Court overruled the *Credit Lyonnais* approach and held that directors do not owe particular duties to creditors in the proximity of insolvency. It held on the contrary that '[i]t is well established that the directors owe their fiduciary obligations to the corporation and its shareholders'.

This stockholder-oriented (in the proximity of insolvency) and creditor-oriented (in insolvency) approach is inconsistent with the conclusions of the U.S. Supreme Court in several bankruptcy cases. This judicial body has frequently observed the existence of a link between interests in the procedure and the residual value of the claim. This link and the connected fiduciary duty therefore should exist even when the company is not insolvent.

Therefore if – as the Supreme Court suggests – rights over an insolvent company fall on a large number of stakeholders, it is arguable that directors

---

193 See, for instance: *Verestar* (n 147) holding that under Delaware law, when managing a corporation in the vicinity of insolvency, directors must consider the best interests of the corporation, not just the interests of either creditors or shareholders alone. While this duty does not necessarily place creditor interests ahead of the interests of shareholders, it requires the board of directors to maximise the corporation's long-term wealth creating capacity.

194 *Trenwick America Litigation Trust v Ernst & Young*, 906 A.2d 168 (Del. Ch. 2006). This decision allowed directors to engage in appropriate, calculated risk-taking with the aim of adding value to their companies because they enjoy the wide protection granted by the business judgment rule: MS Huebner and DS Klein, 'The Fiduciary Duties of Directors of Troubled Companies' (2015) 34(2) Am. Bankr. Inst. J. 18, 19.


196 Ibid.

197 See, for instance: *Pepper v Litton*, 308 U.S. 295 (1939) where the Supreme Court held that managers have broad fiduciary duties to creditors as well as stockholders.

must consider a wider array of interests rather than merely those of the formal and former owners of the company and their creditors. When this shift occurs is, however, a matter of contentious debate.199

4.3(b)(iii) Half-way Findings

Principle-based theorists have provided evidence to argue that, under general law, the duties of directors are stakeholder- rather than shareholder-oriented. In line with these findings, this work supports the view that the qualities of certain claimants (such as disparities in volition, cognition and access to secondary market)200 and the circumstance that not all insolvency procedures are distributional in nature,201 suggest the opportunity to consider the interests and expectations of a wider variety of stakeholders than shareholders and contractual claimants.

Nevertheless, it is undeniable that the current laws and jurisprudence still support a shift towards a stronger protection of contractual creditors’ interests and expectations in the proximity of and particularly in insolvency, as evidenced in the table below.

199 Jelisavcic (n 84) (suggesting a financial definition of the court’s “vicinity of insolvency” standard which relies on the Z-score method to predict corporate insolvency); JA Pearce II and IA Lipin, ‘The Duties of Directors and Officers within the Fuzzy Zone of Insolvency’ (2011) 19 Am. Bankr. Inst. L. Rev. 361 (proffering a similar approach to determine the nature and content of directors’ duties in the different stages of companies’ life).

200 Lipson (n 186).

201 If a procedure such as a Chapter 11 reorganisation or an English administration is not designed to liquidate assets but to re-organise a firm and thus preserve or create new value, it makes little sense to determine claimants’ rights solely on the basis of their distributive entitlements.
<table>
<thead>
<tr>
<th>Solvent Times</th>
<th>Near Insolvency</th>
<th>Insolvency</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.K.</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consider: <em>Style</em> (2016) and <em>Sequana</em> (2016)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>U.S.</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Where corporate and insolvency statutes adopt a more encompassing approach (in line with principle-based theories), the judiciary is more adherent to neoclassical visions of the role of corporate directors and office-holders. As a result, the position of the courts is more aligned with the tenets of proceduralist theories discussed in chapter three, as courts, both in equity and outside it, have primarily considered qualified interests, i.e. the interests of those who have a contractual claim against the company.

The lack of guidance from case law and the reported criticisms towards clear-cut, either creditor or shareholder-oriented approaches suggest a half-way consideration, i.e. that there is no such thing as the creditors’ or shareholders’ interest, but only conflicting stakeholders’ interests.202

The next sub-section presents some reflections to support the view of principle-based theorists that the category of interested parties should include all those stakeholders who have controlling, risk bearer claims against the distressed company. Directors should consider the position of these stakeholders throughout the entire life of the company. However, in times of distress, the

---

202 Some scholars have suggested that these and related problem could be ameliorated by the adoption of financial measures – such as Altman’s Z-score – to define the boundaries of solvency, zone of insolvency, insolvency in fact and insolvency procedure: Jelisavcic (n 84); Pearce and Lipin (n 199) 397. This thesis rejects this approach as predictive models assume that interested parties have timely access to transparent and faithful business accounts. Corporate scandals such as *Enron* and *Carillion*, as well as anecdotal evidence suggest that this assumption is un-tested and probably incorrect in a large number of cases.
interests of these parties may intrude to the point that directors should use insolvency remedies to protect their risk bearer rights.

4.3(c) A Normative Argument to Consider the Interests of All Controlling Stakeholders

It is a truism to state that broad policies, strategic plans and day-to-day decisions of any corporation are determined or highly influenced by a close group of people. These are the professional managers who sit on boards or the director and majority or sole shareholder in medium to small corporations. A hotly debated question is the benefits which should be paramount to these directors whenever they exercise their decision-making powers.

Sub-section 4.3(b) explained what interests are currently protected by company law and the judiciary, both in solvent and insolvent times. It has discussed the contrasting views about corporations’ obligations to stakeholders. Commentators who grappled with this issue tried to understand if stakeholders other than stockholders are entitled to benefit from the directors’ fiduciary duties and at which stage of the company’s life.

This thesis contends that this approach is incomplete. It maintains that the controversial issue of whether a corporation owes an obligation to stakeholders can only be addressed after it has been established who the company’s residual claimants are, in the different stages of its life.

This is not to say that the bearers of societal or wider interests should always be entitled to extract value from the debtor’s insolvency or that their claims should prevail over contractual, secured creditors. Nevertheless, the value-only approach advocated by some commentators may prove inadequate.

---


204 Paterson (n 23) 4-5, observing that ‘it is right to include [...] a wider range of stakeholders than merely creditors because otherwise a series of costs are externalised (such as the cost of lost jobs)’. 
To determine who the residual claimants are, it is necessary to inform this corporate and insolvency law debate with some findings from corporate governance theories.\textsuperscript{205}

This debate has been particularly exciting in the U.S., which has always viewed the company as a political “hot potato”, in particular after the period of corporate scandals and takeover frenzy of the late Seventies and Eighties. In England this topic has been somehow underestimated, at least until its centrality has been re-established in the wake of the financial crisis.

For decades, neo-classical legal scholars and economists have argued that corporations are owned by shareholders and that they should therefore be managed in their sole interest (“finance model”).\textsuperscript{206} According to these commentators, managers have a legal obligation to act in their only or prevailing interest because they own the company and they bear the risks associated with the misuse or decline of the company’s value. It follows from this reasoning that, when the company is systemically unable to pay its debts as they fall due, the shareholders lose most or all of their ownership and controlling rights in the company. These rights accordingly are transferred to the next beneficiaries in line: the contractual creditors.\textsuperscript{207}

This perception has been extensively criticised in legal and economic literature and this work is not the first to point out that shareholders are not always or the only residual claimants of a corporation (especially large ones with widely spread share ownership).\textsuperscript{208} The assertion that stockholders are the residual

\textsuperscript{205} For similar findings: SJ Lubben, ‘The Board’s Duty to Keep Its Options Open’ (2015) U. Ill. L. Rev. 817, 818.


\textsuperscript{207} Paterson (n 23) 24: ‘\textit{w}hen a company is insolvent, it is tolerably clear that directors’ duties to the company should represent the interests of the creditors’.

\textsuperscript{208} See, among others: RE Freeman, \textit{Strategic Management: A Stakeholder Approach} (Pitman: Boston, 1984) 31 (arguing that stakeholders are not only those groups without whose support the organisation would cease to exist but the group of people and organizations to whom management need be responsive); Blair (n 84); LE Mitchell, ‘A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes’ (1992) 70 Tex. L. Rev. 579, 582-583; GT Garvey and PT Swan, ‘The Economics of Corporate Governance: Beyond the Marshallian
claimants does more to obscure the important issues than to illuminate them.\textsuperscript{209} It underestimates that contractual creditors supply capital to the corporation and they receive repayment of the principal amount with interest.\textsuperscript{210} Similar considerations apply to workers and, to a more limited extent, tort claimants.

Limited liability contradicts the observation that shareholders are the only risk bearers: creditors, as well as other parties in interest, bear the risk of failure of a solvent corporation. Consequently, if the risk of failure looms over a wider category of stakeholders, it does not seem appropriate to restrict the category of residual claimants in insolvency to contractual creditors and equity-holders.

Additionally, the \textit{de facto} separation of equity ownership from control, with the stock of medium and large companies frequently distributed to a significant number of institutional or small investors, makes the afore-mentioned neo-classical assumption even more challenging to be endowed.

If we adopt a legal perspective, therefore, we can observe that shareholders do own the company but they do not necessarily control it or take part in its active life\textsuperscript{211} and they may not be the only or major residual claimants. They have a right to a dividend if a dividend is declared, a right to vote at general meetings and a right to any residual surplus upon liquidation. Their interests are not the company’s interests, both in the U.S. and in England.

\begin{flushright}
\end{flushright}

\begin{flushright}
\textsuperscript{210} Callison (n 186) 431.
\end{flushright}

\begin{flushright}
\textsuperscript{211} This is the situation as today, but it may well change in the future, thanks to the use of technologies such as blockchain. For instance, the Spanish bank Santander has recently announced that it became the first company in the world to use blockchain technology to allow investors to vote at an annual meeting: A Mooney and N Megaw, ‘Santander Shows Potential of Blockchain in Company Votes’ \textit{Financial Times} (London, 17 May 2018) <https://www.ft.com/content/c03b699e-5918-11e8-bdb7-f6677d2e1ce8> accessed 17 September 2018. Thanks to the use of blockchain, investors do not have to cast their vote by proxy two weeks before the meeting and any concern of loss or manipulation of the casted vote is vacated. Still it is debatable whether casting a vote in an AGM is sufficient to claim that equity-holders “control” a company.
\end{flushright}
For the purpose of determining if this approach is correct, the key issue is to clarify the meaning of “ownership”. As logic tells us, definitions are *ad hoc*, in the sense that their validity depends upon their ability and usefulness to analyse a problem and draw valid conclusions. If we accept that ownership, as commonly understood in practice, implies detaining a proprietary right over a portion of the company, only *some* shareholders own a company.

The author however assumes that selected risk bearer rights (including fiduciary rights) should be recognised to all those stakeholders who receive the “residual return” and bear the “residual risk” in a business by reason of their specialised inputs to its activity and functioning.

Under this narrative (commonly known as “the pluralist model”), these stakeholders have a quasi-ownership, risk bearer claim and a residual right of control of the company even if according to law they do not own any assets of the company. It therefore follows that the company should be conceptualised as a bundle of self-interested constituencies, each with different interests and risk levels. Directors have a fiduciary duty to assess the relevance and prominence of the risk bearers' interests throughout the company's life and activity, as evidenced in the recently revised version of the Corporate Governance Code.

---


213 Ownership rights are not recognised in some financial instruments such as shares without voting rights, whose holders are generally compensated for their investment/loan with higher interest rates or a larger portion of the profits.

214 Blair (n 84) (arguing that in her ‘wealth maximisation model’ managers should try to maximise the wealth of all stakeholders. Stakeholders, who are not simply shareholders, share in the company’s residual gains and risks). Shareholders are traditionally considered residual claimants because they are remunerated only after all other contractual claimants, such as lenders, employees, customers and suppliers.

215 The pluralist model has first been advocated in the U.S., where it has been translated into state laws from the mid-80s, even if the federal legislator has always been reluctant to endorse it. In England, this model has first been advocated by the Commission on Public Policy and British Business: *Promoting Prosperity: A Business Agenda for Britain* (Vintage: New York, 1997). Despite having been rejected by the Company Law Review Steering Group (Committee on Corporate Governance, *Final Report* (Gee, 1997), para 1.17), it seems that the CA 2006 and the recent proposals for reform of s.172 support the pluralist model.

216 Kandestin (n 186) 1239.

The category of risk bearers or risk takers, therefore, should include many more players than the shareholders-owners of the distressed company and their contractual creditors. While it is impossible to define ex-ante all the potential stakeholders, this list may include:

- **Employees** and **Shareholders** with company-specific skills, a consideration extremely actual in economies (such as those considered in this study) where manual, repetitive labour is increasingly replaced by automation and employers compete on the job market for highly-skilled workers.²¹⁸ It might be true that outside insolvency, these parties have received additional consideration for their skills. At the same time, their decision to work for or promote the success of a particular enterprise may have significantly restricted their career opportunities in other sectors or companies, due to the highly skilled nature of their work or activity;

- **Suppliers** whose business is highly dependent upon the orders of the distressed corporation where neither party can promptly find a competitor to supply goods and services of the same quality and at comparable price in a reasonable time. Examples include companies such as Delphi for General Motors, or Takata for the automotive industry in general. The dependency can be determined by asking if the collapse of the debtor would determine a ripple effect on its supply chain and, potentially on the considered sector of the economy;

- **Tort Claimants** in cases where the insolvency petition was prompted by the desire to shield the company from damage liabilities and preserve or promote its viable business;

- **Pension funds** in cases where the insolvency filing was prompted by the desire to skirt contractual liabilities or make the company more attractive to a potential buyer in a takeover bid;

- **Citizens** and **Communities**, for instance in cases where the debtor is a polluter, or where the company is located in depressed or high-

---

²¹⁸ It has been observed that ‘[t]he new model of production more closely resembles the old craft systems, which used less rigid manufacturing technologies but relied on more highly skilled workers’ - see Blair (n 84) 272.
unemployment regions, or when the industrial network of activities in a certain area is strictly connected, with the result that if one company went out of business, a domino effect on several other businesses is likely to occur.

The pivotal issue of the insolvency theories analysed in this study is their failure to measure and count as wealth creation the share of the rents\textsuperscript{219} generated thanks to the contribution of these stakeholders. At best, they are simply classified as “claimants”.

Corporate governance scholars have evidenced the need to recognise the centrality of these players. Principle-based theorists have confronted this challenge and suggested an approach that considered, protected and promoted their interests. Principle-based theories fail to comprehensively address the issue of the limits of insolvency law for the reasons evidenced in sub-section 4.2(b). Nevertheless, as evidenced in this section, the “inclusive vision” promoted by these theorists is sound and deserves to be considered in conceptualising a novel approach to the definition of the limits of this area of law.

4.3(d) Should Controlling Interests Be Relevant under Insolvency Law? A Theory of Wealth-Maximisation of Stakeholders’ Interests (‘WMSI’)

Where sub-section 4.3(c) demonstrated that the claims of risk bearer right holders should be considered in insolvency scenarios, it provided little assistance in determining how their claims should be assessed against the holders of personal and proprietary interests. If the comparison occurred at face value (i.e. considering the nominal value of each party’s claims), it is likely that the rights of secured creditors (mainly proprietary) would hierarchically

\textsuperscript{219}The notion of “rent” is used as a synonym of “economic profit” to describe returns greater than the minimum required to induce the firm to supply goods or services: Blair (n 84) 241; Mazzucato (n 1) 4-5. Rents can be generated from new wealth being created or from rent-seeking activities that do not generate but extract or transfer rents from one group of people to others (e.g. collusion or monopolization of a market, the majority of financial activities and the pricing of certain goods such as pharmaceutical products).
prevail in the majority of situations. In Korobkin’s words, inclusivity would not lead to rational planning.\textsuperscript{220}

The question of how those who have an interest in a company ought to be protected (particularly in rescue cases) is a challenging one.\textsuperscript{221} To provide an answer, it is pertinent to imagine the parties’ interests and expectations as a pie chart, in which each of the stakeholders retains a share of (personal, proprietary or risk bearer) interests over the company. Should the company face financial distress, the expectations of one or more of these categories cannot simply be wiped out. They are re-modelled according to their nominal value, the residual value of the enterprise and the turnaround options available to the distressed company.

For instance, imagine that company (A) files for insolvency protection. It has secured creditors (SC) for £20, trade creditors (C) for £40, arrears to its employees (E) for £20, unfunded pension obligations (P) for £25 and it faces environmental cleaning costs (EC) for £25, while its shareholders (S) paid £1 to incorporate the company. Total liabilities \(L\) are therefore £131.

\[
L = SC + C + E + P + EC + S
\]

The value \(V\) of its remaining assets is £80 if sold in piecemeal sales. Accordingly, if the only available option was liquidation, the proceeds from the assets should be distributed among the creditors in accordance with the order of priority negotiated by the parties and established by the law.

Imagine now however that a potential bidder (B) is interested in A. B sees the potential for future earnings (X) due to the competitive range of products that the two merged companies would be able to offer on the market, the professionalism and productivity of A’s employees, the expertise of some of A’s shareholders, some of A’s facilities and B’s capital. Unfortunately, he is willing to offer only £70, because of the risks associated with the merger and the circumstance that only some of A’s employees are considered “strategic”.

\textsuperscript{220} Korobkin (n 4).

\textsuperscript{221} Paterson (n 23).

\textsuperscript{222} The formulas in this sub-section have been autonomously conceived by the author.
Liq. = £80

B = £70 +/− X

If it is assumed, as the finance model does, that shareholders and creditors are the only residual claimants of the distressed debtor, it is likely that such an offer would be outright rejected. If, however, it is considered that the same rights recognised to creditors should be equally vested in all the other stakeholders in proportion to the controlling value of their claims, the final result might be reversed, as:

\[ SC + C + S = £61 \]

\[ E + P + EC = £70 \]

The stakeholders may at this point decide that, to facilitate the M&A process, some consideration in the newco (D) is recognised to the retained employees and shareholders, while lump payment to pension funds may also be agreed.

An approach that valorises the interest of a wide array of stakeholders has been observed in several recent rescue and liquidation cases. In Chrysler’s case, shares in the newco that acquired the profitable assets of the bankrupt automotive corporation were given to employees and third parties despite the fact that more senior creditors had not been paid in full. Similarly, Sir Philip Green’s £363m payment to the pension fund of failed retailer BHS has given the scheme’s 19,000 members the chance to receive better benefits than available through an industry-backed lifeboat fund even if more senior creditors had not – once again – been paid in full.223

223 In the case of BHS, Sir Green’s payment was solicited by other considerations. It has been observed that for the period 2004-2015 (when BHS was sold to the British businessman Dominic Chappel for £1), Sir Green and his family extracted from the company an estimated £580 million while they left a £571 million deficit in the pension fund (which was in surplus when Sir Green bought the company in 2004); S Butler, ‘How Philip Green’s family made millions as value of BHS plummeted’ The Guardian (London, 25 April 2016) <https://www.theguardian.com/business/2016/apr/25/bhs-philip-green-family-millions-administration-arcadia> accessed 17 September 2018. This promoted some commentators to label Sir Green (and entrepreneurs acting in similar fashion) as ‘value-takers’: Mazzucato (n 1) 1.
In other cases – such as the collapse of Carillion – the lack of consideration for the expectations of all company's constituencies has sparked criticisms and consequences that are likely to go well beyond the case itself. A damning 100-page report of the Work and Pension and the Business, Energy and Industrial Strategy committees suggested not only to act against Carillion's rogue directors, but also against the Big Four accountancy firms that were engaged in checking the financial situation of the company. These accounting firms failed to properly scrutinise the debtor's balance sheet and were blamed for prioritising their own profits ahead of good governance at the companies they are supposed to be putting under the microscope (they approved Carillion's accounts despite its spiralling debt).

Stakeholder-oriented solutions can also be employed to avert disaster. This is what happened recently when the then Transport Secretary Chris Grayling (Con.) decided to re-nationalise the East Coast Mainline Service from 24 June 2018, thus terminating the East Coast franchise five years ahead of its contractual termination.

The decision qualified as a bail-out by the opposition and some commentators was not simply in the interest of the franchisee, a joint venture between Stagecoach (90%) and Virgin (10%). It was also in the interest of the workers, who did not lose their jobs or saw their pension schemes

---

224 The report noted in particular the harmful consequences for certain stakeholders such as employees (who either lost their jobs or saw their pensions curtailed or both), small businesses, contractors and suppliers left fighting for survival.
228 J McDonnell MP (Lab) (@johnmcdonnellMP) ‘Good to see Grayling implementing first stage of Labour’s Manifesto promise to renationalise the railways. I think I’m right in saying that he’s now nationalised more railways than any Labour minister in 6 decades. Come on Chris, East Coast line today, the whole system tomorrow’ (16 May 2018, 1:13 PM). Tweet.
curtailed, as well as the suppliers of these companies, as they did not face the risk of partial or no repayment following the insolvency of the train operator. Finally, it was also in the interest of the passengers, who should not face significant disruptions as the service will be operated by an operator of last resort, as well as the citizens. The decision may have come with a significant cost: the Shadow Transport Secretary Andy MacDonald claimed that taxpayers suffered a £2 billion loss from the early termination of the franchising.

Consider now the case in which the nominal value of the claims of the holders of personal and proprietary rights far exceeded those of the holders of risk bearer rights. In this case, the office-holder (who might well be the debtor) might not be forced to pursue the interests of risk bearer claimants if they conflicted with the other participants in the insolvency procedure.

However, imagine if it were possible to adopt a course of action that equally protected the rights of personal and proprietary claimants and those of risk bearers but required more time to be implemented or was surrounded by higher uncertainties than the course of action preferred by the majority of personal and proprietary claimants. In that case, the office-holder would have – under the WMSI theory – the obligation to consider this alternative course of action. The office-holder would have an obligation to pursue the alternative course of action only if it was proven that the risk bearer claimants had controlling interests in the company that exceed those of the other claimants. The proof of the existence, extent and relevance of these controlling interests is equitable in nature.

Stakeholder-oriented solutions would not necessarily maximise the return to creditors, but they have the potential to maximise the wealth creation for a wider range of parties-in-interest. Specifically, they have the potential to

---


231 Hansard HC vol 641 col 288W (16 May 2018). It seems that the figure presents a loss of income for the government rather than an expense, as it refers to the money that the joint venture should have paid to the government for running the service from 2018 to 2023: C McGrath and N Stinson, ‘Collapse of Virgin Train East Coast deal leaves taxpayers £2BILLION out of pocket’ Express.co.uk (London, 17 May 2018) <https://www.express.co.uk/news/politics/960843/virgin-east-coast-trains-main-line-richard-branson-bailout-labour> accessed 17 September 2018.
allocate capital to those best able to use it. These solutions do not represent a 
breach of the principle of pari passu distribution as stakeholders are treated in 
accordance with the substantive principles underpinning this area of law, 
particularly the principle of protection of the relative value of individual rights 
against the debtor.

This approach would better explain the reluctance with which Anglo-American 
courts implement the principles of pari passu treatment of equally-ranking 
creditors and modified universalism in cross-border cases where protection of 
local/domestic creditors is at stake.232

Principle-based theorists are forced to admit that there might be exceptional 
circumstances in which some of the above-mentioned principles cannot be 
applied.233 The WMSI theory can more easily justify the need to weight 
principles by referring to the stakeholders’ risk bearer rights that each of the 
stakeholders has towards the insolvent estate. Principles are not excepted: they 
are simply weighted on the basis of the pre-established and recognised rights 
over the insolvent estate. Such an approach would be flexible enough to 
vindicate social and wider interests in the enterprise while not unduly affecting 
the private-ordering of corporate purpose.234

The nominal value of the claim against the insolvent debtor is only the starting 
point to determine the rights that each (category of) stakeholders have 
towards the insolvent estate. As it will be demonstrated in the following chapter, not 
only in each moment of a company’s life but also once the choice of the 
insolvency path (liquidation or rescue) has been taken, the relative power of

232 For findings on U.S. attitude in the field, see: J Leong, ‘Is Chapter 15 Universalist or 
Territorialist?’ (2011) Wis. Int’l L. J. 110. For evidence on the attitude of English courts, see the 
Supreme Court decision in Rubin v Eurofinance SA [2012] UKSC 46, [2013] 1 AC 236 and related 
articles on the topic.
233 Bork (n 19) 172 (where he conceded, with reference to the Australian case Akers v DCT, that 
‘there may be exceptional cases in which protection of local creditors is required’).
234 DG Yosifon, ‘Opting Out of Shareholder Primacy: Is the Public Benefit Corporation Trivial?’ 
(1997) 5(1) Corporate Governance 3, 4 (arguing that stakeholder theories are incompatible 
with business as they are both misguided and mistaken).
each of the considered stakeholders may and does vary as ‘the fiduciary construct is a function of the firm's financial condition’.\textsuperscript{235}

While in general the opinions of contractual creditors will be kept in higher esteem in liquidation procedures - albeit with significant exceptions, such as in “liability” cases -, a majority vote based on the stakeholders’ controlling interests (rather than on the nominal value of their claims) might be considered, especially in rescue cases. Such an expedient is necessary to offset the generally accepted consideration that:

\begin{quote}
... when the ability of a company to generate revenues falls to the point that it can pay its debts but no more, neither creditors nor shareholders have incentives that are consistent with the long-term health and survival of the firm.\textsuperscript{236}
\end{quote}

It is not unheard of that the opinion of some stakeholders or parties-in-interest will matter more than others with reference to certain decisions. The key issues are to determine with reasonable certainty the cases in which this happens and to grant increased controlling power only to those stakeholders who would bear the consequences of the decisions.

4.3(e) Concluding Remarks

The apparent departure from some of the substantive principles of insolvency law advocated here - such as the APR and the pari passu principle of distribution - is inescapable, but not problematic whenever this choice is being taken in the interest of all the stakeholders, including those who have residual risk bearer interests in the company.

APR and pari passu distribution principles continue to have general application, as they have been conceived to protect the rights of all stakeholders. It would be counter-logical, however, that the achievement of a potentially optimal result for the stakeholders is prevented by a strict and mechanical implementation of the above-mentioned principles.

\begin{flushright}
\textsuperscript{235} Rao (n 191) 75.  \\
\textsuperscript{236} Blair (n 84) 25.
\end{flushright}
The insolvency procedure represents the place where conflicting interests are weighed. As a result, in the process of weighting principles, the system in reality assesses the preponderance of the controlling interests which it purports to promote. As Blair observed in devising her corporate governance proposition, ‘“If the party who controls the use of an asset also reaps the benefit of using it efficiently - and bears the cost of its misuse - that party has a significant incentive to see that the asset is used well.”’

237 Principle-based theorists have demonstrated that these parties are not simply the shareholders (in solvent times) and the contractual creditors (in insolvency or in the vicinity of it). They demonstrated the existence of a governance problem in insolvency cases. They had however failed to devise uniform recommendations for institutional reform, due to the controversial nature of the notion of the “principle” which underpins their theories.

This section has conceptualised and made a case for a WMSI theory to determine the course of action of corporate entities, inside and outside regulated “insolvency” procedures. According to this theory, in regulated insolvency procedures office-holders should consider and weight the interests of a wider variety of claimant than today, as the rights of risk bearer claimants intrude in the system. As a result, office holders should choose the course of action that appears to rationally promote the majority or most important interests of those who control the distressed company.

4.4 Findings and Open Problems

The basic premise of any principle-based approach is that principles (and rules based on these principles) can favour the orderly solution of insolvency cases and that insolvency law assumes the existence of a body of principles outside its

237 Blair (n 84) 235.
238 The notion refers to those situations in which decisions are taken and control rights are exercised by parties who do not bear all the possible negative consequences arising from their implementation.
Unfortunately, principles alone appear unable to consider the specific complexities of many insolvency cases.

This chapter has nevertheless demonstrated the declaratory value of principle-based frameworks. These visions confirmed the weaknesses of proceduralist and autonomy-based solutions as applied to insolvency law, but they failed to provide an alternative, coherent conceptualisation of this area of law.

This de-constructivist analysis has also evidenced that the group of people who can place a claim against the insolvent debtor is wider than that assumed by neo-classical economists and proceduralists. Other claimants should be granted protection by insolvency law because they have rights over the insolvent company, as they control a portion of it by reason of a risk bearer interest on its assets and activities.

Principle-based theorists rightly remarked that insolvency laws should respect the stakeholders’ controlling rights. Accordingly, the decision on when to file for insolvency should take into consideration the prevailing controlling interests at the time of the filing.

Company law scholars, economists and executives demonstrated that corporations are structured or should be structured to maximise their wealth-creating potential for all their stakeholders, i.e. the parties that contribute specialised inputs to the company. Principle-based theorists have suggested that insolvency law should represent a system of laws, customs and practices designed to manage the affairs and distribute the collective loss of the debtor according to the stakeholders’ controlling rights.

Despite this relevant breakthrough, principle-based theories are not perfect as they fail to provide sufficiently certain procedural solutions to TCP dilemmas and to properly appreciate the need to preserve – to the highest possible extent – the autonomy of the parties.

---

239 G McCormack, ‘Equitable Influences and Insolvency Law’ (2014) 7(3) C.R. & I. 103, 104 (observing – speaking of the effect of insolvency on company contracts – that ‘the commencement of insolvency proceedings may affect the [contractual] rights of counterparties, but the consequences are not fully spelled out in the insolvency legislation’).

240 Blair (n 84) 274.
Coupling principle-based theories and corporate governance studies has so far achieved unsatisfactory results. Corporatist visions of the company have provided little guidance on the definition of the limits, content and objectives of the law. They simply offer ‘a mask behind which corporate managers exercise unrestrained social and economic power’.  

The lack of satisfactory answers to these continuing concerns suggests the need to explore and design an alternative approach that can better balance these conflicting needs. Multi-value approaches may not necessarily entail the rejection of either proceduralist, ex-ante bargain models or no-insolvency propositions.  

Chapter five explores if it is possible to recognise a constitutive value to principle-based theories by combining them with other approaches.

---


CONTENT

A New Conceptualisation to Determine the Limits of Corporate Distress Law

PART II
CHAPTER 5 - A NORMATIVE ANALYSIS OF ELIGIBILITY REQUIREMENTS

«In most cases there is little or no doubt as to a company’s insolvency, but in marginal situations the basis of valuation and the assessment of values upon that basis can be crucial. Here lie the seeds of a potentially difficult problem»

5.1 INTRODUCTION

Chapter one introduced the notion of “insolvency law” used for the purposes of this thesis:

*the sector of the law that deals with the distress and restructuring (rectius: rescue) of ailing companies that include the discipline of any statutory mechanism that has the effect of giving either the debtor or their legal representative the power to unilaterally accept, disclaim or amend existing contracts to pursue the interests of the debtor’s ‘owners’.*

In chapters two to four, the author investigated if and to what extent the most commonly accepted theories of the foundations and framework of insolvency law restrict the use of insolvency remedies to only those cases that fall within the given definition. That question was answered in the negative.

The de-constructivist analysis established that any theoretical explanation of the nature of this area of law shall encourage:

1. Preservation - to the highest possible extent - of the autonomy of the parties [party autonomy objective];

2. Establishment of a system of rules and principles capable of promoting the efficient management and ensuring a predictable outcome of any insolvency case [legal predictability objective];

3. Recognition and protection of the legally enforceable interests of all the stakeholders who control the debtor [inclusivity objective].

---

2 Above sub-section 1.3(c) of this thesis.
These theoretical findings provide some guidance in answering the second part of the research question of this thesis, i.e. to what extent and if at all should statutory insolvency rules and norms depart from the common law of contract as it applies to solvent companies.

Early Seventies: The United States.

Businesses needed their small packages to be delivered within short time to any location in the country. This could only be achieved by means of an airfreight system. However, the existing providers were unreliable as they relied on passenger airlines and independent ground handling companies to handle the packages.3

Fred Smith, the founder of Federal Express ('FedEx')4 revolutionised the market by developing a completely new concept of shipping that relied on the company's own employees to collect the parcels and the company's own airplanes to distribute them overnight throughout the States by means of a hub-and-spokes network based in Memphis.

Yet in the process of establishing this network the founder and the managing directors of the company faced many difficulties. While the company was incorporated in Delaware on 18 June 1971, it started operating only on 12 March 1973 and the first day of operation was a colossal fiasco, with only six (!) parcels collected and delivered (on time).5

For the first half of the decade the company experienced serious financial difficulties. FedEx was cash-flow insolvent to the extent that on several occasions the company had to rely on bank overdrafts to meet its payment obligations.6

---

5 Frock (n 3) ch. 14. The outcome of the first day of operation was so disappointing that the managers started referring to it as a “system test”, placed the packages that the company received in the following month on commercial flights and re-launched the service with an expanded network on 17 April 1973.
occasions employees were asked to not cash in their payroll cheques.\textsuperscript{6} The directors took any possible gamble to keep the company afloat, to the point that in a particularly desperate moment the founder used the remaining $5,000 deposited on the company’s account at a casino in Las Vegas to get the money the company needed for the jet fuel payments.\textsuperscript{7} Finally, creditors were aware that there were not enough assets to repay their loans, to the extent that a local lender, ‘\textit{in a show of protecting its collateral}’,\textsuperscript{8} ordered the company to ground the planes but agreed on checking that the fleet was “grounded” at mid-morning and early evening, thus \textit{de facto} allowing the company to operate its midnight services.

After this initial struggle, \textit{FedEx} changed the way companies do business, and not only shipping ones. In fact, it allowed ‘\textit{established firms to expand their services}... [and] \textit{smaller ones to look and act like corporate giants}’.\textsuperscript{9} Nowadays, the company is successful and profitable.\textsuperscript{10} Yet are we sure that insolvency law should have played no role in this story? If the company had to rely on insolvency rules, should the application have been triggered by the ascertainment of the company’s cash flow insolvency? Should the stakeholders have relied on the alternative criteria of “risk”? Or should they had proven the existence of a “common pool” problem?

This chapter addresses these questions and marks the passage to the operational part of this work. The author analyses the three possible alternatives mentioned above to determine when the provisions of this area of law should prevail over the general rules of the law of contract. These alternatives are “insolvency” (section 5.2), “risk” (section 5.3) and the “traditional common pool” approach (section 5.4) (collectively known as “standard requirements”).

\textsuperscript{6}Frock (n 3) 107.
\textsuperscript{7}Frock (n 3) 101. The gamble was successful, as Fred Smith won $27,000 and was therefore able to pay the $24,000 bill for the fuel.
\textsuperscript{8}Ibid 106.
\textsuperscript{9}Ibid 1.
\textsuperscript{10}According to the latest available data, the company operates in more than 220 countries and territories, employs more than 225,000 people, deals with around 6 million packages daily, has a fleet of 670 aircrafts and more than 100,000 vehicles and annual revenues of $36.2 billion: <https://about.van.fedex.com/our-story/company-structure/express-fact-sheet/> accessed 16 August 2018.
While it is submitted that no standard is perfect and that deviations from optimal results are to be expected, the key issue is whether the distortions and incentives to inefficiency and abusive or strategic behaviour are outweighed by opposite gains, such as enhanced legal predictability of the system, or more complete respect for the autonomy of the parties.

Conclusions may vary greatly depending on the nature of the business and the relationship between lenders and borrowers. The mix of sophisticated and unsophisticated lenders, the duration and the size of the loans, the sector of the economy, the size and nature of the business, the existence of transaction costs are all factors that affect the valuation on the opportunity to rely on any of the above-mentioned standards.

This chapter argues that none of the standard requirements can properly meet the objectives that emerged from the de-constructivist analysis of this thesis. This finding paves the way for investigating if an alternative eligibility requirement that considered risk bearer interests is better capable of determining the cases when distressed corporate entities ought to disregard the tenets of the general law of contract.

5.2 “INSOLVENCY”

5.2(a) The Idea of “Insolvency”

A clear definition of insolvency (or, in the English version, “inability to pay debts”) is ‘fundamental’ to any system of insolvency law. The FedEx case proves the validity of this statement. Yet, legislatures and judges have struggled so far to provide a flexible and sufficiently certain description of this concept.

This section analyses the definitions of insolvency found in English and U.S. laws, suggested by the literature and applied by the courts to determine if the current understanding of this notion is consistent with the autonomy, predictability and inclusivity objectives suggested by the de-constructivist analysis of the theories that underpin these legal systems.

5.2(a)(i) The English Approach

**English law** has always included a mix of specific and general circumstances under which creditors may petition for the opening of insolvency proceedings. For instance, under the Joint Stock Companies Act 1844, although section IV described insolvency as a situation in which the company is ‘unable to meet its Engagements’, a creditor was entitled to petition for the debtor’s liquidation in other specific situations.

Currently, insolvency statutes do not offer a definition of insolvency, but only of the ‘inability to pay [the company’s] debts’. This condition shall exist to file for administration (other than for applications by a qualifying floating charge holder) or liquidation (other than solvent members’ voluntary liquidations). No legal consequences, however, attach to a debtor simply by reason of its inability to pay its debts. All consequences stem from the opening of an insolvency procedure.

The law distinguishes between “cash-flow” or “balance-sheet” insolvency. Nevertheless, as observed by Goode, there is ‘a remarkable dearth of English authority on the meaning and content of both the cash flow and the balance sheets tests of insolvency’. This pushed English judges look to other common

---

12 For a history of the evolution of the English notion of “inability to pay debts”, see MS Wee, ‘Misconceptions About the “unable to pay its debts” Ground of Winding Up’ (2014) L.Q.R. 648, 650-669.
13 An Act for facilitating the winding up of the Affairs of Joint Stock Companies unable to meet their pecuniary Engagements.
14 These were the inability of the debtor to pay, secure, or compound for a judgment debt within 14 days after notice requiring payment (s. V); the non-compliance with an order of a court of equity to pay a sum of money after service of order for payment on a peremptory day (s. VI); and where the creditor has filed a writ of summons for a debt and the debtor has not paid, secured or compounded the debt, or make arrangements to defend itself against the writ within one month from its service (s. VII).
15 s.123 IA 1986. For the history of the development of this provision under English law, see: P Walton, ”Inability to Pay Debts”: Beyond the Point of No Return?” (2013) 2 J. Bus. Law 212.
20 Ibid 113.
law jurisdictions to provide some guidance on the interpretation of this notion.\(^{21}\)

Under previous law, the concepts of cash-flow and balance-sheet insolvency were conflated.\(^{22}\) It was the 1986 Act which split these concepts for the first time. Cash-flow or commercial insolvency\(^{23}\) can be proven in five separate instances, two of which are applicable only in Northern Ireland\(^ {24}\) and Scotland.\(^ {25}\) The law facilitates the burden of proof on the creditor in two cases: (1) when the request for the payment of a debt exceeding £750 has been notified to the debtor and had not been paid for more than three weeks;\(^ {26}\) and (2) if the execution procedure triggered by the court has returned even partially unsatisfied.\(^ {27}\) At the same time, creditors can petition for the debtor’s insolvency whenever they prove to the satisfaction of the court that the company is unable to pay its debts as they fall due.\(^ {28}\) While courts are generally reluctant to admit insolvency petitions on the basis of a single failure to pay a creditor,\(^ {29}\) there have been exceptions.\(^ {30}\)

Since the enactment of IA 1986,\(^ {31}\) it had been contentious whether the cash-flow inability to pay the debts should be only actual, or whether parties are

---

\(^{21}\) See Briggs J (as he then was) in \textit{Re Cheyne Finance Plc (in receivership)} [2007] EWHC 2402 (Ch), [2008] All E.R. 987, [41]-[50].

\(^{22}\) S.518(1)(e) of the Companies Act 1985 formerly read: ‘A company is deemed unable to pay its debts […] if it is proved to the satisfaction of the court that the company is unable to pay its debts and, in determining that question, the court shall take into account the company’s contingent and prospective liabilities’.

\(^{23}\) Goode (n 19) [4-15]-[4-21]; McPherson & A Keay, \textit{The Law of Company Liquidation} (4\textsuperscript{th} edn, Sweet & Maxwell: London, 2018) [3-025]-[3-034].

\(^{24}\) s.123(1)(d): when a certificate of enforceability has been granted in respect of a judgment against a company.

\(^{25}\) s.123(1)(c): when the induciae of a charge for payment on an extract decree, or an extract registered bond, or an extract registered protest, have expired without payment being made.

\(^{26}\) s.123(1)(a) IA 1986.

\(^{27}\) s.123(1)(b) IA 1986.

\(^{28}\) s.123(1)(e).


\(^{30}\) In \textit{Cornhill Insurance Plc v Improvement Services Ltd} [1986] 2 B.C.C. 98 (Ch) the court refused to dismiss an insolvency petition against a well-known and apparently profitable company (at 942), while in \textit{Re A Company} [1950] 94 Sol. Jo. 369 the court held that delays in payment may engender a suspicion of financial embarrassment, even if towards a single creditor.

\(^{31}\) While the Companies Act 1985, in 2.581(1)(e) (now repealed) expressly mentioned that inability to pay the debts could be determined by keeping into consideration contingent and prospective liabilities, s.123(1)(e) IA 1986 omits any reference to future liabilities.
entitled to rely on (contractual)\textsuperscript{32} contingent and prospective liabilities\textsuperscript{33} to prove the existence of a cash-flow insolvency. The current position was introduced by Briggs J (as he then was) in \textit{Cheyne Finance}.\textsuperscript{34} After a lengthy analysis of the evolution of English law, of the then existing literature and of the case law in Australia, Briggs J concluded that:

\begin{quote}
\textit{Cash flow or commercial insolvency is not to be ascertained by a slavish focus only on debts due at the relevant date. Such a blinkered review will, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases fail to see that due to an endemic shortage of working capital a company is on any commercial view insolvent} [...].\textsuperscript{35}
\end{quote}

This position was approved by the U.K. Supreme Court in \textit{Eurosail}.\textsuperscript{36} \textit{Eurosail}, a special purpose entity set up by the Lehman Brothers group in the proximity of its collapse, issued loan notes to \textit{BNY Corporate Trustee Services Ltd} (‘\textit{BNY}’). The conditions attached to this transaction incorporated (with minor modifications) the provisions of s.123(1) and (2) IA 1986 and recognised to the noteholder (\textit{BNY}) the power to enforce a notice and declare the notes “due and repayable” on the occurrence of certain specific events of default. The service of an enforcement notice had the effect of changing the priority among \textit{Eurosail}’s claimants.

After two other companies in the \textit{Lehman Brother} group filed for protection under Chapter 11 of the U.S. Code, \textit{BNY} sought the court’s direction as to whether the conditions of issue of the notes had occurred. In other words, the question concerned the interpretation and effect of s.123(1)(e) and (2) IA 1986.

At first instance, the judge held that the conditions set out in s.123(1)(e) had not occurred because the assets to be valued for the cash-flow test were only

---

\textsuperscript{32} As observed by the literature, any reliance on liabilities that might incur from the operation of the business would amount to speculation and should therefore be dismissed: B Parker and M Buckley, \textit{Buckley on the Companies Act} (Butterworths: London, 1981) 535.

\textsuperscript{33} Contingent liabilities are debts that arise whenever a certain event or condition occurs, while prospective liabilities are contractual debts owed at a certain time in the future.

\textsuperscript{34} \textit{Cheyne Finance} (n 21) [28]-[51].

\textsuperscript{35} \textit{Cheyne Finance} (n 21) [51].

\textsuperscript{36} \textit{BNY v Eurosail} (n 29) 1423.
the present assets of the company, without considering any contingent or prospective liabilities. The Court of Appeal upheld the Chancellor's decision.

The Chancellor and the Court of Appeal justified the need to consider only present assets and liabilities to differentiate the tests introduced with the Insolvency Act 1985 (‘IA 1985’) – which added the words “as they fall due” to s.123(1)(e) and a direct reference to the company’s future assets and liabilities only in the balance-sheet test of s.123(2). Yet, the Supreme Court was not persuaded by this material difference in the law. The Supreme judges looked at academic commentaries and the history of the passage through Parliament of the Insolvency Bill in 1985 to conclude that the difference of form in the revised provision of s.123(1)(e) made little significant change in the law apart from emphasizing that the cash-flow test was concerned with debts falling due in the near future.

The pre-IA 1985 insolvency test required account to be taken of contingent and prospective liabilities. Therefore, on appeal by the appellant noteholders, the Supreme Court held that the test in s.123(1)(e) IA 1986 ‘was concerned not simply with the petitioner’s own presently-due debt […] but also with debts falling...”

---


39 In particular: Walton (n 15).

40 BNY v Eurosail (n 29) 1424 at [37]. This conclusion clashes with Walton’s observation that, pursuant to the decision in European Life (Re European Life Assurance Society (1869) LR 9 Eq 122) and the Cork Committee’s recommendations, the cash-flow test took no account of future or contingent liabilities, as these were relevant only for a balance-sheet test: Walton (n 15) 230.

41 The Supreme Court considered in particular the following cases: Re Capital Annuities Ltd [1979] 1 WLR 170; Re A Company (No. 006794 of 1983) [1986] BCLC 261; Byblos Bank SAL v Al-Khudhairy [1987] BCLC 232 (CA).
due from time to time in what was, depending on all circumstances, but especially the nature of the company's business, the reasonably near future'.

The *Eurosail* approach is currently generally applied by the courts. As a result, it is nowadays possible to claim that the words “as they fall due” in s.123(1)(e) IA 1986 transform the cash-flow test in a flexible and fact sensitive requirement to which balance-sheet insolvency is not irrelevant. The analysis of cash-flow insolvency shall not be carried out mechanistically but in a manner that has regard to commercial reality.

The **balance-sheet or absolute test of insolvency** is described as the situation in which the debtor's assets are worth less than its contingent and prospective liabilities. Simply proving that a company is cash-flow solvent does not authorize the exclusion of a balance-sheet test: a company may be declared insolvent even if it is paying its debts as they fall due because its liabilities (including contingent and prospective ones) exceed its assets.

Together with s.123(1) IA 1986, the balance-sheet test is – albeit not at face value – a deeming provision, i.e. 'a section or clause of a statute, regulation or other legal instrument that explicitly states how something is to be treated or regarded'. In other words, the court does not need to be satisfied with the company actually being unable to pay its debts, but only with the conditions set out in the law are met.

---

42 *BNY v Eurosail* (n 29) 1424. The Supreme Court also observed that once the court had to move beyond the reasonably near future, any attempt to apply the cash-flow test would become speculative and the only sensible approach would be the balance-sheet insolvency test. For an analysis of the decision, see: R Fisher, *Eurosail and Balance Sheet Insolvency: Are We Any Clearer?* (2013) 6(4) C.R. & I. 83; D Allison, *The Supreme Court Decision in Eurosail* (2013) 10(5) Int. C.R. 288; H Anderson, 'Six of the Best: The Record of the Supreme Court in the Insolvency Cases Decided in its First Four Years' (2014) J. Bus. Law 194; N Ayres, 'The *Eurosail* Ship has Sailed... and Left Muddied Waters in its Wake' (2014) 7(2) C.R. & I. 66.


44 *Re Rococo Developments Ltd* [2016] EWCA Civ 660, [2017] Ch. 1, [24].

45 Goode (n 19) [4-22]-[4-39]; McPherson & Keay (n 23) [3-035]-[3-038].

46 s.123(2) IA 1986.


49 Walker LJ observed that s.123(1)(e) and (2) are not really deeming provisions: *BNY v Eurosail* (n 29) 1419 at [25].
This situation requires a deep or at least reasonable knowledge of the company's affairs and financial statements. Usually, only insiders (such as directors and shareholders) are in possession of this piece of information. Alongside with the added complexity that an application for balance-sheet insolvency entails over a more straightforward cash-flow petition, insolvency orders based on this ground are comparatively less frequent.

Perhaps to facilitate the burden of proof on the creditors in a balance-sheet petition, courts have clarified that the test shall include contingent and prospective liabilities, but not contingent and prospective assets, while the statutory notion of “liability” offered by the legislator is broader than the notion of “debt” (which is relevant for the cash-flow insolvency test).

At the same time, the existence of a net liability in the company's balance sheet is not in itself sufficient to determine the existence of a balance-sheet insolvency. In the appeal case of Eurosail, Lord Neuberger MR – borrowing from the findings of the Cork Report – held that a company could be declared balance sheet insolvent only when it has reached the 'end of the road', the 'point of no return'. In other words, it was held that balance sheet insolvency occurred only whenever the company used its assets and cash to fund current operations in a manner that would deceive the trust of future and contingent creditors.

Walker LJ – while not reaching divergent conclusions from the lower courts on the Eurosail dispute – rightly “scaled down” this threshold, which would

50 The balance-sheet test, however, remains the only applicable test once the court has to move beyond the near future: BNY v Eurosail (n 29) [37]; K Baird and P Sidle, ‘Cash Flow Insolvency’ (2008) 21 Insolv. Int. 40.
51 Byblos Bank v Al-Khudhairi (n 41).
52 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.
54 BNY v Eurosail (n 38) [48].
55 Henderson (n 37) 56.
56 The Supreme Court dismissed both the appeal and the cross-appeal and agreed – albeit for different reasons – with the lower courts' judgments that Eurosail was not insolvent according to the meaning of s.123(1)(e) and (2) IA 1986.
otherwise have been hardly compatible with the purposes of the administration procedure as described in para 3, Sch. B1 IA 1986.\(^{57}\) He replaced the “point-of-no-return” test suggested by Neuberger with the “balance of probabilities test”, thus making it somehow easier for applicants to prove the existence of a situation of balance-sheet insolvency\(^{58}\) (unless, as in the *Eurosail* case, the liabilities could be deferred for over 30 years).

Nevertheless, the burden of proving the existence of balance-sheet insolvency is still on the petitioning party.\(^{59}\) This conclusion has been previously criticised by some commentators,\(^{60}\) who also suggested that court should follow the more “mechanic” approach introduced by James V.C.’s judgment in *European Life*\(^{61}\) to assess the balance-sheet solvency of a company. The *European Life* test shares some similarities with the “point-of-no-return” test advocated by Neuberger MR in the *Eurosails* appeal.

The Supreme Court’s decision in *Eurosail* represents the authority under English law to determine when a company is balance-sheet insolvent. While recent cases highlighted that the cash-flow and balance-sheet insolvency tests shall remain separate,\(^{62}\) they also stressed that they are linked as matters which affect one shall also be considered to determine the other. As some commentators rightly observed, elements of futurity must be considered in both tests, with the result that they are linked in ‘*some sort of continuum from the immediate to the long-term future*’\(^{63}\) and cannot be considered in isolation.\(^{64}\)

It still appears that courts shall ‘*look at the company’s finances from a commercial and overall perspective and consider the facts of each case*’\(^{65}\) to

---

\(^{57}\) *BNY v Eurosail* (n 29).


\(^{59}\) *BNY v Eurosail* (n 29) 1424 at [37].

\(^{60}\) Walton (n 15) 236 (arguing that courts should give a present-day value to assets and future and continent liabilities to determine if a company is balance-sheet insolvent).

\(^{61}\) European Life (n 40). According to this decision, courts should not consider any liabilities, which is not immediately payable unless it is reasonably certain that the existing and probable assets will be insufficient to meet the existing liabilities. Possible liabilities or profits which may accrue in respect of future business are not considered.

\(^{62}\) *Casa Estates* (n 47) and *HLC* (n 43).

\(^{63}\) Anderson (n 42) 197.

\(^{64}\) Ayres (n 42) (arguing that this approach was followed by English courts in the cases of *Casa Estates* and *HLC*).

\(^{65}\) McPherson & Keay (n 23) 112. See also *BTI 2014 LLC v Sequana SA* [2016] EWHC 1686 (Ch), [2017] Bus. L.R. 82 (the court’s focus was on commercial analysis, not a strict accounting test).
determine if a debtor is balance sheet insolvent. This, combined with the fact that judges shall discount future and contingent liabilities\(^{66}\) and that not all contingent liabilities should be considered,\(^{67}\) results in a reduced predictability of the outcomes of the balance sheet test.

5.2(a)(ii) The American Approach

In the U.S., the U.S. Code (U.S.C.) defines “insolvency” as the:

*financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation, exclusive of—*

(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity’s creditors; and

(ii) property that may be exempted from property of the estate under section 522 of[11 U.S. Code].\(^{68}\)

Special definitions of insolvency apply to partnerships\(^{69}\) and municipalities.\(^{70}\)

It seems therefore that the U.S. system relies on a balance-sheet only definition of insolvency.\(^{71}\) However, insolvency represents an eligibility requirement only to file for one of the formal insolvency procedures listed in the U.S. Bankruptcy Code, i.e. Chapter 9.\(^{72}\) For all other procedures, the only requirement set out in the law is that the entity against which the procedure is to be opened is a “debtor” according to the definition (and the limitations) provided by §.109(a)-(h) 11 U.S. Code,\(^{73}\) even if confirmation of a plan can be denied if the plan has not been proposed in good faith and not by any means forbidden by the law.\(^{74}\)

---

\(^{66}\) *BNY v Eurosail* (n 29) [137]. However, no guidance is given on how that would be done.

\(^{67}\) *Evans v Jones* (n 43).

\(^{68}\) 11 U.S. Code, §.101(32)(A).

\(^{69}\) 11 U.S. Code, §.101(32)(B).

\(^{70}\) 11 U.S. Code, §.101(32)(C).


\(^{72}\) §.109(C)(3) 11 U.S. Code. Before the 1978 Act, a company had to be insolvent before it could file for bankruptcy protection.

\(^{73}\) According to this section and subject to the specifications included in sub-sections (b) to (h), ‘only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title’. *Re Hogard*, 43 B.R. 590 (Bankr. D. Minn.)
Chapter 9 is the procedure that deals with municipalities in distress. According to §101(40) 11 U.S. Code, the term “municipality” refers to any political subdivision or public agency or instrumentality of a State. However, the notion of insolvency that is relevant to open a Chapter 9 procedure differs from the general definition reported above. Under §101(32)(C), a municipality is insolvent if it is:

(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

(ii) unable to pay its debts as they become due.

As a result, only cash-flow insolvency is relevant in the U.S. to determine if a debtor can file for a formal insolvency procedure.75

It is therefore possible to observe that U.S. law places little emphasis on the condition of the debtor to open a formal insolvency procedure because the legislator has always intended the Code as an instrument to promote trade, restore the confidence of the parties in the system and reinstate honest but unfortunate debtors to a condition where they could again contribute to the economic growth of the country.76

Cash-flow and balance-sheet insolvency are the notions most frequently used all over the world to determine when a company can file for a formal insolvency procedure.

A cash-flow test is adopted in jurisdictions such as France, where a company is declared insolvent (“en état de cessation des paiements”77) when it is unable to...
meet its current debts out of its current assets. The same approach is followed in Italy, where companies can be admitted to liquidation if they are insolvent (“in uno stato d’insolvenza”). At the same time, the Italian insolvency law allows companies that are in a condition of financial distress (“stato di crisi”) to petition for the opening of a formal rescue procedure and France employs several pre-insolvency procedures that are open to non-insolvent entities.

Judges in Australia rely only on the cash-flow test to determine when a company is insolvent, even if balance-sheet considerations are sometimes taken into account. It should be observed, however, that Australian law does not include a balance-sheet test for insolvency. The same statutory and interpretative approach is followed in Singapore where the law prescribes that a company shall be actually cash-flow insolvent to be wound up (even if courts can wind up a company on just and equitable grounds). However, to be admitted to judicial management (a rescue procedure), the company can only prove that it is likely to become cash-flow insolvent, thus introducing an element of futurity in the cash-flow test (similar to the approach of Briggs J in Cheyne Finance).

Other jurisdictions adopt both a cash-flow and a balance-sheet test. This is the case in Germany, where debtors can petition for the opening of a formal insolvency procedure if they are in one of the following three situations: (1)
insolvency ("Zahlungsunfähigkeit" - cash-flow test); (2) imminent insolvency ("Drohende Zahlungsunfähigkeit"); and (3) over-indebtedness ("Überschuldung" - balance-sheet test). This is also the case in Canada, where debtors and creditors can petition for a liquidation or reorganisation procedure if they are insolvent on either a cash-flow or balance-sheet basis.

Sometimes the insolvency test is linked to further requirements, such as that the amount owed to the creditor exceeds a certain threshold (Canada, as well as Italy).

It is thus possible to observe that the notion of insolvency is not interpreted in a uniform way across jurisdictions and it is not limited to the cash-flow or balance-sheet approach favoured by English and American courts.

It has therefore been correctly observed with reference to the English tradition (but similar valuations apply to the U.S. background) that ‘there is no simple objective point in corporate affairs when the law states that the company is insolvent’. As the law is more concerned in defining procedures which apply whenever vaguely defined events occur, a number of concerned parties (but, particularly, accountants) have the power to manipulate corporate filings.

5.2(b) Literature Review on the “Insolvency” Standard

This section focuses more on the English rather than the American literature, as in the States courts are concerned primarily in checking if the filing has been submitted in bona fide.

Scholars commenting on the nature, scope and clarity of the notion of insolvency do not appear overly concerned with the lack of uniformity across jurisdictions and they rarely question the opportunity that a separate system of

---


87 Article 2, Bankruptcy and Insolvency Act.

88 Art. 15 Legge Fallimentare (Royal Decree no. 267/1942).

89 Finch and Milman (n 18) 122.

rules applies only to insolvent debtors. On the contrary, some of them praise the adoption of flexible paradigms, especially when judicial discretion is used to redress substantial injustice (e.g. when the debtor tries to exploit its dominant position on the market to unduly postpone payments to some of its key suppliers or traders).

Others praise more recent developments and their impact on the voidability of antecedent transactions. Particularly, they commend that the commercial approach now adopted by courts does not result in making life easier to those who might want to exploit the lack of prescriptive nature of the law. For instance, connected parties face an evidential challenge to defeat the presumption of a cash-flow insolvency.

The author, however, disagrees with this latter line of thinking. Specifically, with reference to voidable transactions, the commercial view has rendered it even more challenging for insolvency office-holders to determine when a company is insolvent (or became insolvent as a result of a transaction). Establishing the (in)solvency of the company is key to challenge any transaction. The little clarification provided by English courts in Re Casa and BTI 2014 applies to a very narrow number of cases: cash-flow insolvencies regulated by s.123(a) and (b) and transactions to connected parties.

More in general, while discretion and flexibility are needed to achieve the purposes of the law, their use becomes abusive and unjustifiable when it is made without any connection to them. Excessive reliance on discretion, especially if compared with the more nuanced use of this prerogative in other

91 RV Butler and SM Gilpatric, ‘A Re-Examination of the Purposes and Goals of Bankruptcy’ (1994) 2 Am. Bankr. Inst. L. Rev. 269, arguing that mechanisms for debt collection designed for insolvent debtors would be too costly to apply to solvent debtors.
92 McPherson & Keay (n 23) 101; D Shah, ‘Victory for Common Sense’ (2013) 150 Accountancy 61.
94 s.240(2) IA 1986.
95 Casa Estates (n 47).
96 BTI v Sequana (n 65).
contexts, may suggest a certain degree of unease and dissatisfaction with the current insolvency standard.

The author’s position is not isolated in the academic debate. Other scholars observed that the analysis of whether a company is insolvent is a difficult one and that the decisions in Cheyne and Eurosail (which was held against a “closed” company with no real trade business activity) may have added a layer of complexity to the system. In other words, ‘matters are not [...] quite as straightforward as was once thought’. This is because these cases de facto introduced an element of futurity in all the circumstances in which courts must determine if a company is (in)solvent, while in the past this applied only to balance-sheet orders. Additionally, with reference to the balance-sheet test, Walker LJ failed to deliver any guidance on how to consider contingent and prospective liabilities. This controversial aspect may generate further litigation.

As a result, creditors of trading companies will rely more on s.123(1)(a) or (b) to obtain an insolvency order which could - even if insolvency was proven - be denied by the court applying a holistic, commercial approach to the evaluation of the “inability to pay debts” ground.

5.2(c) The Purpose of “Insolvency”

The previous sections have been instrumental to define the notion of “insolvency”. How does this help us? In other words, does the definition of “insolvency” promote legal predictability, party autonomy and inclusivity?

---

97 This is particularly true for English courts, which admit the use of discretionary powers in business cases only when it would be unconscionable to allow the negotiated act or condition to take effect (‘unconscionability test’). See: Re Lundy Granite Co [1870-71] L.R. 6 Ch. App. 462, followed by, among others: Re MK Airlines Ltd (in liq.) [2012] EWHC 2764 (Ch), [2012] 3 All E.R. 781; Jervis v Pillar Denton Ltd [2014] EWCA Civ 180, [2015] Ch. 87.

98 Cheyne Finance (n 21).

99 BNY v Eurosail (n 29).

100 Walton (n 15) 235; Ayres (n 42); Wee (n 12); MS Wee, ‘Understanding Commercial Insolvency and its Justifications as a Test for Winding Up’ (2015) 1 LMCLQ 62.

101 Walton (n 15) 212 (commenting on the mainstream view in the academia that determining when a company is cash-flow or balance-sheet insolvent is relatively un-problematic in the majority of cases).

Legal predictability (sometimes improperly referred as “legal certainty”) is often mentioned as a mechanism to promote business activity and economic growth\textsuperscript{103} and as a fundamental objective of insolvency practice.\textsuperscript{104} Legal predictability is not directly concerned with the substance of the law.\textsuperscript{105} It requires that similar cases are treated alike, both in the law and – more importantly – by the judiciary, and that this consistency is perceived by prospective litigants.

Consistency in the adjudication process is therefore an essential feature of legal predictability.\textsuperscript{106} Predictability is often seen as competing with flexibility but in reality, some degree of flexibility is necessary to allow courts to apply the law in cases not expressly mentioned in the statutes and to avoid preposterous results.\textsuperscript{107}

It is clear from the way in which “insolvency” has been understood by both the judiciary and the jurisprudence that this concept has not been designed to promote flexibility rather than predictability.\textsuperscript{108} It does not come as a surprise that several authors argue that one of the primary drawbacks that stems from the use of the insolvency paradigm is its lack of finality and its vagueness.\textsuperscript{109}

Even when the creditor proves that the company is insolvent, the debtor can still rely on the discretion of the court not to grant the requested order.\textsuperscript{110} In particular, in Demaglass\textsuperscript{111} Neuberger J (as he then was) held that while unpaid

\textsuperscript{103} MA Clarke and others, Commercial law: Text, Cases and Materials (5\textsuperscript{th} edn, OUP: Oxford, 2017) 10: ‘Businessmen have special needs. [...] They require the decisions of the courts on commercial issues to be predictable so that they know where they stand’.


\textsuperscript{105} This point was made by Masfield LJ in Vallejo v Wheeler (1774) 1 Cowp 143, 153.


\textsuperscript{107} Goode once observed that ‘the man of affairs wishes to have his cake and eat it; to be given predictability on one hand and flexibility to accommodate new practices and developments on the other’: RM Goode, ‘The Codification of Commercial Law’ (1988) 14 Monash U.L.R. 135, 150.

\textsuperscript{108} Cheyne Finance (n 21) per Briggs J at [56]: ‘the effect of the alterations to the insolvency test [...] was to replace in the commercial solvency test now in s.123(1)(e) one futurity requirement [...] with another more flexible and fact sensitive requirement’.


\textsuperscript{110} s.125(1) IA 1986. See Byblos Bank v Al-Khudhairy (n 41).

\textsuperscript{111} Re Demaglass Holdings Ltd (in liq.) [2002] EWHC 3138 (Ch), [2003] 1 BCLC 412.
Creditors usually have the right to a winding up order,\textsuperscript{112} (at least) in case of an opposed petition they have to establish the possibility of some benefit from the winding up.\textsuperscript{113} The fact that the majority in value of creditors support the making of a winding up order is not in itself decisive for granting the order.\textsuperscript{114}

Discretion is a double-edged sword. Where Neuberger used it to restrict the cases when a winding up order is made, others have used it to extend the situations in which formal insolvency procedures can be opened. In fact, it was observed that, even when the debtor proves that the company is cash-flow solvent, the judge can still admit an insolvency petition on the basis that the company is balance-sheet insolvent.\textsuperscript{115}

The discretion of the court also applies to a number of essential elements which are needed to determine if a company is insolvent. Courts may (or may not) look at contingent and prospective liabilities. If they did look at them, there is no guidance on the time period they will look at for future liabilities, as this depends on the circumstances of the case.\textsuperscript{116} With reference to contingent liabilities, there is equally no guidance on the degree of probability required to prove the future event that may determine the existence of the debt.

Secondly, predictability is further tarnished by the fact that the perceived centrality of the notion of insolvency as an eligibility requirement is misleading. Despite Cork’s recommendation that ‘the sole ground upon which the Court may make an Insolvency Order in respect of a debtor, whether individual or corporate, will be that the debtor is unable to pay his or its debts’,\textsuperscript{117} insolvency law remedies can be triggered by companies that are not insolvent. This is proven by the statutory discipline of schemes of arrangement,\textsuperscript{118} CVAs,\textsuperscript{119}

\textsuperscript{112} See also Bove v The Hope Life Insurance and Guarantee Company [1865] 11 HLC.
\textsuperscript{113} See also Re Crigglestone Coal Company Limited [1906] 2 Ch 327.
\textsuperscript{114} Warning of the risks of ‘bad’ discretion, see Goode, who wrote that ‘discretion must be exercised in accordance with settled principles and there is a presumption that a creditor in respect of an undisputed debt is entitled to a winding up order ex debito justitiae’: Goode (n 19) 121.
\textsuperscript{115} Casa Estates (n 47).
\textsuperscript{116} BNY v Eurosail (n 29) [37].
\textsuperscript{117} Cork Report (n 53) para 535.
\textsuperscript{118} S.B95 CA 2006.
\textsuperscript{119} Part I, IA 1986.
administration, MVLs under English law and all the bankruptcy procedures in the U.S. Code (with the sole exception of Chapter 9). Unsurprisingly, the recent proposal on preventive restructuring mechanisms drafted by the European Commission does not mention insolvency as an eligibility requirement.

Not only has insolvency never been the sole ground to petition for the opening of an insolvency case, but also the application of this concept ‘in individual cases can be both vexed and difficult’. This is because the uniform and harmonised understanding of other concepts essentially intertwined with the notion of insolvency (such as “debt” and “credit”) can prove equally troublesome.

For instance, should the notion of “debt” include unliquidated claims or debts for which the creditors themselves have agreed on an extension of time to repay them? Should positive assets include only cash and easily realisable goods, or should they be extended to any good owned by the company that is liable to economic evaluation, and to any loans that the company/debtor may obtain in the near future? In case of an affirmative answer, should a time limit for the realisation of assets, or for obtaining new finance be considered? What should the treatment of leased goods, or of goods in the possession of a company under a ROT clause be like? What should the position of the court be when there are conflicting and equally reasonable views on the valuation of assets, estimation of liabilities and determination of the company’s (in)solvency?

---

120 While this paper highlighted that an applicant shall be ‘insolvent’ to be admitted to administration, this eligibility requirement only applies to administration orders made by the court, with the significant exception of applications made by the holders of a qualifying floating charge. The company and its directors also have the opportunity to place a company in administration out of court, with the result that the eligibility requirement is not preliminary tested by the competent judge.


122 The Bell Group Ltd (in liq.) v Westpac Banking Corp (No.9) [2008] WASC 239 [1064] per Owen J.

123 Goode (n 1) 439.
It is rather unsurprising therefore to observe that both scholars (and even those\textsuperscript{124} who showed a positive attitude towards the insolvency standard) and courts\textsuperscript{125} recognise that the insolvency standard is prone to determine a sizeable degree of uncertainty in the parties (and, as a consequence, in the business).

The concept of **party autonomy** – one of the main features of commercial and contract law –\textsuperscript{126} generally refers to the possibility for parties to agree on the rules that will govern their transactions and affairs.\textsuperscript{127} As a result, party autonomy can be considered as an expression of the more general principle of freedom of contract but it may sit at odds with legal certainty.

It is to be observed that the current Anglo-Saxon understanding of the notion of insolvency does not restrict any of the parties (but particularly the debtor) to file for the application of insolvency remedies when they see fit, or when otherwise contractually agreed with some of the creditors.

Even when insolvency is the primary ground to promote the opening of an insolvency procedure (a circumstance which applies only to English procedures), this is *never* the only one. Not only debtors and companies can voluntarily file for insolvency on other grounds, for instance when the company is solvent.\textsuperscript{128} Creditors also have the right to rely on the just and equitable ground in s.122(1)(g) IA 1986 to challenge the existence of the company and petition for the opening of the liquidation procedure.\textsuperscript{129}

**Inclusivity** refers to the opportunity granted to all stakeholders to exercise participation rights and to the expectation that the person presiding over the

\textsuperscript{124} McPherson & Keay (n 23) 107 and 116.
\textsuperscript{125} Bacon VC *Re London & Manchester Industrial Association* [1875] 1 Ch. D. 466, 472.
\textsuperscript{128} This is the case of members’ voluntary winding up, regulated by s.89-96 IA 1986.
\textsuperscript{129} *Re Dollar Land Holdings Plc* [1993] BCC 823 (Ch); *Bell Group Finance (Pty) Ltd (in liq.) v Bell Group (UK) Holdings Ltd* [1996] BCC 505 (Ch); *Morrice v Brae Hotel (Shetland) Ltd* [1997] BCC 670 (Court of Session).
insolvency procedure represents their interest and is held accountable for the failure to do so.\textsuperscript{130}

The use of market-based tests means that inclusivity is not properly considered, as no space is given to value-driven considerations, which are essential to determine who the residual risk bearers are. At the same time, the implementation of a market-based approach to determine the (in)solvency of a company is also problematic for the contracting parties. This is because there is little guidance, in case law, on whether valuations of the debtor's assets, debts and liabilities should be made on the basis of a going concern or break-up sale and how commodities with no established market value should be considered.\textsuperscript{131}

In England, the situation is further complicated by the presence of different insolvency tests in the law.\textsuperscript{132} Additionally, insolvency has been understood as predominantly a question of fact,\textsuperscript{133} that requires evidential and practical considerations to be determined. Judges may not be the most qualified parties to investigate this notion as a commercial valuation of the company's business requires mastering some basic concepts of economics, finance and statistics.\textsuperscript{134}

Furthermore, the meaning of “question of fact” is in itself misleading. Does it mean that judges are required to investigate the financial situation of the debtor? This approach might be followed in civil law countries, but not in the market-driven jurisdictions such as the U.S. and the U.K., where judges should only decide the insolvency question on assumed facts.\textsuperscript{135}

\textsuperscript{131} Finch and Milman (n 18) 120. On how to compute assets and liabilities, see Goode (n 19) [4-32]-[4-39].
\textsuperscript{132} Autonomous definitions are included in the Company Directors’ Disqualification Act 1986 (for the purposes of directorial disqualification) and the Employment Rights Act 1996 (for the purposes of employee rights to payment from the National Insurance Fund).
\textsuperscript{133} McPherson & Keay (n 23) 101. See also: Cornhill (n 30) (insolvency will be assumed if the company is not in fact paying its debts as they fall due); BNY v Eurosail (n 29) [34]; and Casa Estates (n 47), where Lewison LJ agreed on the fact-finding approach followed in Eurosail and Cheyne Finance (n 21) [29].
\textsuperscript{134} Against: McPherson & Keay (n 23), arguing that ‘the relative accuracy of modern accounting methods and actuarial predictions would enable courts to look in to the future with some degree of accuracy’ (107).
\textsuperscript{135} Cheyne Finance (n 21) [10].
In the latter case, however, we are no longer in front of an objective analysis of the facts, but only of a valuation of the findings disclosed by the parties in court. Is it appropriate to decide a “question of fact” on the basis of an evaluation of the parties’ submissions?

5.2(d) Testing “Insolvency”: The Cases of Rowntree Ventures and Detroit (2004)

To investigate if, despite the theoretical shortcomings raised in sub-section 5.2(c), the insolvency standard does not suffer from significant inadequacies in daily practice, it is appropriate to look at some recent decisions.

The first is the Rowntree Ventures case. One of the contentious aspects of the dispute was the existence of the statutory requirements to serve an administration order against the respondents, Oak Property Partners Ltd (‘OPP’) and Oak Forest Partnership Ltd (‘OFP’).

OPP and OFP carried on the business of property developers. They built hotels and subsequently leased the hotel rooms and common parts on long leases. The applicants were or represented those who had acquired leases upon terms which entitled the leaseholders to a repurchase of the lease. The applicants sought the appointment of administrators. When they purchased their respective leasehold interests, they were given extravagant promises of a guaranteed return which appeared to have been more than optimistic and, quite possibly, reckless or wantonly misleading.

At first instance,\(^{136}\) Purle J noted that:

- On a balance of probabilities, the companies were or were likely to be unable to pay their debts;\(^{137}\) and

- The administration order was reasonably likely to achieve the purpose of the administration, meaning that there must be a “realistic chance”

---

\(^{136}\) Rowntree Ventures Ltd v Oak Property Partners Ltd [2016] EWHC 1523 (Ch), [2016] WL 03564018.

\(^{137}\) Ibid [15].
that at least one of the alternatives set out in para 3(1) of Sched B1 IA 1986 will be achieved.\(^{138}\)

Purle J was also sceptical of the respondents’ accounts and cash-flow projections for the incoming months. These projections relied on the recoverability of the debt from a company who recently entered into a CVA (which was itself being challenged), a valuation which assumed a rather optimistic 5 per cent return on investments and the availability of interim finance to assist cash flow.\(^{139}\) Additionally, there was little or no room for slippage.

All these considerations should have led to the conclusion that the company was insolvent, both on a balance-sheet and cash-flow basis. The company was burning cash outside insolvency and some of the main risk bearers had no voice in the administration of the business. This should have led the judicial authority to grant the petition.

However, Purle J in a judgment issued on 10 June 2016 held that he was not ready to exercise his discretion and grant the petition because he wanted to give the companies ‘the opportunity to endeavour to see [their] way through difficulties’.\(^{140}\) The Chancery Court judge held that he would have not exercised his discretion had the applicants provided ‘firm evidence, as opposed to a suspicion of past fraud, that those in control of the company either had in some way misappropriated assets or were likely to do so in some intervening period...’\(^{141}\)

Not surprisingly, by the time (29 June 2017) the case was referred to the Court of Appeal,\(^{142}\) both respondents had filed for CVL.

\(^{138}\) Ibid [22] for OPP (‘... for the reason that I have given concerning the avoidance of ad valorem charges, an administration would be reasonably likely to achieve a better result for creditors than a winding up, if that were the only option’) and at [32] for OFP (‘... an administration would be better than a winding up’).

\(^{139}\) Ibid [15]–[20]. In particular, evidence of emergency financial arrangements was described as “shaky” as it appeared to be provided by a person who was an acting (but not yet actual) director and it was not yet subject to contract at the time of the filing.

\(^{140}\) Ibid [32].

\(^{141}\) Ibid [33].

The Court of Appeal considered that the Chancery judge had attached too much
weight to the possibility of turnaround. There was no factor pointing clearly
against the making of an order once the statutory preconditions had been
established. The Chancellor noted the high bar in challenging the exercise of the
judge’s discretion but considered that in the circumstances he would have
exercised his discretion to make the administration order. However, such an
order was no longer possible as a result of the CVL (para 8(1)(a) Sch. B1 IA
1986).

The first instance case is problematic – despite the overruling by the Court of
Appeal – not because Purle J erred in his business assessment, but because he
disregarded the doctrine of precedent and decided to conduct a business
assessment exercise in a circumstance where there was no need to do that.

It is a well-established principle of English law that courts should not interfere
in the running of a business (and in alleged breach of duties) unless the director
took a course of action that no other reasonable person would have made.143 As
courts are reluctant to second-guess board decisions, it is not apparent why
they should be reluctant to grant creditors’ petitions that are based on
reasonable grounds and are commercially sound, while the counter-arguments
from the debtor are based on “shaky” and “optimistic” assumptions.144

Furthermore, as his conclusions conflicted with the statutory and regulatory
requirements to file for administration, this should have suggested a larger use
of caution rather than discretion.

---

143 This is known as “Wednesbury standard”, as it was first conceived in the case Associated
Provincial Picture Houses Ltd v Wednesbury Corp [1948] 1 KB 223 (CA). On that occasion, the
Court of Appeal held that “[t]he court is entitled to investigate the action of the local authority
with a view to seeing whether they have taken into account matters which they ought not to take
into account, or, conversely, have refused to take into account or neglected to take into account
matters which they ought to take into account.” (233, 234). Only in case of a decision so
unreasonable that no reasonable authority could ever have come to it, courts have the
discretion to interfere with it. See: P Davies and S Worthington (eds), Gower: Principles of
Modern Company Law (10th edn, Sweet & Maxwell: London, 2016); E Lim, ‘Judicial Intervention
169.

144 Rowntree v Oak (n 136) [19] and [20].
It is not only the English courts, however, that defy statutory requirements and rely on judicial discretion to determine when a company should file for insolvency.

A careful observer would recall that municipalities are subject to Chapter 9 of 11 U.S. Code, which is the only section of the Bankruptcy Code that prescribes the debtor to file for statutory protection in cases of insolvency. Surely the existence of an established condition of insolvency should suffice to push a debtor under the Code’s protection.

This apparently logical assertion has proven wrong. Take, for instance, the solution that in 2004 Mayor Kwame Kilpatrick adopted to cover part of the $1.7 billion shortfall of the Detroit retirees’ pension fund.

The city had a legal obligation to meet this shortfall. As it did not have enough money, the rational solution would have been to reduce its expenses and workforce and negotiate a financial plan with its creditors, similar to an English CVA. Failure to meet any or both of these conditions would have resulted in the city’s default and admission to Chapter 9.

As both solutions were not very enticing for Detroit’s elected officials and their major creditors, these parties devised a different solution.

Under Michigan law, cities cannot carry bonds totalling more than 10 per cent of the assessed value of the private properties within their remit. This meant that in 2004 Detroit could theoretically ask for up to $1.3 billion in bond debt. As the city had already issued obligations for more than $700 million, it would not have been possible to borrow from the market enough money to cover the pension deficit.

As a result, the city decided to create two service corporations, independent but financially intertwined with the city government. These corporations would have borrowed the money ($1.44 billion) which would have covered the pension deficit through the use of certificates of participation.
Despite the city having won “The Bond Buyer’s Midwest regional Deal of the Year” in 2005 for this financial scheme, this deal was later described as ‘a subprime loan on steroids’. It is easy to agree with the latter qualification as, despite the existence of two bond insurers (Financial Guaranty Insurance Company and Syncora Holdings) who should have paid out the bondholders in the event of default of any of the service corporations, the city was ultimately responsible for the debt of these corporations (and for their failure).

Detroit in 2004 was an insolvent city. Chapter 9 requires insolvent municipalities to seek statutory protection under 11 U.S. Code. Yet, no petition was filed.

5.2(e) Findings

This broad, factual understanding of the notion of insolvency has resulted in the approval of insolvency petitions in cases where there was no “true” (i.e. cash flow or balance sheet) insolvency, thus further affecting the certainty and predictability of any insolvency system based on this eligibility criterion. It has also resulted in the opposite outcome of the cases described under sub-section 5.2(d), where insolvent debtors were not admitted to insolvency procedures.

This trend is not limited to the jurisdictions considered in the study. For instance, the EUIR Recast now applies and grants automatic recognition throughout Europe to all proceedings that are based on laws relating to insolvency. Insolvency is no longer a requirement for a proceeding to fall under the scope of the EUIR Recast.

---

147 Cases include Re Casa Estates (UK) Ltd (in liq.) [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).
148 Art. 1(1) holds that ‘[t]his Regulation shall apply to public collective proceedings, including interim proceedings, which are based on laws relating to insolvency […] where there is only a likelihood of insolvency’. 
These observations, coupled with the underwhelming findings of our theoretical criticism of the “insolvency” standard lead the author to believe that it is appropriate to look at alternative eligibility requirements to determine whether they better promote procedurally fair and efficient outcomes.

5.3 “Risk”

Another criterion that can be used to determine if a company is in a situation of distress and therefore should file for insolvency is the existence of a qualified risk. In general terms, this notion refers to any source of uncertainty that can impact the smooth running of personal and corporate life. In financial terms, it refers to ‘the possibility of financial loss or failure as a quantifiable factor in evaluating the potential profit in a commercial enterprise or investment’.149

Why is the notion of “risk” important for the purpose of this study? Because the commencement of a formal procedure may be based on an accepted notion of “risk”, which could therefore be used to distinguish situations where individual, self-interested behaviour is acceptable from those where it is not.

5.3(a) The Concept of “Risk”

What “risk” is in legal terms is a hotly contended topic. Legal scholars tend to adopt an internal/predictive approach to the notion of risk (and crisis). They argue that, if an honest and reasonably skilled manager concludes that the existing and prospective revenues are more likely than not to be insufficient to cover existing and planned liabilities, then the risk of a crisis should prompt the manager to “take actions”.150 These actions, however, may not necessarily entail an insolvency filing.

In order to determine when risk can no longer be handled under the general rules of contract law, scholars refer to corporate finance and economics models. Corporate finance literature has identified manifold functions of risk, not all of

150 R Guidotti, ‘Emersione della Crisi e Opportunità di Risanamento’ (24 November 2016) IlCaso.it 3 (translated to English from Italian by the author of this thesis).
them relevant to the insolvency debate. Although the taxonomy of risk is necessarily subjective, the most widely accepted categories include credit, market, operational, liquidity and legal risk.\textsuperscript{151}

Some of these concepts have been integrated into insolvency prediction models to determine if a company is likely to file for insolvency protection.\textsuperscript{152} These concepts are operational, credit and liquidity risk.

Operational risk\textsuperscript{153} summarizes the risks a company undertakes when it attempts to operate within a given field or industry. According to Basel II,\textsuperscript{154} an operational risk is:

\begin{quote}
... the risk of loss resulting from inadequate or failed processes, people and systems, or from external events. This definition includes legal risk, but excludes strategic and reputational risk.\textsuperscript{155}
\end{quote}

An operational risk is a risk not inherent in financial, systematic or market-wide factors. It includes risks resulting from breakdowns in internal procedures, people, systems or (to a more limited extent) external events. It focuses on how things are accomplished within an organisation.

Operational risk events frequently hit the headlines, especially if they occur in large, public corporations. Examples include the Madoff investment scandal.\textsuperscript{156}

\begin{thebibliography}{9}
\bibitem{Girling} Some large companies also recognise that risks are inter-related. As a result, they regularly run and update enterprise risk management (‘ERM’) exercises to determine their exposure to several functions of risk, including geopolitical and liquidity issues.
\bibitem{BaselII} Basel II is a set of international banking regulations put forth by the Basel Committee on Bank Supervision, which levelled the international regulation field with uniform rules and guidelines.
\bibitem{OperationalRiskDefinition} S.644, \textit{International Convergence of Capital Measurement and Capital Standards: A Revised Framework} (Bank for International Settlements, 2014). The Basel II definition of operational risk has been adopted or adapted by many businesses and is now generally accepted as the standard. It has been incorporated into national regulations across the globe with only minor adaptations and is consistently referred to by regulators and operational risk managers: Girling (n 153) 2.
\end{thebibliography}
the Nomura bond trader fraud\textsuperscript{157} and the UBS trading scandal.\textsuperscript{158} Not only can these events cause significant loss of money for the companies affected by them. They can also determine a situation of financial or economic distress that can lead to insolvency.

To manage and measure operational risk, both quantitative and qualitative approaches are needed.\textsuperscript{159} Operational risk frameworks and insolvency prediction models come into consideration when indicators show that these breakdowns can cause harm to the soundness of the debtor or the industry as a whole.

Credit risk\textsuperscript{160} refers to the risk that a borrower may not repay a loan and that the lender may lose the principal of the loan or the interest associated with it. Credit risk arises because borrowers expect to use future cash flows to pay current debts, but it is almost never possible to ensure that borrowers will definitely have the funds to repay their debts. Interest payments from the borrower or issuer of a debt obligation are a lender's or investor's reward for assuming credit risk.

Credit risk is pervasive in modern, market-driven and consumer-based societies, such as those considered in this thesis. From utility and telephone bills to car loans, people expect to buy on credit. Similarly, companies have significantly increased their liabilities in recent times, with the result that

\bibitem{panjer2016} Panjer (n 151); RA Jarrow, ‘Operational Risk’ (2008) 32(5) JBF 870 (provides an economic and mathematical characterization of operational risk).
nowadays English and North-American companies are amongst the most highly leveraged among OECD countries.\textsuperscript{161}

While availability and acceptability of credit facilitates modern life and promotes economic growth, unpaid debt obligations may cause financial failures of both the company financed by debt and the lender. To minimise this risk, corporate governance theorists and economists devised models to determine the proper amount of interest that should be charged to offset the risk of default.\textsuperscript{162}

This risk, however, has been exacerbated in recent times, due to the de-personalisation of the borrower-lender relationship and the circumstance that very few lenders hang on to the loan they make. Additionally, major lending institutions are no longer the dominant source of credit to the global economy.\textsuperscript{163}

*Liquidity risk*\textsuperscript{164} is sometimes classified as an integral element of credit risk. However, despite the obvious inter-relations, it is preferable to categorize liquidity as an autonomous function of risk as it affects not only borrower-lender, but also any debtor-creditor relations.

Liquidity ‘can be viewed as the essential resource that permits a company to replace its liabilities, meet contractual obligations, and fund growth, all at a reasonable price, as and when needed’.\textsuperscript{165} This situation is commonly understood as the risk stemming from the lack of marketability of an asset or investment that cannot be bought or sold quickly enough to prevent or minimize a loss. The individual or company that own the asset or investment title may as a result fail to meet short-term debt obligations, thus affecting their lenders and creditors.

\textsuperscript{162} Some of these models are discussed in sub-section 5.3(c).
\textsuperscript{163} Caouette (n 160) 10.
\textsuperscript{165} Banks (n 164) 7.
Financial institutions and large, public companies are constantly monitored to assess their level of liquidity risk (and financial solidity). Risk measurement systems are devised to monitor the borrowers’ solvency, so that all parties can retain confidence in the financial system and the economy can expand.\textsuperscript{166} Despite that, cases such as Carillion prove that auditors may fail to identify potential liquidity risks.\textsuperscript{167}

The next section investigates if insolvency prediction models built upon these notions provide satisfactory answers and guidance on when to use insolvency remedies.

5.3(b) The Predictive Myth

While predictive models fall outside the scope of this thesis, it is pertinent to explore if it is possible to rely on the taxonomy of risk to predict when a company should file for insolvency.

The early literature on bankruptcy prediction models relied on pre-insolvency performance accounting indicators to determine if and to what extent a company was financially distressed.\textsuperscript{168} Examples of these indicators are profitability, liquidity and leverage. The focus of the analysis was the existence of a liquidity risk and the obvious conclusion that insolvency filings could be justified only when the company was cash-flow or (to a more limited extent) balance-sheet insolvent.

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{166} E Allaj, ‘Risk measuring under liquidity risk’ (2017) 24(3) Applied Mathematical Finance 246.
\end{itemize}
\end{footnotesize}
Criticisms relating to violations of the statistical assumptions underlying these multivariate discriminant analyses (‘MDA’) models led researchers to develop conditional probability models, the most popular being the logit.\(^{169}\)

More recently, researchers suggested including market variables in these prediction models,\(^{170}\) thus moving from MDA and static logit models to a “discrete-time hazard model”. Contingent claim models,\(^{171}\) that basically assume that shareholders have a call option (for insolvency) whenever the company is balance-sheet insolvent, have also been proposed.\(^{172}\)

Predictive models have not gone unquestioned. In particular, the author of this thesis believes that they feature at least four major shortcomings.

First, empirical evidence proves that the predictive ability of each model varies over time.\(^{173}\) However, some authors suggested that predictions could be more accurate if the models included reference to specific characteristics of the business, such as firm diversification.\(^{174}\) Other empirical studies proved that artificial intelligent models\(^{175}\) such as neural networks perform better than models that rely on a set of variables chosen with criteria used in the financial


\(^{175}\) Artificial intelligent models can also rely on easily interpretable white box hypothesis and work equally well as neural networks: L Obermann and S Waack, 'Demonstrating Non-Inferiority of Easily Interpretable Methods for Insolvency Prediction' (2015) 42 Expert Syst. Appl. 9117.
This aspect, therefore, does not cause too much alarm and would not prevent the use of predictive models in insolvency scenarios.

The second criticism is much more substantial. It was argued that these models fail to apply to all companies and all sectors of the economy, irrespective of the period in which they are conceived. To overcome some of these limits, Wu and other scholars\(^{177}\) proposed the adoption of a new predictive model that considered a larger variety of data, econometric approaches and performance metrics. He also argued that the general model should in any case be integrated with company-specific characteristics.

This, however, leads to the third difficulty. One of the issues of this conceptualisation and early models, such as the Z-Score conceived by Altman,\(^{178}\) is that the predictions are dependent upon the need of large accounting data. For instance, Altman’s Z-Score relied on five financial ratios (profitability, leverage, liquidity, solvency and activity) to predict whether a company has high probability of being insolvent. Additionally, they still rely on the basic assumption that companies file for insolvency when they are insolvent, an assumption which was found theoretically unsatisfactory for the reasons evidenced in sub-section 5.2(e).

This requirement for a constant flow of detailed, updated and accurate information means that the use of these models is restricted to insiders (directors and controlling shareholders), institutional and financial creditors and auditors. In troubled times, the majority of them have strong incentives to keep this information confidential to promote the information holder’s individual interests over the collective well-being. All other insolvency stakeholders are left in the dark, unable to monitor the performance of the company in a predictive way.\(^{179}\)

---


177 Wu (n 173).

178 Altman (n 168).

Forthly, even if this information was available, these models are by nature retrospective. They look at *consolidated* data from the previous fiscal year, which means that almost two years may lapse from the moment the figure (e.g., revenue) is produced to when the assessment is carried out.

The only way to overcome the last two issues is to improve the flow of information and the ability to assess investment risks. Unsurprisingly, the legislature in both the U.S. and the U.K. reacted by introducing more stringent **reporting requirements**.

In the United States reporting requirements for public companies are detailed in the Securities Act of 1933 and the Securities Exchange Act of 1934. Recently these acts have been amended in the wake of corporate scandals[^180] and the financial recession[^181] to improve accountability and transparency of U.S. corporations. The system requires periodic disclosures by means of annual Form 10-K and quarterly Form 10-Q and companies shall also file Form 8-K on the occurrence of certain significant events[^182]. Other federal securities’ laws and Securities and Exchange Commission (‘SEC’)[^183] rules require disclosures of a variety of events affecting the company.

The primary financial reporting framework, utilized by non-governmental entities in the United States, is represented by the U.S. Generally Accepted

---

[^180]: Sarbanes-Oxley Act of 2002, P.L. 112-106, enacted April 5, 2012. Sarbanes-Oxley Act was principally a reaction to *Enron*’s corporate and accounting scandal. However, during this same period, the equally dramatic actual or pending bankruptcies of *WorldCom*, a long-distance telecommunications company, and *Tyco*, a diversified equipment manufacturer, influenced the content of the legislation.


[^183]: The U.S. Securities and Exchange Commission (‘SEC’) is an independent agency of the United States federal government. The SEC holds primary responsibility for enforcing the federal securities laws, proposing securities rules, and regulating the securities industry, the nation’s stock and options exchanges, and other activities and organizations, including the electronic securities markets in the United States. It was created by means of the Securities Exchange Act 1934.
Accounting Principles (‘GAAP’) which have been established by the Financial Accounting Standards Board (‘FASB’). Nevertheless, companies that are privately owned are not required by law to disclose detailed financial and operating information in most instances, even if a requirement for an audit may be specified by third parties such as lenders or other stakeholders.

In the United Kingdom, all private limited and public companies must file their accounts to the Companies House, but small companies and micro-entities may prepare a less detailed abridged version which may omit reference to certain balance-sheet items. S.394 CA 2006 establishes the duty to prepare individual accounts, whilst in accordance with s.395 such individual accounts may be either “Companies Act individual accounts” or “IAS individual accounts”.

Private companies choose their own accounting reference dates and submit their financial information and annual return annually to the Companies House. Private companies are not generally required to have an audit of their financial statements, unless they are regulated by certain bodies such as the Solicitors Regulation Authority (‘SRA’) or the Financial Conduit Authority (‘FCA’).

Accounting standards and corporate managements have been reformed in recent years. In the wake of the Enron, Tyco International and WorldCom corporate and accounting scandals, more disclosure requirements were introduced by means of the Companies (Audit, Investigations and Community Enterprise) Act 2004. Reporting requirements had also been reinforced through the enactment of s.417 CA 2006. This section puts a strong emphasis on

---

184 The Financial Accounting Standards Board (‘FASB’) is a seven-member independent board consisting of accounting professionals, who establish and communicate standards of financial accounting and reporting in the United States. FASB standards, known as generally accepted accounting principles (‘GAAP’), govern the preparation of corporate financial reports and are recognized as authoritative by the SEC.

185 Prepared in accordance with the accounting and disclosure requirements of company law and with the Financial Reporting Standards (‘FRSs’) published by the Financial Reporting Council (‘FRC’) (‘UK and Irish GAAP’).

186 Prepared in accordance with the International FRSs published by the International Accounting Standards Board (‘IASB’), as adopted by the European Union. The IAS Regulation (Regulation (EC) No. 1606/2002) restricts the use of IASB to public companies listed on a regulated EU market, such as the London Stock Exchange.

managing and controlling risk. In fact, unless the company is subject to the small companies’ regime, its directors have to inform the company’s shareholders and creditors by means of a “business review” within the directors’ report on how they have performed their duties and what actions they have undertaken to promote the success of the company (pursuant to s.172 of the same Act).\textsuperscript{188}

These regulatory innovations, both in the U.S. and England, demonstrate an increased attention to risk-based approaches and risk-centred strategies for corporate management.\textsuperscript{189} It has been contended, however, that the most successful applications of these innovations have been made in private practice by financial creditors.

However, financial creditors have embraced these new approaches through their intensive care units not to foster a wider, more-collective approach to corporate distress, but to either extract further, individual benefits from the ailing company, or to relocate debt-collection activities from the formal to the turnaround stage.\textsuperscript{190}

Additionally, as these innovations tend to affect primarily regulated companies, they may also prove untimely. In fact, with increasing opportunities to decouple creditors from borrowers, financial borrowers may have little incentives to benefit for long-term wealth generation that can be triggered by a meaningful implementation of the business review requirement).

\textsuperscript{188} This section was repealed by Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013/1970 Pt 2 reg.5 (1\textsuperscript{st} October 2013: repeal had effect in respect of financial years ending on or after 30 September 2013). It was replaced by the requirement for companies (other than those subject to the small companies’ regime) to prepare a stand-alone strategic report in accordance with sections 414A to 414D of the Companies Act 2006.


carry out extensive and expensive monitoring activities when they could rely on instruments such as financial derivatives to spread insolvency risks across the market.

In conclusion, despite the above-mentioned efforts to improve accountability and to manage insolvency risk in a more open and preventive manner, reporting requirements appear to have a predictive nature only with reference to public companies. However, it is questionable, even with reference to these players, if annual or quarterly reports can timely disclose operational risks (credit and liquidity risks should be easier to monitor, in the absence of fraudulent behaviour).

The following sub-section looks at whether the shortcomings are intrinsic to the predictive models, or extrinsic on their reliance on the insolvency paradigm. If the latter was the case, prediction models could be satisfactorily used to determine the limits of insolvency law.

5.3(c) The Purpose of “Risk” and Prediction Models

Can and should “risk” and prediction models be used to determine when insolvency rules should depart from the common law of contract?

A cursory look at risk models may lead the reader to believe that their reliance on economic and financial indicators can promote legal predictability in the application phase. The author has already demonstrated why this impression is fallacious. So far there is no single approach to the systematization of methods for insolvency risk prediction. This means that there is no objective view on the tools that can and should be used to monitor the risk of insolvency.

Additionally, the proposed predictive tools are ill-positioned to determine when a company should file for insolvency for their reliance on accounting and largely outdated data that are usually only in possession of managers, close advisors and a restricted list of financial investors.

Finally, even when successful, their risk analysis is only capable of determining when a company will face unsustainable levels of risk. If these models are used to assess the insolvency risk, they are only capable of determining when a
company will be insolvent on a balance-sheet or cash-flow basis. Section 5.2 has already commented on the appropriateness of an eligibility requirement based on the notion of insolvency. A more objective and neutral approach to the definition of insolvency provides little guidance in answering the research question of this thesis.

Depending on the way in which the legislature has introduced an eligibility test based on a predictive insolvency model, party autonomy may or may not be preserved.

As explained in chapter two, autonomy-driven insolvency scholars understand “autonomy” as the principle according to which contracting parties can determine the consequences arising from the opening of an insolvency procedure.

Predictive models could be compatible if they were used to determine when a company has to rely on statutory remedies. On the contrary, they would fail to meet the autonomy criterion if the nature of the risk also determined the content of the procedure.

Take the case of a company that has liquidity problems (i.e. credit risk) but a sound business (i.e. no operational risk). The use of predictive models based on liquidity ratios might suggest that the company must file for a formal insolvency procedure. This in itself is restriction on the autonomy of the parties, as they might still be willing to negotiate and possibly agree on an out-of-court settlement. However, society as a whole may be willing to accept a restriction to their freedom and autonomy for public policy considerations if it is demonstrated that the majority of companies that face those liquidity risks fail to both turn around their business and operate for the benefit of their creditors and stakeholders.

The predictive models, however, could be employed to assess what procedure is better suited to address the problems of the company. Their use might suggest that in cases of liquidity but no operational concerns, rescue represented a better option than liquidation. If these models were used in this manner, they
would unduly restrict the autonomy and freedom of the interested stakeholders.

Finally, with reference to the inclusivity objective, the literature on prediction models has evidenced that their focus is primarily on contractual relations. In theory, external factors could be and are sometimes included in prediction models, as they impact on the solvency of the ailing debtor.

A model that relies primarily on performance accounting indicators fails to provide guidance for situations that arise from either non-contractual relation (such as tort liabilities) or non-foreseeable contractual events (e.g. punitive damages or sudden depreciation of corporate assets).

For instance, take the case of a company that faces tort liabilities capable of threatening its survival. If prediction models were the only criterion to determine eligibility to file for insolvency, the company could not avail itself of insolvency remedies until one or more of the following events occurred. These are the imposition of substantial and final civil awards for damages, the significant reduction of its stock value (for public companies), a major decline in its business caused by the negative consequences stemming from the tort dispute or a combination of them. Waiting for the occurrence of one or more of these events may be against the interests of the company's stakeholders, as early filing yield more value to interested parties.

5.3(d) Testing Predictive Models: The Cases of Cambridge Analytica and O.W. Bunker

How do predictive models hold-up in real life? For the purpose of assessing their predictive value, this sub-section considers recent insolvency cases of public companies, as it has been claimed under sub-section 5.3(b) that these are the most likely candidates to prove if these instruments work.

Take the case of Cambridge Analytica, a political-consulting firm that operated both in the U.S. and the U.K. The company found itself at the centre of a data-collection and privacy scandal. It purchased the data of 87 million Facebook users from the creator of an app named “This Is Your Digital Life” but used them for purposes beyond what was initially agreed and consented. It is alleged that
this data was leveraged as a campaigning tool in recent consultations, such as the U.K. referendum on the withdrawal from the European Union (23 June 2016) and the last U.S. presidential elections (8 November 2016).

On 2 May 2018 Cambridge Analytica directors, blaming the adverse publicity triggered by the company's alleged involvement in these illegal practices but still denying any wrongdoing, ceased all company's operations and filed for insolvency protection in the England. On 17 May 2018 they filed a voluntary Chapter 7 bankruptcy petition in New York.

In a financial statement, the company – whose parent SCL Elections has also shut down – said that it was no longer viable to continue operating the business which was now in a “precarious financial condition”. At the same time, it pledged to meet all the obligations towards its employees.

However, some commentators observed that the company was not known to hold significant debts. Therefore, it was argued that the decision to file for insolvency protection was determined by other factors. These included the need to start afresh with a similar business but under a different name (as the business itself proved highly profitable) and to shield the company from civil and tort liabilities.

The case of Cambridge Analytica is primarily a case of operational mismanagement. No credit or liability risk is apparent. Predictive models based

195 Ibid.
196 Ram and Kuckler (n 192).
197 The company could have been fined for up to £500,000 only in the U.K. for breaching privacy rules: Ram and Kuckler (n 192).
on operational risk might have justified the *consideration* of remedial actions from the moment in which it became apparent to the board that the data purchased by the company had been used beyond the consented use.

However, *filing* for (which is a significant step beyond considering) insolvency protection would have been justified only if the board concluded that the company would not have survived a scandal based on the alleged misuse of this data. This would have rendered the test completely speculative. Probably for this company that threshold had never been reached, and breached.

Additionally, *Cambridge Analytica* is a case where the informed parties had an adverse incentive to disclose the existence of this scandal, even if any delay caused by a breach of directors' duties may not be inconsequential.\textsuperscript{198} In the case of *Cambridge Analytica*, disclosure occurred with an article jointly published in *The Guardian* and *The New York Times* on 17 March 2018.\textsuperscript{199} Following the publication of that article, the risk of imminent failure of *Cambridge Analytica* was apparent to the business community and a predictive model based on operational risk would have been of little or no avail at that instance.

*Cambridge Analytica* is no isolated case and not the first one to show the failure, inaccuracy and lack of predictive value of risk-based models. Not only do they fail to predict strategic filings – which commentators\textsuperscript{200} and this thesis have

\textsuperscript{198} See above sub-section 4.3(b) of this thesis.


proven to occur in practice and with alarming frequency – but they may also fail to predict “normal” corporate failures.

This might be the case of the collapse of *O.W. Bunker*. Before filing for insolvency, the company was the leading global independent marine fuel (bunker) company. Founded in Denmark in 1980, it had operations in twenty-nine countries. It acted as a physical distributor and reseller of marine fuel. It also provided risk-management solutions to control costs, minimise risk, and protect against market fluctuations. At the end of 2013, *O.W. Bunker* was the second largest listed company in Denmark after *Maersk*.

*O.W. Bunker* sourced fuel bunkers from maritime operators by a chain of contracts with subsidiaries and independent suppliers. Each contract contained a retention of title (‘ROT’) clause in favour of the supplier and a provision that payment was due a fixed number of days after delivery. Some of these suppliers, depending on the law governing their contracts, were also believed to have a maritime lien on the vessel for the provision of necessaries.

Each supplier gave permission for the ship owner to consume the bunkers while payment was pending as the vessel went about its business, thus impliedly accepting that all or substantially all fuel bunkers may be consumed before payment became due.

On 7 November 2014, the holding company of the *O.W. Bunker* group filed for bankruptcy in a Danish court, following an alleged fraud in its Singapore subsidiary and substantial losses relating to unsupervised over-the-counter trading. Shortly afterwards, on 12 November, *PwC* was appointed as receiver for the security agreement. On 13 November, the U.S. entities of the group (*O.W. Bunker U.S.A.*, *O.W. Bunker North America Inc.*, *O.W. Bunker Holding USA* and *North America*) filed a Chapter 11 petition in the Bankruptcy Court for the District of Connecticut.

---


A cursory *ex-post* analysis of the circumstances of the failure may reasonably lead the observer to conclude that the *O.W. Bunker* collapse was due to the behaviour of a rogue employee. This would also be the *ex-ante* conclusion of a predictive model, as otherwise it would not be possible to explain why *ING Bank*, which acted as a syndicate of lenders to the *O.W. Bunker* group, failed to identify any sign of imminent failure before the eleventh hour.

Nevertheless, as explained by several commentators, the collapse of the Danish multi-national enterprise was primarily due to operational reasons. The company operated in a low-profit, highly competitive market that had been badly affected by the aftermath of the financial crisis. The company had a long-established approach to business and a cost structure that was no longer competitive. If it was not for the accounting scandal, it is likely that the company would have been forced to file for insolvency protection in the following months. Yet, it seemed that *ING Bank* failed to take any meaningful action to deal with these operational issues, probably under the assumption that its claim was fully secured.

It is not possible to know at this stage if *ING* predicted the operational crisis of *O.W. Bunker*. What is apparent is that the bank did not take proactive steps to avert the crisis. It might be argued that the failure was not to be attributed to the predictive model, but to the fact that the beneficiary of the information and the debtor had aligned interests, which drew their attention away from the corporate issues. The question still stands: what is the practical value of a model that *may* predict a condition for filing (operational risk) but fails to pass this information to the stakeholders, which could act on its base?

5.3(e) Findings

The inextricable reliance on the notion of insolvency affects the adoption of any of these predictive models as the demarcation line between contract and insolvency law remedies. In other words, these models may predict with sufficient accuracy when and if a company is cash-flow or balance-sheet

---

insolvent, but not when a company should and does file for insolvency protection.

Despite their name, these instruments provide little help to assess when a company does, should and ought to petition for the application of insolvency remedies. This is due to a variety of reasons, the most significant being their focus on financial indicators (such as profit, loss, balance-sheet and cash-flow insolvency) and their reliance on accurate and timely information, thus raising issues of asymmetry between stakeholders and cost of the monitoring system.

5.4 THE “TRADITIONAL COMMON POOL DILEMMA”

5.4(a) To Be or Not to Be a “Problem”

Insolvency is a black-or-white eligibility requirement: only if a company is insolvent it may file for insolvency remedies. The TCP narrative adds a layer of complexity: if a company experiences a TCP-type situation, it may not mean that insolvency remedies should apply.

With reference to risk, it was argued that only qualified risks justify filings. Similarly, only qualified TCP-type situations should lead to filings. In other words, if the company and its stakeholders experience a TCP-type situation, the list of available remedies should be restricted to those provided by contract law. It is only when this dilemma deteriorates to a problem that insolvency remedies should trump contractual rules.

Companies are best understood as common-pool resources to which a large number of the people have access. The conflicting expectations of these people may lead to a sub-optimal use of the resource, thus creating a TCP dilemma.

This situation was first described by Hardin204 in an entirely different context, i.e. the over-use of renewable205 or non-renewable (yet limited) resources such

---

204 G Hardin, 'The Tragedy of the Commons' (1968) 162 Science 1243. This is one of the most often-cited scientific papers of the second half of the twentieth century, but pessimism on the sustainable management of common-pool resources was expressed by authors such as Aristotle, the French naturalist Marcet and Lloyd; T Dietz and others, 'The Drama of the
as fish and potable water which may lead to problems of overuse and affect the long-term sustainability of the affected eco-system. Common-pool systems also face free-rider problems, i.e. the cost associated with devising a monitoring and joint-administration system of the commons\textsuperscript{206} and with forcing users to contribute to maintain the system in equilibrium or to exclude free riders.

Hardin also described the situation as a “tragedy of the commons”,\textsuperscript{207} thus paving the way to neo-classical economists who argued for the importance of unitary ownership (private or governmental) to address TCP issues.\textsuperscript{208}

This narrative has not proven entirely persuasive\textsuperscript{209} and Hardin’s theories have not been received without criticism. Some scholars argued that Hardin confused the concept of common property with a situation in which people have free access to use a commons.\textsuperscript{210} Later commentators\textsuperscript{211} evidenced that the conflict

\begin{footnotesize}
\begin{itemize}
\item Money in insolvency cases can be described as a “renewable” resource as long as the amount of it appropriated by each of the claimants does not exceed the regeneration rate triggered by the rescue procedure. Nevertheless, in the majority of insolvency cases, money is an exhaustible resource. Ostrom argued that many of the conclusions of her studies applied to both renewable and exhaustible resources: E Ostrom and others, \textit{Rules, Games, & Common-Pool Resources} (University of Michigan Press: Ann Arbor, 1994) 8.
\item In line with the scientific literature in the field, the word “commons” is used in this text as a synonym of “common-pool resource” to describe ‘a diversity of resources or facilities as well as to property institutions that involve some aspect of joint ownership or access’ - Dietz (n 204) 18 -. A common-pool resource is not necessarily a common property: it may not be owned by a multiplicity of players. As evidenced by Thomas Dietz, the terms “commons” and “common-pol resource” refer to ‘the characteristics of the resource rather than on the human arrangements used to manage it’ - Dietz (n 204) 17 -.
\item He argued that ‘freedom in a commons brings ruin to all’: Hardin (n 204) 1244.
\item In particular, against the need to privatize the goods and promote autonomy-based solutions for common dilemmas see: T Tietenberg, ‘The Tradable Permits Approach to Protecting the Commons: What Have We Learned?’ in National Research Council (eds), \textit{The Drama of the Commons} (National Academy Press: Washington D.C. 2002); CM Rose, ‘Common Property, Regulatory Property, and Environmental Protection: Comparing Community-Based Management to Tradable Environmental Allowances’ in National Research Council (eds), \textit{The Drama of the Commons} (National Academy Press: Washington D.C. 2002).
\item SV Ciriacy-Wantrup and RC Bishop, ‘Common Property as a Concept in Natural Resources Policy’ (1975) 15(4) Natural Resources Journal 713, 715.
\end{itemize}
\end{footnotesize}
'could be averted by mechanisms that cause individuals to act in the interest of the collective good rather than with narrow self-interest'.

These are very technical comments that fall outside the scope of the thesis. Despite the criticisms, the author agrees with Hardin that there are significant obstacles to identify the critical factors that can promote a successful governance of the commons (in our case, the agreement on a restructuring plan, for instance) without the privatization of the company's assets (i.e. their sale or assignment to secured creditors) or the definition of state-imposed regulation (i.e. insolvency law). These obstacles are magnified in large commons and international arenas, where consensual governance is less likely to be achieved.

Nevertheless, TCP dramas can be diverted if debtors and creditors act according to the interests of a wider group of stakeholders and not only to fulfil their personal interests. The problem faced by people in a TCP drama is one of organization: how to change a situation in which each party acts as an independent appropriator of limited goods to one in which all stakeholders take or accept decisions that are designed to maximise their wealth.

---

212 Dietz (n 204) 4.
216 Ostrom (n 213) 39. The author also observed that in common pool situations the key issue is represented by devising strategies to allocate limited resources in an efficient manner, i.e. avoiding rent dissipations, reducing uncertainty and preventing conflict over the assignment of rights (at 48).
Hardin’s theory is based on the prisoner’s dilemma narrative,\textsuperscript{217} in which predictions are inferred from the behaviour of two perfectly informed people under a one-shot condition and with no communication. Not only is this not necessarily a truthful picture of how things occur in reality, but the perfect market-zero transaction cost (‘PM-ZTC’) approach also prevents the author from exploring alternative solutions based on practical experience.

People do play the same game repeatedly (as they use the commons more than on one occasion) and communication between them is possible\textsuperscript{218} (although asymmetries of position and information may affect the outcome).\textsuperscript{219} Other authors, such as Ostrom, challenged Hardin’s assumptions on the basis of how people behave \textit{in practice}.

Ostrom conducted a series of studies on TCP situations in the use of communal tenure in high mountain meadows and forests; the use of groundwater basins in the Los Angeles area; and fisheries in Turkey, Sri Lanka and Nova Scotia.\textsuperscript{220} These were all TCP dilemmas, similar to those faced by a distressed corporation. However, she concluded that it is not always the case that individuals jointly using common pool resources behave as to produce TCP problems, which is what Hardin defined as “the tragedy of the commons”.\textsuperscript{221}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{218} P Barham and J Dayton-Johnson, ‘Unequal Irrigators: Heterogeneity and Commons Management in Large-Scale Multivariate Research’ in National Research Council (eds), \textit{The Drama of the Commons} (National Academy Press: Washington D.C. 2002) conducting an empirical study to investigate the impact of heterogeneity among the users of a common pool resource and describing the factors that may promote successful common management of these resources without the need of governmental intervention. See also: S Kopelman and others, ‘Factors Influencing Cooperation in Common Dilemmas: A Review of Experimental Psychological Research’ in National Research Council (eds), \textit{The Drama of the Commons} (National Academy Press: Washington D.C. 2002).
\item \textsuperscript{220} Ostrom (n 213).
\end{enumerate}
\end{footnotesize}
TCP dilemmas – which, in the insolvency context, are both allocative and (re)distributive in nature\textsuperscript{222} – may not deteriorate into TCP problems.

TCP problems are qualified TCP-type situations where the parties who have legally enforceable rights against the debtor (including risk bearers) cannot agree on a consensual and value-maximising course of action. Is the TCP problem the proper notion to determine when statutory insolvency rules and norms ought to depart from the common law of contract as it applies to solvent companies?

5.4(b) What Makes a TCP Problem “Problematic”?

One of the dominant theories regarding the nature of insolvency law and what it should accomplish is the creditors’ bargain theory.\textsuperscript{223} It argues that ‘[c]orporate reorganization is essentially an attempt to maximize asset value in the face of a collective action problem coupled with a private information problem’.\textsuperscript{224} The proponents of this theory suggested that insolvency law should be designed as a set of rules to overcome TCP problems.\textsuperscript{225}

According to these commentators, a TCP problem usually arises whenever a company is unable to pay its debts as they fall due or when it appears from the company's books that it is hopelessly insolvent.\textsuperscript{226}

These commentators maintain that the TCP problem is simply a multi-party version of the "prisoner's dilemma".\textsuperscript{227} Parties recognise that self-interested

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{222} See above sub-section 1.3(a) of this thesis.
\item \textsuperscript{223} The theory has been mainly developed by the American scholars Jackson and Baird. See section 3.2 of this work.
\item \textsuperscript{225} Later versions of this theory replaced the common pool narrative with a new framework that incorporated a common disaster component to business failure. The purpose of this change was to explain some of the various (re)distributional effects that commonly take place in insolvency law: TH Jackson and RE Scott, ‘On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors’ Bargain’ (1989) 75(2) Va. L. Rev. 155.
\end{itemize}
\end{footnotesize}
actions fail to achieve a socially optimal result but, nevertheless, they are pushed to betray the common good for a (potentially) individual larger gain. When a TCP problem arises, there is an overlapping distribution of rights among the unsecured creditors of the failing debtor. As no creditor has the right to impose a dominant strategy over the others, each of them has an interest in defeating the rateable principle of distribution that applies in insolvency law.

These scholars compared insolvent debtors to a jointly owned pool of fish and creditors to self-interested fishermen. Overfishing would be against their ultimate interests, yet self-interested creditors have strong incentives to behave irrationally. This situation is the equivalent to Hardin’s “tragedy of the commons”. Whenever TCP problems come to the fore, insolvency statutes should apply to lead to the most economically efficient outcomes that parties would not otherwise achieve absent this statutory incentive.

Not all commentators (including the author of this thesis) agree that this TCP-type situation is “problematic”. Another contentious aspect is the identification of who is affected by a TCP problem.

It has already been observed in this thesis that (re)distributive theorists maintain that equality – and deliberate deviations from equality – should be the focus of any insolvency policy. Accordingly, existing bankruptcy systems should shrink ‘the collection rights of the most powerful creditors in order to

---

228 Jackson (n 226) 12-14.
229 Picker (n 227), arguing that insolvency remedies are not needed to solve the common pool problem, as negotiated secured credit arrangements can more efficiently deal with allocation issues.
231 See Ostrom studies, reported in sub-section 5.4(a).
232 Chapter four.
233 Against, see FH Easterbrook, ‘Is Corporate Bankruptcy Efficient?’ (1990) 27 J. Financial Econ. 411, 414. The author demonstrated that if junior, unsecured creditors are treated more harshly in reorganisation rather than in liquidation/auction procedures (but the reasoning would remain valid even if the opposite was true), it would not follow that auctions have a potential (re)distributive effect. These considerations affect the efficiency of each of the considered procedures, not their effects.
achieve somewhat greater distribution among all those who have a stake in the debtor’.\textsuperscript{234}

The case for a (re)distributive explanation of some insolvency statutes has some impressive foundations. For example, in the U.S. the legislature\textsuperscript{235} seems to have adopted such a view. However, this position is countered by those commentators who argue that ‘[t]he rights which bankruptcy legislation grants and takes away [...] are mostly modifications of expectations which arise from market exchanges’.\textsuperscript{236}

The judiciary usually refrains itself from equitably extending the scope of statutory (re)distributive protection. For instance, in the U.S., in Canada S. Ry. V. Gebhard\textsuperscript{237}, the Supreme Court clarified that ‘[e]very member of a political community must necessarily part with some of the rights which, as an individual, not affected by his relation to others, he might have retained’.\textsuperscript{238}

As a matter of fact, (re)distributive policies are currently pursued by both English and American insolvency laws (see, for instance, the preferential treatment recognised to employees). Consequently, we are left in the dark in the determination of what is a problematic TCP problem. This observation seriously questions the desirability of using the TCP standard as the criterion to determine the dividing line between corporate and insolvency rules.


\textsuperscript{235}‘[R]eorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the value of the estate should be apportioned among creditors and shareholders’ S. Rep. No. 989, 95\textsuperscript{th} Cong., 2d Sess. 11, reprinted in 1978 U.S.C.C.A.N. 5796.

\textsuperscript{236}JW Bowers, ‘Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses’ (1994) 72 Wash. U. L.Q. 955, 965. For the analysis of procedural-based theories, see chapter three of this thesis. See, in particular, Jackson (n 226) 17 (ftn 22).

\textsuperscript{237}109 U.S. 527, 536 (1883).

\textsuperscript{238}Ibid.
5.4(c) Literature Review on the TCP Standard

The existence of a TCP has been questioned for several reasons, including for its lack of persuasiveness and proper consideration of anti-common behaviours.

The theory of anti-commons originated in the context of property law, where it was first introduced by Michelman and then extensively investigated by Heller. Anti-common behaviour has been described by insolvency scholars and it has been frequently and well documented in practice. For instance, in the case of the Chapter 9 procedure involving the city of Detroit, the city bonds’ insurers argued that the turnaround plan was discriminatory as financial creditors were paid no more than 10 cents for the dollar, while unsecured pensioners received compensation for roughly 60 per cent of their unfunded claims. This was despite the state of a near unanimity of other claimants in regards to the proposal, which represented the best possible compromise between the interests of all parties affected by Detroit’s collapse and the best bet to ensure a viable future for the city.

---


244 Bomey (n 146) 217-218.
Conflicts among different classes of creditors are the norm rather than the exception in insolvency cases. While it is true that insolvency rules should acknowledge the existence of anti-common problems and provide appropriate remedies to remove any such blockage caused by them, such a debate focuses again on the content, rather than the limits of insolvency law.

On a side note, in some circumstances common and anti-common issues can be hard to distinguish. The institutional lenders’ opposition to a rescue plan that results in a lower return to creditors may be interpreted as an anti-common practice by those workers who lose their jobs and by the local communities. At the same time, the closure of a failing business may result in a less competitive (hence more profitable) market, in higher returns for creditors, in lower procedural and social costs, and in more secure job opportunities for the redundant workers (who are, nevertheless, usually treated as preferential creditors). As a result, the question arises whether the potential institutional lenders’ veto power is a common or an anti-common type of situation?

Anti-common theories may prove that the proceduralist vision of insolvency law is too narrow-focused to be persuasive to determine the content of the law. However, they do not prove that there is no TCP deadlock for contracting creditors and legally recognised claimants in the period before an insolvency procedure is commenced.

Other authors, on the other hand, have questioned the existence of such a problem only with reference to limited sectors of the economy. More

---

245 Ibid.
247 To explore the implications that the anti-commons problems and related hold-out behaviour can have on the determination of the appropriate venue for a cross-border insolvency procedure: Rj de Weijs and MS Breeman, ‘COMI-migration: Use or Abuse of European Insolvency Law? ‘ (2015) 11(4) Eur. Company & Fin. L. Rev. 495.
generally, there is a large portion of insolvency scholars who claim that common pool and collectivist approaches fail to recognise the interests of non-contractual creditors, focus on non-efficiency objectives and assist corporations to stay in business.

Despite these contrasting views, as a matter of fact, it is possible to observe that if each creditor is free to pursue his own agenda, this would reduce the likelihood to (efficiently and quickly) agree on a reorganisation plan. While this observation does not prove that a TCP issue exists, it is nevertheless possible to conclude that, left alone, creditors on the whole are unable to ex-post maximise their return from an insolvent or otherwise financially distressed debtor.

5.4(d) The Purpose of the TCP Standard

The literature review mentioned in sub-section 5.4(c) has challenged the existence of a TCP problem, but it has provided no final answer on the opportunity to use this criterion as a demarcation line between corporate and insolvency remedies. Accordingly, this section investigates if an insolvency system that revolves around the TCP notion is able to deliver outcomes that are consistent with the autonomy, predictability and inclusivity objectives adopted in this study.

In general terms, it is impossible not to observe that the TCP criterion draws heavily on the notion of insolvency. Sub-section 5.2(a) has already hinted that the alleged simplicity and straightforwardness of the insolvency notion can be more apparent than real, as the way in which this concept has been understood by both the judiciary and the jurisprudence has resulted in a flexible understanding of its content and characteristics.

---

249 Finch and Milman (n 18) 30.
251 DR Korobkin, 'The Role of Normative Theory in Bankruptcy Debates' (1996-97) 82 Iowa L. Rev. 75.
The reliance on the insolvency concept is unwarranted. Both in its allocative and its (re)distributive understanding, the TCP dilemma refers to a condition among the *creditors*, who are no longer able to rely on their legal or contractual rights to satisfy their claims in the ordinary course of business. Insolvency, on the other hand, is a condition that affects the *debtor*.

While insolvency almost invariably leads to the emergence of a TCP dilemma among the debtor's creditors, the latter problem may pre-date the existence of an insolvency situation. Nevertheless, Jackson and other law and economics scholars have used the creditors’ bargain model to suggest that insolvency remedies should be granted (and cases commenced) whenever there are multiple creditors and a reasonable prospect of insolvency.\footnote{Jackson \(n\ 226\) 201.} Insolvency remedies would be triggered whenever there was the potential that the joint actions of the self-interested owners would lead to non-efficient outcomes\footnote{Block-Lieb \(n\ 239\) 374-379; S Block-Lieb, ‘Congress’ Temptation to Defect: A Political and Economic Theory of Legislative Resolutions to Financial Common Pool Problems’ \(1997\) 39 Ariz. L. Rev. 801, 810.}. Autonomy of the parties would be preserved (as contractual securities and covenants would not be affected by the insolvency filing). The enhanced legal *predictability* in the system would result in lower cost of credit and a substantially fair treatment of the creditors.

This conclusion is however acceptable only in a perfect market, zero transaction cost (PM-ZTC)\footnote{LM LoPucki, ‘Strange Visions in a Strange World: A Reply to Professors Baird and Rosenzweig’ \(\text{Oct. 1992}\) 92(1) Mich. L. Rev. 79.} environment. Reality may be strikingly different.

Take, for instance, the existing business environment in the U.K. Small and medium sized enterprises (i.e. businesses that employ less than 250 people) represent 99.9% of businesses in the country, with micro companies (i.e. those with less than employees) accounting for 96% of the market.\footnote{C Rhodes, *Business Statistics* \(\text{HC 2017-06152, 28 December 2017}\) <https://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06152> accessed 17 September 2018.}

Empirical research in the field proves that MSMEs rely primarily on loans to fund their activity. These loans are usually provided by banks or hire purchase...
lenders. Additionally, micro-companies use venture capital, hire-purchase leasing and factoring less frequently than larger corporations.

Unlike other voluntary and involuntary financers of MSMEs activities (“non-adjusting lenders”) such as small trade creditors, tort claimants, employees and suppliers, institutional lenders are well placed to assess the vitality and economic prospects of the borrower. If monitoring costs are excessive and their claims are fully secured, they may decide not to do so and rely on financial instruments to reduce the risk of default. However, these institutional lenders will never find themselves in the situation of non-adjusting lenders, who ‘are like ships’ officers who can calculate the expected size of a hull fracture but not whether it will be above or below the waterline’.

This asymmetry of information and powers means that institutional lenders have a strong incentive not to manifest the existence of a TCP conundrum. Their pursuance of individual maximisation policies would prejudice the interests of non-involved third parties (for instance, by means of the request of new securities for new loans). In other words, they have an incentive to keep the company afloat until it is hopelessly insolvent and at that point they are those who will recover the most from the company’s liquidation.

As a result, while in theory the TCP standard could provide legal predictability and respect the autonomy of the contracting parties, in practice the same parties have strong incentives not to manifest the existence of this condition.

The legislature could introduce mechanisms to reduce the asymmetries of powers and information between the parties and to ensure a higher level of protection to non-adjusting lenders in the ensuing insolvency procedure. Technology could also promote a wider and inexpensive means to share


258 Finch and Milman (n 18) 83.
financial and operational information to the debtor’s contractual claimants if transactions took place on a de-centralised and public ledger such as blockchain.259

This, however, looks to be an uphill battle. Not only the structure of the market suggests that these statutory corrections are needed for the vast majority of cases. They should also be introduced against the foreseeable strong opposition of institutional lenders who - historically - have always had a strong lobbying group both in the U.S. and in the U.K.’s legislative bodies.

With reference to the last objective of this study (i.e. inclusivity), the previous sections have demonstrated that while TCP dilemmas (and problems) affect a variety of stakeholders, the mainstream allocative insolvency theories and practices tend to consider, protect and promote primarily the interests of contractual claimants who hold a legally enforceable, usually proprietary interest against the debtor. In other words, the notion of the TCP problem revolves around the concept of legally and equitably enforceable rights, with the result that any other claimant is automatically not included in the insolvency procedure.

Additionally, the difference in powers and relative positions among the traditional claimants means that some of them are more likely to use insolvency remedies to prejudice the interests of non-adjusting parties. In Finch’s words, ‘[t]he collectivism advocated by Jackson is treated as neutral but it begs distributional questions’.260

Inclusivity, therefore, seems to be only partially achieved. Additionally, respect for claimants’ rights appears primarily and purely formal. In other words, the use of a TCP standard can lead to substantial prejudice against certain categories of creditors.

259 Blockchain is a trust-less, public ledger that operates by means of the web. It is characterised by co-ordination, irrevocability and record keeping at the level of each of the nodes of the system, i.e. the computers that validate and relay blockchain transactions.

260 Finch and Milman (n 18) 32.
5.4(e) Testing the TCP Standard: The Cases of Carillion and Tesla

Would a common pool standard triggered by parties who have legally enforceable (proprietary and personal) rights against the debtor work in practice? If so, to what extent? To try to give an answer to these queries, this work refers to two recent and controversial corporate cases: Carillion and Tesla.

Carillion Plc (‘Carillion’) rise and spectacular fall has been described as ‘a story of recklessness, hubris and greed’,261 ‘a failure of a system of corporate accountability which too often leaves those responsible at the top – and the ever-present firms that surround them – as winners, while everyone else loses out’.262

Carillion was a major strategic supplier to the British public sector which employed 43,000 people, 19,000 of which were located in the U.K. alone. The company won several building contracts with local and central authorities and it provided school meals and defence accommodation. The company’s 2016 accounts, published on 1 March 2017, described a company in financial health: revenues were up 14 per cent over the previous fiscal year to £5.2 billion, while profits before taxation registered a fall of 5 per cent over the previous year to a still healthy £146.7 million figure.263 On the basis of these results, the company agreed to pay a record dividend of £79 million, out of which £55 million were distributed on 9 June 2017, just one month before the July 2017 profit warning.264

---

262 Ibid 68.
The 10 July 2017 profit warning was followed by a second one in September 2017 in which Carillion reduced the value of its contracts by more than £1 billion the value of its contracts. On 12 January 2018 the company paid £6.4 million to a series of advisors and lawyers, while three days later it presented a petition for compulsory winding up to the court. The company declared liabilities of nearly £7 billion and just £29 million in cash. Investigations from the Parliament, FCA, FRC and the appointed liquidators are underway to establish the existence and nature of any wrongdoing from past directors and the accounting audits.

Carillion left a pension liability of £2.6 billion. It also owed around £2 billion to its 30,000 suppliers. It is expected that both the Pension Protection Fund and these suppliers will get little out of the liquidation.

The preliminary report of the Business, Energy and Industrial Strategy ('BEIS') and Pensions Committee concluded that the system of internal checks and balances supposed to prevent board failures of the magnitude of Carillion failed spectacularly. Non-executive directors did not monitor, challenge and properly scrutinise the activity of executive directors, who acted with the connivance of the accounting firm charged to oversee the veracity and accuracy of the company’s accounts. The company showed a chronic lack of accountability and professionalism, while the deterrent effect of s.172 CA 2006 proved insufficient to affect the behaviour of the directors of the company to the extent that the Joint Committee recommended that the Insolvency Service investigated potential breaches of these duties.

The business model was one that has been described as “dash for cash”. Its acquisition strategy lacked any coherent strategy but to remove competitors
from the market and the company funded its spending spree through debt. The company became reckless in the pursuit of growth and had scant regard for long-term sustainability and the impact of its decisions on its constituencies.

Would the outcome have been different if the parties who had legally enforceable rights against Carillion relied on the TCP standard?

The question should probably be answered in the negative. Carillion's collapse was sudden and from a publicly-stated position of strength. Before July 2017 Carillion showed no manifest sign of crisis and all the parties who could have affected the situation of corporate distress of the company were involved in the scheme, failed to check the veracity and accuracy of the figures provided by the board or acted in their own personal best interest.

While shareholders were concerned with the company's net debt and the pension deficit, they preferred to divest rather than to attempt to modify the culture of the company. The government report also observed that while major investors failed to exercise sufficient influence on the board, this was primarily due to the lack of trustworthy information from the board and auditors. Third parties such as employees and, more importantly, suppliers and competitors had no possibility of raising the private concerns that they might have nurtured against the business model of the company.

These observations are in line with one of the preliminary findings of the report. While the economic system is predicated on strong investor engagement, the mechanisms and incentives to support engagement are weak. In other words: in the case of Carillion parties were driven into a TCP problem,

---

274 For instance, in early 2015 UBS claimed that total debt was higher than Carillion were publicly stating. This did not prompt an investigation from non-executive directors and accounting auditors, but only an increase in investors short selling against Carillion's shares. See: BEIS and Work and Pensions Committees, ‘Carillion: Second Joint Report’ (n 179) 14.
275 Ibid 50.
276 It might be argued that suppliers and creditors could have voiced their concerns about the financial stability of the company. In fact Carillion, despite being a signatory of the Government’s Prompt Payment Code since 2013, usually paid for supplies after 120 days from delivery (unless the supplier accepted a reduction in the price originally agreed by the parties through the use of an early payment facility option): BEIS and Work and Pensions Committees, ‘Carillion: Second Joint Report’ (n 179) 24-26. It is to be investigated however, if Carillion’s practices represented a unicum in the industry.
but this has promoted neither a timely filing for corporate distress remedies nor a balanced consideration of residual-risk takers interests by the parties who had the powers to act.

The course of action suggested by the report is rather unimaginative: to strengthen the regulators’ investigative and sanctioning powers. The beginning of this section has however proven that regulations and regulators may not be the appropriate solution to all issues.

This thesis submits that it might be preferable to empower those who are closer to the company (in the case of Carillion, long-term shareholders, pension trustees and regulator, suppliers, employees and competitors) to raise issues about the manner in which the company is run before the only course of action left is liquidation. The TCP standard based on proprietary and personal rights does not address the corporate governance, representation and power imbalance issues evidenced in the Carillion case. It looks mainly like an insolvency standard in disguise and it does not promote the early emersion of potentially irreversible crises (which is the underlying objective of the Anglo-American insolvency system).

In the U.S., Tesla, Inc. (‘Tesla’) is not (yet) an insolvency story.

In May 2018, Tesla – a niche battery electric car maker who has launched on the market luxury vehicles such as the Model S sedan and the Model X crossover – was valued on the NY Stock Exchange approximately $48 billion. The market value of Tesla was approximately the same as General Motors, a company that in the 2017 fiscal year sold

---

9.6 million vehicles and generated some $146 billion in revenue (compared to some 102,862 and $11.8 billion respectively at Tesla).\textsuperscript{278}

*Tesla* is not a profitable company. In all financial years since 2008 the company has registered a loss, which peaked to almost $2 billion dollars in 2017\textsuperscript{279} in the company's attempt to ramp up the production of its first, "affordable" mass-produced electric vehicle, the Model 3.

In an attempt to goad financial critics who had been warning about the risk of insolvency, on 1\textsuperscript{st} April 2018 Elon Musk, the co-founder. CEO and product architect of *Tesla, Inc.* tweeted:

*Tesla Goes Bankrupt. Palo Alto, California, April 1, 2018 -- Despite intense efforts to raise money, including a last-ditch mass sale of Easter Eggs, we are sad to report that Tesla has gone completely and totally bankrupt. So bankrupt, you can't believe it.*\textsuperscript{280}

The joke was not well received by the market, with *Tesla* stock losing 6\% of their value in the aftermath of this announcement amid other safety concerns linked to the disclosure of the U.S. National Transportation Safety Board that it was investigating the crash of one of *Tesla’s* Model X.\textsuperscript{281} In May 2018, the company shares also suffered another setback when the company's CEO in a conference call with the analysts refused to answer some pressing questions about the poor financial performance of the automaker and the need to raise new capital.\textsuperscript{282} On May 18, 2018 *Tesla* shares closed at $276.82 per share, down from more than $380.00 in mid-September 2018.


\textsuperscript{280} Elon Musk (@elonmusk) (1 April 2018, 3:02 PM). Tweet.

\textsuperscript{281} P Kwan Yuk, 'Tesla shares sink following disclosures about fatal crash' *Financial Times* (New York, 2 April 2018) [https://www.ft.com/content/96d927ac-366e-11e8-8eae-e06bde01c544](https://www.ft.com/content/96d927ac-366e-11e8-8eae-e06bde01c544) accessed 17 September 2018.

\textsuperscript{282} R Water and N Bullock, 'Tesla stock slides 6\% after Elon Musk's 'bonhead' analyst call' *Financial Times* (San Francisco and New York, 3 May 2018) [https://www.ft.com/content/9ac68b1f-2e4f-11e8-a7a9-37318e776bab](https://www.ft.com/content/9ac68b1f-2e4f-11e8-a7a9-37318e776bab) accessed 17 September 2018.
*Tesla* is not a cash-flow “insolvent” company: according to the “First Quarter 2018 Update”\(^{283}\) the company had a cash balance of $2.7 billion at the end of the first quarter of 2018. Furthermore, it seems that investors are still willing to lend money to the company and raise further capital should the need to do so arise.

Therefore, there is no TCP problem among those who can claim proprietary and personal rights against the company and no risk of imminent filing. In the author’s view, this is problematic, as *Tesla* should not be allowed to remain on the market.

It is a truism to say that the exuberant and unconventional attitude of Elon Musk has massively contributed to the promotion of the electric technology for vehicles as an alternative to combustion or hybrid-electric engines. In the wake of the 2016 Volkswagen diesel scandal and in an effort to reduce CO2 and NOX emissions (which are responsible for pollution, global warming and respiratory diseases), several countries have launched or are exploring plans to promote the use of electric vehicles and to abandon diesel-burning engines.

Companies like *Tesla* have contributed to spreading the perception in the public opinion and governments that battery-powered electric vehicles are readily available on the market, they do not contribute to pollution and that this technology can be used by the general population. All these perceptions are false.

Take for instance the first statement that battery-powered electric vehicles can replace combustion cars in the short term. According to JATO,\(^ {284}\) while sales of battery electric cars increased 78% in 2017 to 668,000 units worldwide (compared to a global market increase of little more than 2 per cent), they still represented a fraction (0.77%) of global car sales and they are concentrated in


markets (such as China, the U.S. and Scandinavian countries) where the sales of these models are heavily incentivised by governments.

It is also untrue that the production of battery electric car vehicles is harmless for the environment. In the U.K., legislation dictates that 95 per cent of a car has to be recycled\(^ {285} \) but this cannot apply to battery electric vehicles, as nobody has yet devised a strategy to recycle the batteries themselves. Also, the process of manufacturing a car is energy intensive and if this energy is not produced from renewable resources, the electric manufacturer contributes to global pollution. Furthermore, the main metals that are used in the production of battery vehicles (lead-acid, nickel, lithium and zinc) are rare and exhaustible.

Lastly, electric vehicles cost significantly more than comparably sized and equipped combustion cars while their depreciation is significantly faster, as batteries lose a significant part of their duration in the first few years. Anybody who has a cell-phone for more than one year can witness the sharp decrease of the duration of each charge since it was new. As car batteries use the same technology of cell-phones (only on a larger scale), the same issues are experienced after their prolonged use.

The race to produce battery electric vehicles has forced other automakers to introduce these models in their portfolio. However, no electric vehicle is profitable for the automaker that produces it. It is estimated that General Motors loses $9,000 for each Chevrolet Bolt it produces, while Fiat Chrysler Automobiles suffers a staggering $20,000-dollar loss for each sub-compact electric Fiat 500 the company sells.\(^ {286} \)

Allowing a company like Tesla to operate on the market launches a series of wrong signals to the public: battery-powered electric cars are cool and affordable, they can be mass-produced and they are the solution to pollution


issues. *Tesla* has a disrupting effect on the automotive industry and market and it should not be allowed to operate.

It is submitted that the company could not be subject to compulsory liquidation for grounds of public interest pursuant to the procedure and conditions outlined in s.124A IA 1986. This is not simply because the company is incorporated in the United States.\(^{287}\)

In submitting a petition under s.124A IA 1986, the Secretary of State for BEIS should act in the public interest.\(^{288}\) Such a power is needed because it would be inappropriate to rely only on creditors and contributories to prevent behaviours that may harm the general good.\(^{289}\) It is mainly designed to identify companies’ illegal practices,\(^{290}\) but petitions have been allowed to remove companies from the market that were trading in an unsatisfactory although not necessarily unlawful manner.\(^{291}\) Insolvency is not necessarily a requirement or a ground needed to justify the government’s intervention,\(^{292}\) as it is not the allegation of illegal activity.\(^{293}\)

However, s.124A IA 1986 presents a last resort mechanism. Courts are rightly reluctant to admit any such petition only on grounds of unsatisfactory trading

\(^{287}\) The Secretary of State can submit a petition under s.124A IA 1986 against a company incorporated in a foreign jurisdiction, but only if the company has its principal place of business in England: *Re A Company (No. 007946 of 1993)* [1994] Ch. 198; *Re Normandy Marketing Ltd* [1993] BCC 879.

\(^{288}\) *Re Millennium Advanced Technology Ltd* [2004] EWHC 711 (Ch), [2004] 1 WLR 2177 [33].

\(^{289}\) McPherson & Keay (n 23) 278.

\(^{290}\) *Secretary of State for Trade and Industry v Bell Davies Trading Ltd* [2004] EWCA Civ 1066, [2005] BCC 564.

\(^{291}\) *Secretary of State for Trade and Industry v Driscoll Management Facilities Ltd* [2001] WL 949826. The companies were controlled by or closely associated with an undischarged bankrupt, had been used as part of this bankrupt debt management business, failed to maintain adequate records and conducted the business in a highly unsatisfactory manner. Similarly, in *Re Corvin Construction Ltd* (unreported) the Chancery Division (Companies Court) held that it was just and equitable and in the public interest to wind up six linked construction companies where there was cogent evidence demonstrating that they lacked commercial probity, failed to file full and true accounts, allowed an undischarged bankrupt to operate as a *de facto* director and failed to cooperate with an Insolvency Service investigation. For a list of cases in which petitions on ground of public interest have been allowed, see: McPherson & Keay (n 23) 279.

\(^{292}\) *Re SHV Senator Hanseatische Verwaltungs Gesellschaft mbH* [1997] BCC 112 (CA); *Re Marann Brooks CSV Ltd* [2003] BCC 239; *Secretary of State for Business, Enterprise and Regulatory Reform v Art IT Plc* [2008] EWHC 258 (Ch), [2009] 1 BCLC 262.

\(^{293}\) *SHV Senator* (n 292). However, Park J. in *Secretary of State for Trade and Industry v Travel Time (UK) Ltd* [2000] BCC 792 held that it was desirable, if not essential, that the petition alleged intentional and dishonest deceit of the public.
and require proof of intentionally deceitful behaviour.294 The public interest test has a high threshold and usually the court shall be satisfied that the petitioner is acting in the interest of the society as a whole and the respondent has breached minimum standards of commercial behaviour295 or the code of ethics296 before granting the order. This is particularly true if the petition is against a public company which still retains the confidence of the stock market and the financial community, as is the case in regards to Tesla. The company is selling a genuine product (even if at a loss), it has not made disreputable claims in its advertising and customers’ funds are no more at risk than in any other business enterprise which requires payment upon order.297

All these circumstances make it extremely unlikely that a court would even consider a petition against a company like the Californian manufacturer. While it might be argued that public interest petitions aim at removing companies from the market that have a disruptive effect on the economy (and it is submitted that Tesla fits that description), the Secretary of State and courts’ powers are limited to cases where companies have at least breached accepted and minimum standards of behaviour. This is not the case with Tesla.

Tesla does not face a TCP problem; hence no action can be taken to protect the interests of its residual risk-takers (including the society as a whole). The use of a TCP standard would do nothing to address the issues associated with the production and commercialization of Tesla’s vehicles evidenced in this sub-section.

5.4(f) Findings

Section 5.4 reported the existing literature on the drama of the commons. The author has explained the reasons that support the recognition that TCP dilemmas occur in several contexts, including the economic and financial crisis of a corporation.

294 Ibid.
295 Re Walter L Jacob [1989] 5 BCC 244.
When assessed against the autonomy, legal predictability and inclusivity objectives, TCP theories based on legally enforceable (proprietary and personal) rights seemed more promising than the other eligibility standards mentioned in this study. However, they are far from perfect.

If a TCP standard operated in the context of creditors having legally enforceable rights against the debtor, it would produce sub-optimal results. It would allow informed creditors to exploit their informational advantages over no or less-adjusting ones. It would be also incapable of considering, protecting and promoting the interests of residual-risk takers. This is a major shortfall, as section 4.3 and principle-based theorists have argued that an insolvency system should aim to consider, protect and promote the expectations of all risk bearers.

The main problem with the “traditional” common pool narrative described in this section is that its application has been restricted only to those parties who can claim ownership rights against the debtor. To overcome this limit, the author is committed to conceptualise a theoretical framework that maximises the wealth of those who claim risk bearer (as opposed to ownership) rights against the debtor. A task that will be undertaken in the next chapter of this work.

5.5 CONCLUDING REMARKS

Rather than identifying the limits (in the sense of boundaries) of insolvency law, this chapter has evidenced the limits (in the sense of shortcomings) of the most frequently used and cited eligibility standards. Insolvency, risk and TCP problem among contractual claimants leave the door open to criticism when assessed against the party autonomy, legal predictability and inclusivity criteria.

At the same time, section 5.4 has evidenced that common pool dilemmas exist. New approaches need to be explored to avoid that when these dilemmas escalate to common pool problems, the law fails to provide adequate guidance to the affected stakeholders (such as in the cases of Carillion and Tesla).
It therefore appears appropriate to investigate if standards, that are not based only on economic indicators or that do not consider only the contractual and legal rights of selected stakeholders, may result in a more procedurally efficient and fair use of the resources, while being consistent with the fundamental pillars of the Anglo-American insolvency framework. The next chapter is dedicated to conceptualising and testing the theory of WMSI theory to determine if an innovative eligibility criterion may provide better answers to the theoretical and practical shortcomings of the approaches de-constructed in chapter five.
CHAPTER 6 - THE “REVISED COMMON POOL” STANDARD: A GATEWAY TO CORPORATE DISTRESS REMEDIES

«In developing corporate insolvency law, there [should be] an awareness of implications on the ground and of impact on the resilience of enterprises as well as on credit and employment relationships»¹

6.1 INTRODUCTION

The previous chapter argued that it is not possible to state in general terms whether the standards traditionally employed to determine the use of insolvency remedies promote predictability, party autonomy and inclusivity. It also suggested that an eligibility criterion triggered by the existence of an otherwise unsolvable TCP dilemma may be the most promising among those analysed insofar.

It has been observed that the conceptual and practical shortcomings attributed to the TCP explanation are primarily due to the decision to restrict its narrative to the owners of proprietary and personal rights against the debtor.

This chapter therefore offers the conceptualisation of a new theoretical framework (hereinafter called “wealth maximisation of stakeholders’ interests” or ‘WMSI’) to determine when companies should file for corporate distress remedies.

Section 2 describes the issues that arise when “revised common pool” (‘RCP’)² situations go unnoticed and the consequences associated with that approach by referring to the Chapter 11 procedure of Continental.

Section 3 introduces an alternative eligibility criterion (the RCP standard) which extends the analysis of the common pool dilemma to those who have

¹ Vanessa Finch, speaking of the challenges that has to be faced by insolvency law if it is to develop in a manner that contributes to the (business) life of the nation: V Finch and D Milman, Corporate Insolvency Law: Perspectives and Principles (3rd edn, CUP: Cambridge 2017) 25.
² For the definition of ‘revised common pool’ issues, see sub-section 1.3(a) and below in this chapter.
vested interests in the company, i.e. those stakeholders who control it without necessarily having ownership, proprietary or personal rights against its assets.

In line with the approach employed in chapter five, this section questions the assumptions upon which the RCP standard and the WMSI theory are based.

The validity and desirability of an alternative approach to the definition of the limits of corporate distress law is best illustrated – from a methodological point of view – by examples. Sub-section 3(d) therefore explores the implications arising from the introduction of the new RCP standard by analysing the same cases where the TCP standard had proven inadequate: Tesla and Carillion. It also discusses the impact of the RCP standard on cases where companies have not been administered in the interest of all stakeholders, as the corporate failure of Millennium Labs demonstrates.

Section 4 investigates the procedural requirements needed to make the proposed standard into living law. It also suggests how a recent case in the airline industry (the 2017 failure of Alitalia) would have been decided under the operation of the RCP standard. Section 5 critically assesses the proposed WMSI theory against other proposals that investigate the relationship between contract and corporate distress law and explains the reasons for preferring the taxonomy proposed in this work.

By drawing on behavioural studies, section 6 explores some of the possible reasons why – regardless of the benefits potentially associated with the RCP standard – English and U.S. insolvency laws still rely (albeit to the very limited extent described in sub-section 5.2(a)) on the “insolvency” test as the eligibility criterion for insolvency filings. In particular, sub-section 6(a) highlights the biases that affect the decision-making process that need to be addressed and overcome to align statutory choices with welfare-increasing solutions. At the same time, as the author recognises that the offered conceptualisation is not immune from criticism, sub-section 6(b) warns about the limits of this research.

Section 7 concludes by summarising the arguments in support of this new conceptualisation and the steps that need to be taken to transform it into living law and by acknowledging the limits of the research.
6.2 “Revised Common Pool” Problems

The current Anglo-American legislative framework does not offer appropriate guidance to determine when a company should file for insolvency and it lacks proper remedies to prevent a strategic or abusive use of corporate distress remedies.

At the same time, common pool dilemmas exist. If these dilemmas escalate to common pool problems, a law based on a proprietary understanding of the common pool drama may fail to provide adequate remedies for the stakeholders, as the cases of Carillion and Tesla demonstrate.

This section observes the consequences and discusses the implication of the Continental Chapter 11 procedure. In this case, the risk bearer interests of the company’s stakeholders were neglected to prioritize the claims of those who had personal and proprietary rights against the American airline.

By drawing on this experience, this section clarifies what the RCP dilemma is and it envisions how the RCP eligibility standard would influence corporate filings when assessed against the free-for-all approach currently favoured in the Anglo-American tradition.

6.2(a) Continental (1983) RCP Problem

«If the Wright brothers were alive today, Wilbur would have to fire Orville to reduce costs»

Innovations in IT and products (i.e. planes) as well as liberalization of the once regulated aviation market (at regional and global level) have “shrunk” our world. This has given an increasing number of people the opportunity to fly, either for business or pleasure. At the same time, these events have promoted

---


4 According to the U.K. Civil Aviation Authority, in the last quarter of 2017, U.K. airports handled sixty-five million terminal passengers, representing 2.9 per cent growth against the same quarter in the previous year and a new high in terms of the number of passengers flown in Q4 of any previous year. On a rolling year basis, terminal passengers also hit a new record (288 million), surpassing the previous rolling twelve-month high set in the third quarter of 2017. Civil Aviation Authority, ‘Aviation Trends. Quarter 4 2017’ (London, 2017) 3 <https://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Data_and_analysis/A
competition, which not only resulted in over-capacity but also in increasing pressure on prices. To remain competitive\(^5\) in an industry which requires significant capital to engender growth but offers thin margins, airlines have to reduce costs.

Labour cost is an example of (quasi-)fixed cost.\(^6\) Fixed costs do not change with an increase or decrease in the amount of goods or services produced or sold by the company as they are expenses that have to be paid, independent of any business activity and output. Quasi-fixed costs are more variable than fixed ones. Some labour expenses (such as training and recruiting costs) are anti-cyclical and tend not to change in the short term, unless the business is subject to an intensive overhaul. However, these costs are marginal in the long run and part of the labour expenses are variable as they depend on the number of hours worked by the employees. This explains the quasi-fixed nature of labour costs.

If the directors of a company believe that their entity is under-performing in the industry due to higher labour cost than the competition, they may and should explore strategies to address this issue.

The same directors may conclude that restructuring is not possible under general law. This may be due to a variety of reasons: inability to unilaterally terminate or modify contracts, to reach an agreement with all creditors, excessive delays caused by negotiations and adverse publicity caused by industrial actions and business reports.

In 1983, Continental Airlines Corp. (‘Continental’) – shortly after a merger with Texas International (31 October 1982)\(^7\) – used insolvency law remedies to

---


\(^7\) For an insight on Texas Air’s attempt to take over Continental, the complexity of takeover battles in the U.S. airline industry of the Eighties and the takeover defences raised by the management (search for a ‘white knight’) and employees (creation of an Employee Stock...
unilaterally amend its labour contracts. Upon filing (24 September 1983), the company and some of its affiliates\(^8\) suspended all flights and resumed their operations only when they were able to hire non-unionized workers.\(^9\) Three days after the filing, Continental resumed half of the pre-bankruptcy flights using only one-third of its former employees.

Because the “founding employees” of the “new Continental”\(^10\) were non-unionised, the company could afford to disregard the original collective bargaining agreements and offer them half of the wages originally given to unionised workers. This also allowed Continental to launch an aggressive pricing strategy, with tickets as low as $49 for all non-stop flights within the U.S. for one week, followed by a $79 fare for two more weeks.\(^11\)

The Chapter 11 procedure which resulted from that filing lasted until 30 June 1986. This procedure has been harshly criticised in literature as an example of strategic use of insolvency remedies for the benefit of a small category of stakeholders.\(^12\)

It has been argued that the filing was motivated only by the need to reduce labour costs. There are several elements that militate in favour of this conclusion. First, when the company entered into Chapter 11 it was neither insolvent nor short of cash.\(^13\) However, prior to the filing, Continental

\(^8\) Continental Air Lines, Inc.; Texas International Airlines, Inc.; and TXIA Holdings Corp.


\(^10\) These were the terms used by Frank Lorenzo, president and chief executive officer of Continental, to describe the company and those hired to run it after the filing in the company’s Annual Report of 1983: KJ Delaney, Strategic Bankruptcy: How Corporations and Creditors Use Chapter 11 Bankruptcy to their Advantage (2nd edn, University of California Press: Oakland, 1998) 96.

\(^11\) Ibid 82-125.

\(^12\) WN Moulton and H Thomas, ‘Bankruptcy as a Deliberate Strategy: Theoretical Considerations and Empirical Evidence’ (1993) 14 SMJ 125. For a conflicting view: DM Flynn and M Farid, ‘The Intentional Use of Chapter XI: Lingering versus Immediate Filing’ (1991) 12 SMJ 63, arguing that ‘Chapter XI can be used as a strategic alternative to realign the organization with its strategic competencies with a higher probability of re-emerging from bankruptcy as a revitalized organization’ (73).

\(^13\) According to Delaney (n 10), upon filing the company had $59 million in cash and marketable securities, $186 million in general accounts receivable and $44 million in accounts receivable from Continental affiliates (97). On top of that, Continental managed in the first days of the procedure to persuade the bankruptcy court to free up $40 million in restricted cash and to substitute new receivables as collateral.
deliberately moved assets to its holding-company *Texas Air* (which was not involved in the rescue procedure) to worsen the appearance of its accounting books. As a result, the bankruptcy court allowed the filing. Additionally, the company made little efforts to reduce fuel, equipment and capital (interest rates on loan) costs before and during the insolvency procedure.

The behaviour of the company’s management also raised extensive criticism. On one hand, as the key figures retained their jobs throughout the procedure, they were not held accountable for previous managerial missteps, including the failure to build an automated reservation system. On the other, they seemed to give the impression on more than one occasion that they used the law for strategic rather than operational purposes.

It is reported that, during a board meeting in June 1983, Richard Adams (Continental’s senior vice-president for flight operations) said: ‘*I don’t believe we can get these concessions [from labour unions] on a voluntary, persuasive basis. We must get [an] awfully big stick. [...] Most effective stick might be Chapter 11*’. Additionally, two days after the filing, Frank Lorenzo (the company’s president and CEO) was quoted in a *New York Times* article saying: ‘*It wasn’t a problem of [insufficient] cash. [...] Our sole problem was labour*’.

*Continental* was able to retain its management, resume operations within a week from the filing and increase its assets by 37 percent during reorganisation. The company emerged from bankruptcy with improved asset and cash flow positions and a more competitive route structure. Despite that, the company filed again for Chapter 11 protection in 1990.

---

14 *Re Continental Airlines* 38 B.R. 67 (U.S. Bankr. S.D. Texas 1983), where Judge R.F. Wheless Jr. rejected the debtors’ unions requests to dismiss the proceedings on ground that they were allegedly filed in bad faith and for the purpose of rejecting collective bargaining agreements. According to the court, the record established that debtors filed this proceeding only when management felt it had no acceptable alternative if it were to have a chance to keep the airline flying and neither the sole nor primary purpose of the filing was to reject the aforesaid executory contracts.


16 Delaney (n 10) 95.

17 Moulton and Thomas (n 12) 130.
As suggested by some authors, one of the possible explanations for this failed attempt to reorganise the company is that *Continental* suffered from several other financial and organisational problems that were not properly addressed in the insolvency procedure. In 1986, the airline was still facing significant challenges with consistently low reliability rankings and a high level of customer complaints compared to its competitors.

Nevertheless, the legality and legitimacy of the filing has never been questioned. Neither should it be, as *Continental* met the eligibility requirements prescribed by the law to file for Chapter 11. Despite that, its filing had proven controversial even in the Eighties. In fact, almost in the same period as *Continental*'s filing, a Supreme Court ruling challenged the ease with which companies could protect themselves from labour contracts while undergoing the Chapter 11 procedure.

The Supreme Court decision in *Bildisco* represented a significant departure from earlier case law. It held that collective bargaining agreements could only be rejected during an insolvency procedure if rejection was necessary to prevent collapse and the balances of the equities favoured rejection. Previously rejection was only possible in case of an imminent failure of the

---

18 Ibid 130.
21 *Brotherhood of Railway Employees v REA Express, Inc.* 523 F.2d 164 (2d Cir.), 423 U.S. 1017 (1975).
22 The latter element was first established as the only test in *Shopmen's Local Union No. 455 v Kevin Steel Products*, 519 F.2d 707 (2d Cir. 1975). This test was then replaced by the more stringent standard in *REA Express* and then combined with the *REA Express* standard in *Re Alan Wood Steel Co.*, 449 F. Supp. 165 (Bankr. E.D. Pa. 1978).
With the Supreme Court’s ruling the balance of equities shifted in favour of rejecting the contract.

*Bildisco* facilitated *Continental*’s filing, as the Supreme Court held that certain bankruptcy law goals (namely, to broaden relief to keep viable businesses afloat) may prevail over conflicting ones, even if the purpose of the latter was to protect the less powerful and unsophisticated party.

On a side note, *Bildisco* prompted Congress reaction. The Bankruptcy Amendment Act of 1984 limited the right of companies to terminate labour contracts by adding §1113 to 11 U.S. Code. Under the new section, proposals to alter or reject a collective bargaining agreement can be approved by a court only if they are necessary to permit the reorganisation of the debtor and they assure that all creditors, the debtor and *all of the affected parties* are treated fairly and equitably.23 The application can be approved only if the authorized representative of the employees has refused to accept the proposal without good cause and the balance of equities favours alteration or rejection.24

6.2(b) *Continental*’s Practical Implications

*Continental*’s filing might be criticised for not being the optimal solution in the given circumstances. Some authors have adopted historical and comparative methods to discuss strategies alternative to the use of insolvency remedies that can improve the performance of airline companies and reduce labour costs.25

More recently, large companies such as *British Airways*26 and *Air France*27 have

---


24 §1113(c)(2)-(3) 11 U.S. Code.


undertaken negotiations with the unions representing their employees to reduce pension and labour costs, although with mixed outcomes. This literature and these cases prove that it is possible to reduce quasi-fixed costs using general law remedies, even if the company operates in a highly competitive market.

The 1983 filing is better explained if it is considered as having disregarded the risk bearer interests of some of its stakeholders, namely its salaried workers. As explained in professional literature, the problems that old Continental was facing in 1983 were manifold and intricate. The staff might have been a contributor to the inefficiencies of the company but were also a residual risk bearer. They had the right to be part of the reorganisation of the company and to influence the outcome with the persuasive voting powers that arose from their controlling stake.

In the case of Continental, workers were not the only risk bearers to be ignored. Similarly, commercial, unsecured traders and pre-paying passengers had vested interests in the company that went by and large unnoticed.

This RCP dilemma had largely been ignored by the management, who simply addressed the TCP conundrum. Coupled with other factors, these circumstances have contributed to devise a rescue plan that failed to ensure the long-term profitability of the company.

If the RCP standard became one of the gateways to corporate distress remedies, the admission to the corporate distress procedure would be subject exactly to

---


29 Recent empirical studies have proven that the possession of intangible assets and assets that can be efficiently sold in an insolvency procedure as well as the existence of unfavourable executory contracts with primary stakeholders (such as workers) can positively influence the likelihood that a corporation will file for Chapter 11: SD James, 'Strategic Bankruptcy: A Stakeholder Management Perspective' (2016) 69(2) J. Bus. Res. 492. Other authors, especially in the U.S., have argued that businesses can gain benefits from intentional insolvency filing: Delaney (n 10); Flynn and Farid (n 12); DA Skeel, Jr., 'Rethinking the Line Between Corporate Law and Corporate Bankruptcy' (1993) 72 Texas L. Rev. 471; Moulton and Thomas (n 12).
this test: is the decision to file inevitable and in the best interest of those who have personal, proprietary and risk bearer interests in the company?

If this standard was used as the eligibility criterion to file for corporate distress remedies, companies like *A.H. Robins, Manville* and *Continental* may well have filed for these remedies, but their corporate governance structure and the nature of the procedure would have been significantly different from those observed in practice.

Insolvency cases suggest the use of eligibility criteria that considers the risk bearer implications of filing for corporate distress protection. The next section investigates how the RCP test should be codified in the law. It explores if an alternative procedure may lead to more optimal filings, i.e. to the use of corporate distress remedies to protect also those risk bearers who have expectations in the company.

### 6.3 The "Revised Common Pool" Standard

This section proposes a new conceptualisation of the law of corporate distress. It argues that the common pool narrative should not be restricted to those who have contractual claims and rights against the debtor. It should include all the stakeholders who have risk bearer interests and expectations against the debtor because, as it was demonstrated in sub-sections 4.3 (c)-(e), these are the residual risk bearers of any company.

**RCP situations** have a dual nature: they are “legal” because they deal with parties who have personal, proprietary and risk bearer interests on the

---


31 For instance, in an empirical study that covered the period 1980-1999, James concluded that strategic filings can implement sustainable performance improvements, increase shareholder value, preserve more value for all primary stakeholders, stem performance declines and foster more value-enhancing relationships with key stakeholders such as customers, suppliers and other trading partners: James (n 29) 498.

32 From now onwards, the author uses the word “corporate distress” to differentiate the proposed framework from the existing “insolvency” law which – as the name implies – requires (at least in theory) that the debtor faces a condition of financial or economic distress to justify the derogation from general rules.

33 Despite these rights also having an equitable nature.
debtor, and they are “common”, because the inability to meet the expectations of some of the company’s stakeholders affects the ability to meet the expectations of the others.

Whenever RCP situations arise, the managers and directors of the debtor should not act solely in the best interest of those who own the company. Sometimes RCP situations can be addressed with the use of ordinary, i.e. non-insolvency remedies. If, however, this is either not done or not possible, then companies develop **RCP problems** that justify the use of corporate distress remedies.

The RCP standard (an eligibility criterion based on the proposed RCP notion) is not primarily concerned with creditors’ co-ordination problems, secured creditors control practices or liquidity problems. It does not ignore their existence, but it focuses more generally on governance issues which include all the above-mentioned issues and more of them. As a result, it can provide a new, normative foundation of the law of corporate distress. Many provisions of the Anglo-American insolvency framework can be justified on the basis that they solve corporate governance problems, not simply liquidity or efficiency ones.

The RCP standard is an eligibility criterion that can be invoked by any applicant, either alone or in conjunction with the insolvency test, to justify the admission to any corporate distress procedure.

---

34 The author’s understanding of these concepts and the difference among them was offered in sub-section 4.3(a). As a reminder, it is worth observing that risk bearer interests should:  
- Not affect neither the nature of the rights entrusted upon other claimants nor their priority in distribution unless where specifically authorized by the (corporate distress) law;  
- Alongside with the other interests recognised by the law, guide the choice of action, not necessarily its content;  
- Be considered not only in times of corporate distress, but throughout the life of the company.

The possibility not only to voice, but also enforce these interests is subject to a corresponding reduction in the rights of the claimants who do not have risk bearer interests in the company. Whenever the latter retain the majority of rents and controlling interests in the company (as it is usually the case in profitable periods), the law could and should only grant limited rights and remedies to the holders of risk bearer interests. These more limited remedies should always include the right not to be unfairly discriminated against stakeholders of the same group or in similar situations.

35 This is the view of those scholars who adhere to the creditors’ wealth maximisation theory, as outlined in chapter two of this thesis.


37 K Ayotte and DA Skeel, Jr., ‘Bankruptcy Law as a Liquidity Provider’ (Fall 2013) 80(4) U. Chi. L. Rev. 1557.
The soundness of the proposal to juxtapose the traditional insolvency test with the RCP standard is based on two considerations:

a) Directors should always act in the interest of the residual risk bearers. Shareholders and contractual creditors are not the only risk bearers in a company;\(^{38}\)

b) The implementation of measures that derogate from general law is subject to proof that the company is facing a situation of corporate distress.

This section discusses the soundness of these assumptions. It also evaluates if the RCP eligibility criterion provides more satisfactory answers than the standards analysed in chapter five when assessed against the inclusivity, party autonomy and legal predictability criteria.

6.3(a) Corporations are NOT Controlled by Either Shareholders or Creditors (Only)

Corporate distress proceedings have been described as a fight for control of the last profitable assets between the opposing instances of creditors and shareholders.\(^ {39}\) Sometimes shareholders prevail (as in the case of Continental\(^ {40}\) and A.H. Robins\(^ {41}\)), while other times creditors (particularly sophisticated ones) have the upper hand. The prevalence of creditors’ interests has been clearly observed in one of the cases mentioned in this thesis, i.e. the bankruptcy of Manville, where the reorganisation plan left the old shareholders with only nominal interests in the newco while unsecured lenders were paid in full.\(^ {42}\)

In reality, corporate distress proceedings can be much more than mechanisms to overcome TCP issues.\(^ {43}\) They can be the instruments used by stakeholders to overhaul the controlling rights over the company and re-allocate them to the

---

\(^{38}\) Residual risk bearers, sometimes known as “residual owners”, are those who stand to gain from profits and suffer from losses: LoPucki and Whitford (n 9) 771.

\(^{39}\) For a literature on the topic, see LoPucki and Whitford (n 9) ftnt 8 and 9.

\(^{40}\) See above sub-section 6.2(a).

\(^{41}\) See above sub-section 1.1(a).

\(^{42}\) LoPucki and Whitford (n 9) 672.

\(^{43}\) As understood by the general literature on the topic. This thesis adopts a revised notion of common pool situations that is wide enough to encompass anti-commons and semi-commons-type cases.
company’s risk bearers. This section draws on legal as well as corporate
governance studies to determine the factors that should guide this re-allocative
exercise. In line with the overall goal of this thesis, this section tries to offer a
practically implementable conceptualisation of corporate governance duties in
times of distress.

Proprietary vs. Controlling Rights

It has been argued that:

*Property rights lie at the foundation of market society. Their
importance derives from the ways they constitute and shape the
economy. Property rights affect economic behaviour by structuring
incentives and disincentives. They determine who bears the risks and
rewards of economic action. [...] Market activity consists chiefly of the
exploitation and exchange of property rights.*


45 This conclusion is in line with Baird and Jackson studies: DG Baird and TH Jackson, 'Bargaining After the Fall and the Contours of the Absolute Priority Rule' (1988) 55 U. Chi. L. Rev. 738, 765 and 775. Where under Baird and Jackson’s narrative, creditors would be the collapsed residual owners of the enterprise, this thesis offers an alternative explanation based on the corporate governance notion of “rent”.

46 For a categorization of property rights: Carruthers and Halliday (n 44) 18-20 (who
distinguished them in usufruct, exclusivity, heritability and alienability); J Christman,
an asset, against third parties, the former affects the way in which the beneficiary can control a property, and to what extent.

If we look at an insolvent company the day before filing for Chapter 7 or liquidation, the owners of the company are still the shareholders. Yet, the owners cannot dispose freely of the assets of the company, as the law provides remedies (i.e. transaction avoidance actions) against those acts performed in gross disrespect of the legal rights of third parties.

Risk bearer interests and expectations (henceforth used as synonyms) are not the same as proprietary rights. As evidenced in sub-section 4.3(d), selected stakeholders (also known as “risk bearers”) can - under limited circumstances - control the company, even against the will of its owners.

This thesis, however, falls short of arguing that risk bearers should be granted proprietary rights in the assets of the company simply by reason of their interest in corporate performance. At the same time, in contrast with the theories envisioned by neo-classical liberal economists and scholars, it provides an alternative explanation for why shareholders and controlling creditors do not and should not be entrusted with an absolute right to control all corporate distress procedures.

Controlling Powers in Times of Distress

‘Ownership of private property is the central mechanism by which incentives are created for the efficient use of resources in a free market economy’. The quote refers to a situation in which a stakeholder has the right to possess or dispose of

---

47 Several authors observed that property rights are nuanced and complex, as different persons may simultaneously have different and sometimes overlapping rights over the same assets (e.g. security right granted to two creditors). For an analysis of the complexities in the ownership structure: RW Gordon, ‘Paradoxical Property’ in J Brewer and S Staves (eds.), Early Modern Conceptions of Property (Routledge: London, 1995).

48 For a definition of “risk bearer”, see sub-sections 4.3(c)-(e) of this thesis.

a company’s assets, to receive benefits from it and to be responsible for the risks associated with misuse or decline in value.\footnote{Ibid 4-5.}

Some scholars such as Milgrom and Roberts\footnote{P Milgrom and J Roberts, *Economics, Organization and Management* (Prentice Hall: Upper Saddle River, NJ, 1992) 289.} have argued that in the corporate context, ownership means to have the residual right to control an asset. As this conclusion is quite contentious, this thesis adopts a different strategy to determine if non-owners may have a right to control a company.

However, this thesis shares Milgrom and Roberts’ assumption that shareholders are not the only residual *claimants* of the company, as limited liability shields them from the full array of (negative) consequences that normally follow from ownership.\footnote{Other scholars, however, argued that reorganising companies should be managed for the benefit of their shareholders: MA Gerber, ‘The Election of Directors and Chapter 11 – The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever’ (1987) 53 Brook. L. Rev. 295, 343-44; ME Budnitz, ‘Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, Or Should the Meeting Be Canceled Altogether?’ (1990) 58 Geo. Wash. L. Rev. 1214, 1233-34.} Another element that refutes the shareholder-centred narrative is the extensive use of share buy-backs by public companies in the U.S. and U.K. Share buy-backs are a way of transferring money from a corporation to shareholders. Both managers and controlling shareholders have a perverse incentive to make use of this practice: share buy-backs are not subject to penalty taxes, favour only those shareholders that are willing to sell and boost earnings per share, which is one of the key measures of corporate success and managers’ pay. It has been observed that between 2003 and 2012, 449 companies listed in the U.S. S&P 500 index deployed $2.4 trillion in buy-backs, a sum which represents 54 per cent of their collective earnings.\footnote{W Lazonick, ‘Profits Without Prosperity: How Stock Buybacks Manipulate the Market, and Leave Most Americans Worse Off’ (April 2014) <https://www.ineteconomics.org/uploads/papers/LAZONICK_William_Profits-without-Prosperity-20140406.pdf> accessed 17 September 2018.} Considering that an additional 37 per cent of earnings was used for dividends, this leaves 9 per cent of profits to capital investment and re-payment of claimants in times of corporate distress.\footnote{M Mazzucato, *The Value of Everything: Making and Taking in the Global Economy* (Penguin Books: London, 2018) 163.}
This behaviour has been labelled as ‘an active choice not to invest to create long-term value’\(^{55}\) capable of jeopardizing the company’s ability to generate long-term returns.\(^{56}\) Indirectly, it also results in shielding (controlling) shareholders and managers from the consequences of corporate distress.

If therefore the negative consequences arising from failure are distributed among a wider number of stakeholders, these stakeholders are risk bearers and should be allowed – under certain circumstances – to control or at least influence the company’s policy and behaviour.

Can private corporations be run with the interest of a wide variety of stakeholders in mind? According to Ostrom,\(^{57}\) the answer should be in the affirmative. Her studies evidenced that in certain circumstances, when communities face RCP situations created by the lack of resources, they are able to conceive, enforce and monitor the application of rules that ensure the long-term sustainability of communal properties for the benefit of all stakeholders.

Limiting the freedom to dispose of an asset in light of the interests of a wider number of stakeholders\(^{58}\) corresponds to recognising that these stakeholders have a set of legally enforceable expectations\(^{59}\) of the performance of the company.

This thesis borrows from corporate governance studies of distressed companies\(^{60}\) to argue that it is preferable to rely on the notion of “rent”\(^{61}\) to

\(^{55}\) Ibid 164.


\(^{58}\) Against: DG Baird and TH Jackson, ‘Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy’ (Winter 1984) 51(1) U. Chi. L. Rev. 97, 101 for whom there is no problem of ‘diverse ownership’ and the failure of a company should not give new powers to those who have cognizable ownership interests in the business outside insolvency law. As a result, if these interests existed, they were immanent for insolvency policy.

\(^{59}\) This thesis assumes that legally enforceable interests should be recognised not only to those who have personal and proprietary interests in the company, but also to those who have risk bearer rights.

\(^{60}\) These are the studies that investigate the legal, cultural and institutional arrangements that affect corporate behaviour. See, among others: Blair (n 49); LoPucki and Whitford (n 9); BE Adler, ‘Financial and Political Theories of American Corporate Bankruptcy’ (Jan. 1993) 45(2) Stan. L. Rev. 311; CM Daily and DR Dalton, ‘Corporate Governance and the Bankrupt Firm: An
determine how control should be apportioned among residual claimants (including the holders of risk bearer interests).

Consider the case in which the total rent generated by the enterprise declines to the point where fixed costs exceed or absorb all the rent. The shareholders (i.e. the repositories of the proprietary rights) would barely have any interest left in the company. Creditors (who are next-in-line in the proprietary-right hierarchy according to the finance model suggested by Berle and Means\(^\text{62}\)) would have a strong incentive to sell the company and its assets to maximise their return. However, such a sale or liquidation may be premature as the enterprise may still be viable (i.e. may still be generating substantial rents or quasi rents) for some of the other stakeholders identified in chapter four, such as the employees or the local community.

As a result, corporate distress law should allow the latter to voice their expectations. In limited circumstances, the rents of these risk bearers may exceed those of the creditors who are running the company, or for the benefit of whom the company is run.\(^\text{63}\) In these cases, the law of corporate distress should ensure that the voice of employees and local communities affects the outcome of the proceedings.

In case of conflict when it is not clear where the interest of the majority of risk bearers lies, priority should be given to those risk bearers that generate value\(^\text{64}\) over rent-seekers.\(^\text{65}\) In those cases it will be necessary to go beyond the face, nominal value of the constituents' claims in order to assess the controlling

\(^{61}\) See above sub-section 4.3(c), ftn 219.

\(^{62}\) AA Berle, Jr. and GC Means, *The Modern Corporation and Private Property* (Commerce Clearing House, Inc. 1932); AA Berle, Jr., ‘For Whom Corporate Managers are Trustees: A Note’ (1932) 45 Harv. L. Rev. 1365.

\(^{63}\) As evidenced in sub-section 4.3(d).

\(^{64}\) For a distinction between value-creation and value-extraction activities, see Mazzucato (n 54) 6-8.

\(^{65}\) The debate about where to draw the distinction between productive and rent-seeking activities is a controversial one. It is likely that the boundary will shift from time to time: the 2008 financial crisis resulted in numerous calls to boost the “makers” in the industry against the “takers” in the finance. This thesis does not offer final views on this matter. However, some commentators observed that “[t]he point is not to blame some as takers and to label others as makers. The activities of people outside the boundary may be needed to facilitate production...” Mazzucato (n 54) 10.
rights of each participant in the corporate distress procedure. This is for instance what happened in the bankruptcy of Detroit,\textsuperscript{66} where the claims of pension funds were given priority over those of short-term investors and bondholders because a portion of those pensioners continued to live in the city, thus contributing to the past, present and future functioning of the municipality with their taxes.

A word of caution is, however, needed. In order not to unduly affect contractually negotiated rights, this argument could only be used in limited circumstances. These would arise only when the approach described in \textsuperscript{sub-section 4.3(d)} would lead to sub-optimal results, i.e. results that would not promote the maximisation of wealth of those who have interests in the debtor.

An exhaustive list of the expectations that each of the parties\textsuperscript{67} who have RCP interests in the company is unnecessary. In the ordinary course of business, managers and directors recognise that stakeholders have different and sometimes conflicting expectations and contractual rights. They use their powers to administer the company for their benefit. The same could and should happen when a corporate distress procedure is under way.

It follows from these premises that while shareholders may be the actors who own the company,\textsuperscript{68} they might not necessarily control it. As a result, directors could not always invest the capital ‘in risky projects designed only to further shareholder interests’\textsuperscript{69}. In the life cycle of a company, there are always other players that can claim the existence of a “controlling interest” in the company.

\textsuperscript{66}See above \textsuperscript{sub-section 5.4(c)}.

\textsuperscript{67}Throughout this thesis “parties” are sometimes referred to as “categories” such as shareholders, creditors, employees. This is done to facilitate the narrative and the understanding of this text. However, the author is by no means suggesting that these “categories” of players have uniform expectations. The expectations of a long-term controlling investor will always differ, both in solvent and insolvent times, by those of a minority hedge-fund shareholder.

\textsuperscript{68}Against, among others: EI Altman and E Hotchkiss, \textit{Corporate Financial Distress and Bankruptcy: Predict and Avoid Bankruptcy, Analyse and Invest in Distress Debt} (3rd edn, John Wiley & Sons, Inc.: London, 2006) 220 arguing – in line with the neo-classical finance model – that in solvent times managers and directors have fiduciary duties only to the corporations and its shareholders, as creditors are entitled to protection only as provided in the terms of their original contracts.

Sub-section 6.3(a) has argued for the existence of a host of stakeholders. Some of them may have risk bearer interests and expectations (albeit not rights) against the debtor. The author has suggested to rely on the corporate governance notion of “rent” to identify the corporate distress mechanisms better suited to promote their interests.

Stakeholders are not on equal footing. If they do not have proprietary rights on the debtor's assets, they are not owners of the company. Nevertheless, directors should look at who generates the most rents and run the company in their best interest. In case of uncertainty, priority should be given to the interests of those risk bearers that generate value over rent-seekers.

It follows that according to the WMSI conceptualisation, corporate distress law should give the debtors (or the person acting on their behalf) the discretion to consider and valorise the interests of both the owners and the risk bearer stakeholders of the company. Derogation from established rules (such as the pari passu principle) should be authorised only in limited, exceptional circumstances. Nevertheless, courts should refrain from second-guessing the commercial judgment of these people to those cases of gross mismanagement of fraudulent behaviour.


See also: LoPucki and Whitford (n 9) 768.

70 Partially distinguished by Blair (n 49) 27 (arguing that being an owner means having the residual claim and residual control rights). Sometimes people may have proprietary rights, but only on assets rather than on the whole company. This may be the case of minority shareholders or equity owners. They are better understood as investors rather than owners. While they can hardly affect the company's policy, the movement of their shares (and of their market prices) provides a message to the directors of the company, who should therefore consider their expectations in running the business.

71 BL Betker, 'Management’s Incentives, Equity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcies' (Apr. 1995) 68(2) J. Bus. 161 (who empirically analysed the incentives needed to deviate from the APR). Against, see: SD Longhofer, 'Absolute Priority Rule Violations, Credit Rationing, and Efficiency' (July 1997) 6(3) JFI 249 (arguing that APR violations create an impediment to efficient financial contracting); LA Bebchuk, 'Ex Ante Costs of Violating Absolute Priority in Bankruptcy' (Feb. 2002) J57(1) J. Finance 445 (arguing that ex-post deviations from the APR have negative effects on ex-ante decisions taken by shareholders).
6.3(b) The “Corporate Distress” Threshold

The use of the RCP standard implies that companies should be able to file for statutory remedies whenever the directors can no longer run the company for the benefit of its stakeholders. This may be caused by a situation of insolvency, but the possibility that the RCP problem emerges at an earlier stage should not be dismissed.

For this reason, this thesis supports the effort made by some scholars to re-conceptualise insolvency law as the law of corporate distress.72 Under this revised approach, the central role of the law of corporate distress should be to facilitate the allocation of the capital in the economy and encourage early restructuring so that capital is allocated to those best able to use it.73 As a consequence, this law should be made of two halves: liquidation mechanisms (including sale of assets)74 designed to maximise creditors’ returns on the one hand, and rescue remedies on the other.

While the arguments of these commentators are persuasive, they do not go far enough. These scholars continue to conceive the law of corporate distress as a fight between contractual claimants. They continue to see these creditors as

---

72 The phrase of “law of corporate distress” is used to refer to those statutory remedies designed to cover the sale of the business and its assets (“insolvency/liquidation law”) and the reorganisation procedures among some or all the company’s stakeholders (“restructuring law” in Paterson’s narrative, “rescue law” according to this thesis): Paterson (n 69).


74 This even if the sale occurred by means of a procedure that should prioritise rescue over liquidation, such as Chapter 11 in the U.S. or administration in England and Wales.
victims of the prisoners’ dilemma: creditors realise that liquidation or divestment from the debtor (facilitated by a dispersed creditor economy)\textsuperscript{75} is not value-maximising, but they are unable to agree on a different, optimal and value maximising rescue strategy.

These scholars observe that under certain circumstances, selected stakeholders reach agreements potentially capable of maximising the return for themselves to the detriment of other stakeholders.\textsuperscript{76} Rarely if ever, these commentators (and stakeholders on their own) adopt a corporate distress (rescue or liquidation) strategy that is in the primary interest of the residual risk bearers of the company.

This thesis tries to overcome these limits by advocating for a different strategy. Should the RCP standard be introduced into law, RCP-related considerations should be employed alongside traditional, insolvency-based evaluations to determine not only when a company should file for corporate distress remedies, but also the procedure for which it should apply.

On the one hand, there should be “asset-maximising” remedies triggered primarily by insolvency-led filings and designed to maximise creditors’ returns. Following the creditor's maximisation approach first conceptualised by Jackson, the priority of the law should be to reduce the incentive for individual enforcement and to maximise the interest of the owners of the company. The law should introduce a rebuttable presumption in favour of liquidation or fire-sale procedures as the preferred mechanisms to deal with the debtor’s inability to pay its debt.

On the other hand, the law should introduce “capital-maximising” remedies triggered primarily by RCP-influenced filings and designed to maximise


\textsuperscript{76} K Ayotte and others, ‘Bankruptcy on the Side’ (2017-2018) 112 Nw. U. L. Rev. 255. They described the nature and mechanics of ‘side agreement’ between selected creditors designed to maximise the return to these parties in an insolvency proceeding. They also developed a proposal that limited negative externalities and opportunities to extract value from non-parties or to the detriment of other, existing stakeholders.
stakeholders’ expectations. As the reason for filing is the inability of the directors to pursue the true interests of the company’s risk bearers, the law should provide the applicant (or the independent party appointed by the panel, see below sub-section 6.4(d)), with sufficient powers to overcome the RCP deadlock.

Conversely to the “insolvency” filing, the “capital-maximising” section of the law should include a rebuttable presumption in favour of rescue remedies. These remedies may well take the form of fire-sales or liquidation of significant portions of the company.

In general, there is no need to restrict the remedies available to the applicant upon filing, as the law of corporate distress is not about preventing creditors from enforcing their rights.77

Whenever there is a RCP problem, the company’s owners have an interest in restricting rather than enlarging the number of people sitting at the bargaining table. The WMSI theory is based on the opposite assumption.78 Corporate distress remedies will promote the transition of insolvency practice to a ‘market for corporate control’.79

The next sub-section tests the desirability of this solution against the autonomy, predictability and inclusivity objectives that have emerged from the deconstructivist analysis of market, proceduralist and principle-based theories.

---

77 American scholars have frequently looked at attempts to extend the purposes of (bankruptcy) law beyond the goal of maximisation of creditors’ return as an attempt to unilaterally restrict the rights of contractual claimants. Among others: JS Rogers, ‘The Impairment of Secured Creditors’ Rights in Reorganisation: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause’ (Mar. 1983) 96(5) Harv. L. Rev. 973 (arguing that it is the bankruptcy clause itself and not the Constitution to restrict government’s powers to unilaterally amend the rights of the creditors); Baird and Jackson (n 58); Kennedy (n 30) 214 (commenting on the Manville case and concluding that the protection granted by the system to secured creditors and – in a more limited extent – existing stockholders was justified, and that bankruptcy courts are still the best forum for resolving conflicts in mass tort claim, labour and environmental bankruptcy cases).


79 Skeel (n 60) 918.
6.3(c) A Normative Criticism of the Revised Common Pool Standard

The use of the RCP standard is likely to promote the early and timely application of corporate distress remedies, in particular in the interests of those who have risk bearer interests in an ailing company. Statistics demonstrate that nowadays the use of corporate distress remedies is not triggered whenever the company is likely to become insolvent, but when it is on the brink of failure. This explains the preponderance of liquidation procedures as the preferred corporate distress mechanism.\(^80\)

However, corporate distress remedies are designed to apply not only when companies are “broken”, but also whenever they are no longer able to meet the expectations of their stakeholders. Preventive restructuring mechanisms valorise the expectations of a wide array of stakeholders. Introducing a new gateway (the RCP standard) and grouping all corporate distress remedies under a new label (law of corporate distress) should therefore promote inclusivity over existing standards, as stakeholders will have more opportunities to have their position considered and their voice heard.

The RCP standard has the potential to promote a more proactive attitude towards dealing with situations of crisis because it addresses the cognitive biases that managers may have when their company faces a moment of difficulty in the market. It has the potential to promote wider societal interests, the protection of which has been argued is the general purpose of insolvency law.\(^81\) There is, however, the risk that wider participation results in longer (and more expensive) procedures and in the inability to agree on a preferred course of action.

---


\(^{81}\) This is the conclusion reached by H Anderson in a recent paper, where he observed that the proliferation of special regimes under English law is designed to do something more than simply offering a collective forum by and for the benefit of the creditors: H Anderson, ‘What is the Purpose of Insolvency Proceedings?’ (2016) 8 J. Bus. Law 670.
With reference to the **autonomy of the parties**, the degree of intrusion and derogation to agreed contracts depends on the nature of the procedure triggered by the applicants. However, if business experts are called to assess the opportunity to file for corporate distress remedies (as suggested in **sub-section 6.4(d)**), the risk of unduly or unilaterally amending contractual provisions is reduced. More in general, statutory deviations from contract law tenets in the law of corporate distress are kept to a minimum. This is to avoid that some parties have a perverse interest to file for a formal procedure, thus frustrating any out-of-court workout and precipitating RCP dilemmas into problems.

Directors would be replaced only whenever it appears unlikely that the existing management protects stakeholders’ expectations. Existing contracts are unilaterally terminated or amended only as a result of decisions that take the expectation of all parties (and not simply the distressed debtor) and the purpose of the procedure into proper consideration.

External regulation comes into consideration to prevent an abusive use of corporate distress remedies. With the purpose of further promoting inclusivity and autonomy, **sub-section 6.6(a)** discusses the conditions that could encourage the community-based approach advocated in this study.

With reference to the **legal predictability** criterion, there is no denying that, if the proposed regulatory reforms are introduced into law, implementation may initially result in higher uncertainty. This conclusion is neither surprising nor problematic.

The last systemic reforms in the field of corporate distress law date back to 1978 in the United States and 2002 in England. Courts had plenty of time (and cases) to develop consistent case law and governments had manifold opportunities to address the shortcomings of the law. However, as short-termism has been blamed as one of the issues of contemporary corporate practice,\(^2\) our evaluation should consider a longer time-frame.

---

The proposed standard does not affect the established business culture. On the contrary - by assuming that parties act in the best interests of the majority of stakeholders because they perceive that this course of action is in their best interest - the recommended reforms reduce the level of involvement of the judiciary in administrative and procedural tasks and the associated risks that business-sound decisions are reversed by procedural or exogenous considerations.

Additionally, strategies could be put into place to reduce the uncertainty initially arising from regulatory reforms. These strategies can draw from the positive experience of soft law mechanisms such as the UNCITRAL Guide and SIPs. Despite their soft law nature, their authoritativeness should not be dismissed, as it has been argued that sometimes the division between hard and soft law is less rigid in the real world than it appears in the books.83

A final disclaimer is needed. The theory requires the cooperation, active involvement and monitoring of several stakeholders. If each of the parties acts in ignorance of the other parties’ position, and as if he or she is conducting a one-off game, the outcome would be similar to the Nash equilibrium in a prisoner’s dilemma game. This outcome would be pareto-inefficient.

To allow the parties to escape this trap, the legislator should design a corporate distress framework that favours trust and communication among all stakeholders. This outcome might appear challenging and to a certain extent naïve in the majority of insolvency procedures. Therefore, section 6.6 suggests strategies that may promote trust and communication on the basis of empirical and behavioural studies.

If stakeholders, especially key-players such as directors, auditors and institutional creditors, are allowed to pursue the maximisation of their own interests, the system would under-perform and society as a whole would

6.3 Testing the Theory of “Wealth Maximisation of Stakeholders’ Interests”

It has been demonstrated that people can and did invoke legal remedies to achieve goals that have never been predicated by the system or envisaged by the legislature. In the corporate distress field, certain large organisations and repetitive players used insolvency rules in a similar fashion. Nowadays, not only large corporations but also SMEs use corporate distress remedies in a strategic manner. Has the RCP standard got the potential to address these risks?

In order to answer this question, one has to look back to the case of Carillion. In theory, the existence in the law of a RCP standard might have suggested the pursuance of different business practices to the company’s directors and a higher, more scrupulous supervision by the company’s non-executive directors and auditors. However, what if directors and auditors have in fact ignored their duties?

It has been evidenced that until the first profit warning was issued (10 July 2017), employees, suppliers, several investors and the public had little notice of the dire financial conditions of the company. However, the list of Carillion’s stakeholders certainly included pension trustees. These trustees invest the assets of a pension scheme for the benefit of their members and negotiate the

---

84 Take for instances cases like General Motors, Chrysler, Carillion or Monarch, where the government has to put taxpayers’ money to avoid the collapse or promote the orderly liquidation of these companies.
85 This conclusion was famously rebutted by M Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (Harvard University Press: Cambridge, MA, 1965) who stated that ‘unless the number of individuals is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, rational, self-interested individuals will not act to achieve their common or group interests’ (2).
87 Delaney (n 10) 160.
88 See the debate on “phoenixism” in sub-section 3.2(a)(i).
contributions that the employer has to ensure that the scheme is properly financed.

Pension trustees can rely (and did rely in this specific case) on advice from the Pension Regulator. Since 2008, they complained that the scheme was inadequately funded but they agreed to compromise on their requests because they were ‘outgunned in negotiations with directors’.89

It is submitted that had the RCP standard been the eligibility requirement for corporate distress remedies, this would have redressed the power imbalance between the parties. As a result, the company might have been forced to agree on higher contributions to the pension scheme or to enforce formal corporate distress remedies at an earlier stage.

It may be that the directors would not have changed their business strategies. However, even if the company would have equally ended up in liquidation, the employees would have suffered less draconian cuts to their pensions and the company would have probably filed for insolvency at an earlier stage. Additionally, the directors would have had less money available to cover their “dash for cash” strategy. In other words, the RCP standard would have favoured a timely intervention of those risk bearers who have both the information and interest to act.

Let us now turn to Tesla. Nowadays, if a person agrees on the analysis of the problems raised by battery-powered electric vehicles (and, in particular, by a company like Tesla), this person would have little or no remedy under the law. This person might pressure the local parliamentary representative to raise the issue in the legislative assembly and adopt consequential actions. Alternatively, he or she might start advertising campaigns to raise awareness among the public, but this would leave them running out of further options.

Legislative consciousness was raised in Singapore which adopts a system of car taxation that considers not only the emissions of the vehicle at the level of the

exhaust pipe (which, in the case of all Tesla cars, is none), but also the pollution that the vehicle generates throughout its life cycle. This means that to establish the annual car tax, the government considers if the automaker uses renewable sources to produce the electricity in its manufacturing plant, its transport facilities as well as the proportion of the vehicle that can be recycled once it is dismantled. As a result, Tesla vehicles are heavily taxed in that country.

If RCP becomes the eligibility standard for corporate distress remedies, any corporation, financial investor or group of individuals who is affected by Tesla’s practices (think, for instance, to diesel owners who see their chance to freely circulate in European streets increasingly curtailed) could act in defence of their rights.

This may cause an increase in litigation, as well as damages to the affected companies (especially those listed on the stock exchange) for the adverse publicity arising from a speculative yet unfounded corporate distress filing.

At the same time, the threshold to obtain the admission to the procedure is higher than a filing based on the insolvency standard. This may help to distinguish Tesla’s position (a company that has almost always been unprofitable since its incorporation) from those of other automakers who invest in the electric technology and still lose money on their research programmes but not at company or group’s level. Sanctions against speculative filings could also discourage a strategic use of the RCP eligibility standard. Therefore, even in the case of Tesla the RCP standard looks more promising than the current status quo.

Finally, it is appropriate to look at the impact of the RCP standard on restructuring plans where the corporate management does not act in the interest of all stakeholders in “solvent times” and the company later files for

---

insolvency (rectius, corporate distress) remedies. This is precisely what happened to Millennium Labs Llc.

Back in 2013, Millennium Labs was a successful and profitable company that offered laboratory-based diagnostic testing, including urine drug testing. The company was owned by its founder James Slattery and the private equity company TA Associates.

The company built its success on billing state authorities for medical testing. It appeared that some of this testing was unnecessary, as an investigation from the U.S. Department of Justice ('DoJ') later found that the company billed “Medicare” for exams on 59 dead people and offered expensive gifts to the medical office staff that prescribed these exams.92

In April 2014, when the investigation was still confidential and in its initial stage, the company decided to borrow $1.825 billion from the market.93 The loan was used primarily ($1.297 billion) to fund a special dividend to its owners. It was syndicated by JP Morgan and the collateral was made primarily by the company’s balance sheet, where millions in revenue were generated by urine drug screens.94

On 20 May 2015, the company, the DoJ and certain U.S. states reached a settlement to resolve the investigative and administrative matters related to the investigation. The company promised to pay $256 million to the counterparties but, after having paid $50 million, its managers realised that the company’s ability to service its debt had diminished to the point of endangering its future viability.

As an out-of-court restructuring proposal failed to reach sufficient support, the company filed for Chapter 11 in the Bankruptcy Court of Delaware on 10

---

94 Beall (n 92).
November 2015. The pre-packaged plan provided for an infusion of $325 million from the old equity holders into the company’s coffers to pay (among others) the remaining part of the settlement agreement. Equity of the reorganised debtor was offered to the 2014 lenders. A condition of the plan, which was approved by the creditors and confirmed by the court on 11 December 2015, was the release of third parties from further liabilities. These third parties included the previous owners.

Some creditors appealed against the third-party releases. They argued that they were given blatantly false representations about Millennium Labs affairs and that information was withheld from them regarding the governmental investigation. As a result, they faced a 50% cut of their original investment, while the previous owners had profited extensively from the business in the years leading to the filing.

After having been dismissed by the Court of Appeal, the appeal was docketed in the District Court which remanded the matter to the Bankruptcy Court questioning whether the latter had the constitutional power to confirm a plan which, because it contained non-consensual third-party release, would prevent non-debtor third parties from pursuing state law claims. The Bankruptcy Court concluded that it had this power, thus leaving the lenders (in this case, risk bearers) without further legal remedies.

As Millennium Labs was not insolvent, it is assumed that the company would have justified its corporate distress application on the basis of a RCP problem. The eligibility panel would have likely admitted the company to the procedure and approved the plan in the same way as the Delaware Court did. At the same time, the need to consider the stakeholders’ best interest would have probably induced the competent court to assess on the merits if the equity holders’

---

99 The pre-pack deal needed to be approved expeditiously for the company to continue to retain its accreditation and continue to operate in the business.
contribution was sufficient or if the 2014 loan presented a reprehensible example of asset-stripping. The RCP standard would therefore have offered substantive remedies to some of the controlling parties while the current law offers no protection.

6.3(e) Findings

A new conceptualisation that revolves around the RCP standard is more likely to achieve higher levels of predictability, inclusivity and preservation of party autonomy than the standards currently used in the Anglo-American systems. It should also enhance the overall value of an enterprise and promote growth and employment, in line with the ideas that underpin the Anglo-American system.100

The next section suggests the procedures that could be introduced into the statutes to promote the use of an eligibility standard based on RCP considerations.

6.4 “WEALTH MAXIMISATION OF SHAREHOLDERS’ INTERESTS”: PROCEDURAL ASPECTS

While the previous sections have made the case for the adoption of a test based on the existence of a RCP problem to determine when a company should file for corporate distress remedies, this section outlines the changes that should be introduced into the Anglo-American statutes to unleash the full potential of this test.

The suggested regulatory changes would support a new, favourable attitude in the business community towards the use of corporate distress remedies, in line with recommendations for the promotion of a corporate rescue culture and destigmatizing “insolvency law”.

This section also looks at how the RCP standard would work in practice by referring to a case in the aviation industry that presents remarkable similarities with Continental's filing in 1983: the case of Alitalia (2017).

6.4(a) Application from the Debtor

Admission to a corporate distress procedure may be demanded by the distressed company itself, by either its majority shareholders or its managers and directors. The filing of the petition instantly affords protection from executive and other individual actions against the company, in the form of an automatic stay or moratorium. The rights of secured creditors would not be different from the current law.

The motion could be based on two grounds. The first (and less contentious) is “insolvency or quasi-insolvency”, that is either the inability to pay existing or prospective debts as they fall due or the existence of a liquidity crisis (hereinafter, “insolvency standard”). The debtor can demonstrate to be insolvent on a cash-flow or balance-sheet basis. If the motion is based on the insolvency standard, there is a rebuttable presumption for the use of certain corporate distress procedures, i.e. liquidation and sale of the company (or its branches) or the business. Due to the insolvent condition of the debtor, it is argued that these procedures should in theory be capable of better allocating the remaining capital for the best interest of the company’s stakeholders than rescue devices.

The second ground ought to be based on the existence of a “revised common pool” problem, i.e. the inability to run the company in line with the expectations of those who have a controlling interest in it. If the motion is based on this latter ground (“the RCP standard”), there should a presumption in favour of rescue-oriented mechanisms as these are capital-maximising remedies designed to maximise stakeholders’ expectations and allocate capital to those best able to use it.

Together with the reasons for filing, the applicants should identify their preferred procedure, the name of the proposed corporate distress practitioner\(^{101}\) (if the assistance of such professional is required by the law) and the request for first-day orders.

---

\(^{101}\) These are the insolvency practitioners in England and the trustees in the U.S.
The written motion should be decided by a panel of up to three independent experts (the “eligibility panel”) which should not sit in a court. For filings from medium and large enterprises with the request of first-day orders, one of the experts should have a judicial qualification (due to the immediate, legal implications arising from the approval or rejection of these requests). The panel could accept the motion, reject it or suggest the opening of an alternative procedure. The judicial member of the panel should have sole authority to approve, reject or amend the request for first-day orders.

In all cases – and particularly those in which one of the parties invoke the use of a RCP criterion – the panels’ valuation to admit or reject the petition to open a corporate distress procedure should be subject to the “balance of equities” standard. Where a “business judgment” test would subject the corporate distress order to the existence of a benefit for the debtor, the “balance of equities” test is more rigorous. In the latter, the panel has the power to reject or amend the petition whenever it appears that: (1) the suggested corporate distress strategy does not address all or substantially all of the issues that determined the company’s collapse; and (2) the proprietary rights of the affected parties would be unconscionably restricted by the petitioned course of action. The goal of this test is to prevent the use of corporate distress remedies to accomplish limited organizational objectives, such as reducing labour costs as in the case of Continental.

If the motion is rejected or the debtor discards the suggested, alternative procedure, the automatic stay terminates and the company goes back to the original, pre-application condition. If the motion is approved or the company accepts the alternative procedure suggested by the experts, the panel prepares a “Corporate Distress Notice” (‘CDN’) which shall be served on all creditors within 7 days.

6.4(b) Application from a Stakeholder

The motion to commence a corporate distress procedure may be submitted by a creditor or another party who has a legally enforceable interest in the company (including local communities and associations of workers, among others).
Only creditors should be able to rely on the “insolvency standard” to submit a corporate distress petition. Alongside with recognised creditors, interested parties who are not contractual claimants under the law could rely on the RCP standard to submit a corporate distress petition.

The burden of proving the existence of a RCP problem ought to be higher than demonstrating the existence of a failure to meet contractual obligations. This burden should fall entirely on the applicant. Limiting the possibility for non-contractual claimants to file a petition only on RCP grounds should not unduly restrict their rights, but it should avert the risk of strategic or abusive requests to the detriment of the debtor.

To avoid the opening of a corporate distress procedure, the company or other interested parties shall demonstrate that it is solvent and (if the application was based on the RCP standard) be capable of ensuring the expectations of those who have controlling interests in it.

The eligibility panel should retain the power to confirm the petition, reject it or authorize the opening of a different procedure than the one suggested by the applicant. The latter power should be exercised with caution. It should be limited to cases in which the creditor or third-party’s application has been opposed by the debtor or – absent any defence – where it would be unconscionable to open the suggested procedure and reject the petition altogether.

The decision of the eligibility panel is formalised in a CDN and then served on all creditors within 7 days.

6.4(c) Right to Appeal

The eligibility panel should always retain the option to amend its initial decision when it appears that it was influenced by the fraud of one of the parties. Once the procedure has been opened, the debtor, the corporate distress practitioner, the office-holder and a qualified majority of claimants could ask the panel to admit the debtor to a different procedure when it no longer appears possible to achieve the purpose of the original corporate distress procedure.
Creditors should have the right to appeal the panel’s decision (authorisation to file for corporate distress and the choice of the remedies) against the same panel (albeit with a different composition) within the date specified in the CDN (between 30 and 60 days from the date of the order). Appeals are possible by the debtor when the petition has been rejected or amended by the panel. Interested parties and debtors could appeal the approval of the creditor or third-party’s petition both on the ground of illegitimacy of the order and on the choice of the procedure.

Generally, appeals should also be possible for any interested party (including those on whom the CDN has not been served) until the decision becomes binding. Whenever it appears that the decision to open a corporate distress procedure may affect a wider audience than contractual claimants (for instance, if the filing is motivated by tort liabilities, as in the case of A.H. Robins), the eligibility panel can order the publication of the corporate distress order on selected websites and newspapers.

To challenge a RCP-based order, appellants should demonstrate that it is possible to address the causes of the crisis without the use of exceptional corporate distress remedies. They could also question the suitability of the chosen procedure as the best means to ensure the protection and maximisation of the proprietary interests of the interested parties.

The decision would become final once the deadline has expired and no appeal has been filed. After that, any interested parties could commence proceedings against the applicants in front of the (insolvency) court where it appears that the decision has been influenced by the fraudulent or dishonest behaviour of the applicant or a third party acting in agreement with the applicant.

If the fraudulent behaviour is proven, the court can adopt the remedies that appear equitable in the circumstances of the case (including disqualification of the directors, personal liability and lifting the corporate veil). The companies and its assets cannot be sold before the decision is final without leave from the court (and not the eligibility panel). Regulators should refrain from introducing new grounds to challenge the panel’s decision, as it is crucial for the success of
any corporate distress procedure that timely decisions are taken and dissenters are brought into line.

Some might argue that courts should retain the power to dismiss a corporate distress petition for “cause”, as it is currently the case in the U.S. In principle, the author is not against the recognition of this power in the law. However, there is a risk that the introduction of this ground for dismissal might encourage speculative applications to the court, where the intent of the applicant is simply to gain a better deal from the corporate distress practitioner or debtor in charge of the procedure. This safeguard might therefore be introduced sometime after the introduction of the changes advocated in this thesis and only if evidence is provided that a significant number of companies are abusing the system. In any case, the right to submit such petition to dismiss the procedure for cause should be subject to penalties (such as the order to refund the defendant’s legal costs) if they are rejected.

First-day orders can immediately be appealed in front of the court, which has jurisdiction for the corporate distress case. This is the local bankruptcy court in the U.S. and the High Court in England.

6.4(d) The Eligibility Panel

Judges are ill positioned to assess and second-guess the soundness of commercial, entrepreneurial decisions because they conduct an ex-post assessment with full knowledge of facts and consequences of decisions taken by parties with limited knowledge and within the course of business. They therefore may be ill-suited to opine if the company is facing a period of temporary distress, in a situation of structural insolvency or if its directors no longer have the ability and time to turn the business around in the interests of those who control it without the help of third parties (such as corporate distress practitioners) or derogations from the general law of contract.

It is therefore expected that empowering a pool of experts of the responsibility to decide if a company could and should benefit from corporate distress remedies is preferable to leaving this decision to the courts. Irrespective of

---

102 11 U.S. Code § 1112(b).
whether the filing is based on the insolvency or RCP standard. These experts should be selected among representatives of the corporate distress profession, creditor groups and other interested bodies.

The main goal of the eligibility panel is to determine if the decision to file and the admission to the proposed procedure was influenced by organisational powers. In other words, the panel should check whether corporate distress remedies were requested to promote the interests of some stakeholders at the expense of other parties who have legitimate interests in the debtor.

Is an eligibility panel needed? This question may be answered in the negative if we consider that one of the goals of corporate distress law is to promote early filings and avoid “zombie company” problems. It has been argued that the market may work out a proper balance, while a minimum requirement could be the proof that absent restructuring the company would inevitably fail. Any additional test or check may delay the commencement of a procedure and impose additional costs on the debtor.

However, the author believes that a market-only solution would not work. As stakeholders have little or competing interests to file for corporate distress remedies, incentives (for instance, tax waivers) are needed to promote early filings in a market-only approach. If incentives are too generous, the risk is that companies would make use of corporate distress remedies in a strategic way, to gain an unfair competitive advantage. No independent authority could be able to challenge the filing. As judicial solutions are perceived as ineffective, costly and lengthy, this thesis recommends a solution which retains the flexibility of the market approach and the independence and rigour of judicial supervision.

---

103 Paterson (n 69) 18.
104 Ibid.
The proposed eligibility panel bears some similarities with the “Pre-Pack Pool”.\textsuperscript{107} The system should be largely automated and the panel members should be appointed on a rota basis. Ideally, the system should be able to determine the outcome of the application within two business days from its submission.

However, the eligibility panel should also have some peculiarities over its English “godfather”. In fact, unlike the experts in the Pre-Pack Pool, it is suggested that the persons appointed to the eligibility panel should cover this position on a permanent basis due to the high number of expected applications. Additionally, application fees (currently £800 plus VAT) should be significantly lowered so that they do not present an obstacle to filing for corporate distress. A one-panellist session should be the norm and the panel should sit in a session of three experts in more complex cases (e.g. competing petitions).

In the majority of cases, the panel should reach a decision based on the documents submitted by the applicant. If the circumstances require a deeper analysis of the case, the panel may adopt preliminary measures and postpone the final decision after a meeting with the interested parties or after having received a report from a panel-appointed, independent expert on the viability of the company.

The most significant advantage of the eligibility panel over alternative bodies appointed by the government or the judiciary is that the management of the corporate distress filing is dealt with by professionals, who share the same background and expertise as the parties. They are part of the same community. As a result, they are more likely to spot strategic but not necessarily abusive behaviour and to adopt flexible solutions to meet the issues raised by corporate distress practice. Courts and regulatory bodies would retain a monitoring and

supervising role, to ensure that parties have the right incentives to behave in the common interest.

The eligibility panel is akin to a self-regulation mechanism and the opportunity to rely on industry-led measures might not be apparent. In fact, several scholars have argued that whenever there is a TCP issue, the parties affected by this problem suffer from a perverse incentive to over-use the goods and internalise any profit (free-riding). This incentive prevails over any opposite inclination to conserve the goods or limit their exploitation for the common interest.\textsuperscript{108}

Traditional scholarship has therefore suggested that, in these cases, the most appropriate solution is ‘to have an external body impose a management structure over the resource’.\textsuperscript{109} This is what happens nowadays in the majority of formal and hybrid corporate distress procedures, as parties are required to follow a detailed statutory procedure and their actions are supervised by external authorities, such as judges and corporate distress practitioners.

The eligibility panel challenges this approach. Even in cases of RCP problems, political scientists have proven that under certain conditions communities of resource users can develop rules that avoid the tragedy of commons without external intervention.\textsuperscript{110} State-imposed measures are not always necessary: what is needed is a system that inspires the confidence and trust in the players. Pursuant to this line of thinking, this thesis recommends the adoption of a decentralised approach to assess the eligibility for and the content of the corporate distress procedure. The eligibility panel is one manifestation of this novel approach.

6.4(e) Alitalia (2017) Recast

The implications of the RCP standard are best illustrated by referring to recent cases. In particular, this section looks at the issues that surrounded the recent failures of Alitalia and Air Berlin because, like Continental, these companies

\textsuperscript{108} G Hardin, ‘The Tragedy of the Commons’ (1968) 162 Science 1243.
\textsuperscript{110} Ostrom (n 57); Pennington (n 109) 24.
operated in the aviation industry and the cases may provide good lessons for Anglo-American companies.

If the RCP standard was applied as the eligibility criterion to file for corporate distress remedies, it is expected that the majority of cases would not be decided in a manner significantly dissimilar to the existing status quo. Therefore, the majority of decisions in front of the eligibility panel would be dealt with in a quick, mainly administrative manner.

However, the potential of the suggested proposal lies in the ability to address the shortcomings of the existing system, as evidenced throughout this thesis. These inadequacies become apparent when the system overlooks the existence of RCP dilemmas and eventually RCP problems. This might have been the case in the recent filing for the extraordinary administration procedure of Alitalia (May 2017).

Investigation of this situation is appropriate because Alitalia represents a significant case, due to the number of people affected by its failure, the relevance of the company for the national economy and the political implications arising from its dismissal. It concludes that it is likely that Alitalia directors faced a RCP problem when they filed for the extraordinary administration procedure in 2017.

Alitalia, the once state-owned Italian airline operator, was struggling to compete in the market since the progressive liberalization of the European aviation industry.\(^{111}\) It did not post a net profit since 1999 as it had faced competition from low-cost carriers, lacked a growth strategy, suffered from continuous strikes and proved unable to cut its costs.

After several attempts to restructure, rescue and sell the company, Alitalia first filed for insolvency protection on 29 August 2008\(^\text{112}\) to be eventually sold to a consortium of Italian investors (CAI – Compagnia Aerea Italiana S.p.a.) later that year.\(^\text{113}\) In 2014, due to a new liquidity crisis, 49 per cent of the shares of Alitalia were sold to Etihad Airways,\(^\text{114}\) while the Italian consortium remained the owner of the residual shares.

Despite the support of a strong, international partner, Alitalia failed in its turnaround efforts. In spring 2017, the company’s staff rejected an agreement signed by management and trade unions that would have slashed jobs and salaries as a condition for shareholders to inject fresh funds through a capital increase of up to 2 billion euros.\(^\text{115}\) Alitalia was then admitted to an extraordinary administration procedure by the government on 2 May 2017.\(^\text{116}\) This thesis focuses its analysis on the 2017 filing.

While the company was no longer the leading air carrier in Italy,\(^\text{117}\) it still operated from important Italian hubs and in a growing yet competitive market. In May 2017, filing for corporate distress protection was no longer avoidable as the company’s negative cash flow would have brought Alitalia to breach the


\(^{117}\) Anna.Aero Staff, ’Would Alitalia be missed in Italy? Only has 9% of international seats this summer; Easyjet, Ryanair and Vueling could take up domestic slack’ Anna.Aero (10 May 2017) <http://www.anna.aero/2017/05/10/alitalia-possible-collapse-analysed/> accessed 17 September 2018.
minimum capital requirements to operate as an air-carrier and no lender was willing to grant further finance at market conditions.

The opening of this procedure allowed the government to appoint three commissioners and grant the company a loan of 600 million euros\(^\text{118}\) (later increased to 900 million)\(^\text{119}\) to cover the expenses for the duration of the procedure. It was envisioned that what was left of the company should have been sold to the highest and most promising bidder within six months of the filing.

Due to uncertainties following the general political elections in March 2018, at the time of this thesis the company is still under insolvency protection. While the previous Italian government ruled out the possibility that the company be re-nationalised,\(^\text{120}\) this seems to be the preferred plan of the current government.\(^\text{121}\)

The existence of the RCP gateway in corporate distress law would have significantly affected the way in which the 2017 crisis was handled. It is likely that the shareholders would have filed a liquidation petition on the basis that the company was insolvent. However, the directors would have submitted a petition to sell the business (or a portion of it) by means of a corporate distress procedure, on the basis that the company faced a RCP problem.

In this case, the presence of a RCP problem suggests the need to sell the company with urgency to avoid a prolonged management of the company in an insolvency context that has resulted in further deferral of investments and the definition of a viable commercial strategy, as well as in further reductions of the


return (rectius, increase of losses) for some of the risk bearers (i.e. Alitalia staff and Italian citizens).

Had the RCP standard been enforceable on that occasion, the eligibility panel would have appointed one or more corporate distress practitioners, who would have sought a quick sale of the remaining profitable assets to one or more competitors. The outcome would have been similar to the almost contemporary failure of Air Berlin, whose assets were sold to Easyjet, Lufthansa and at an auction, with part of the staff partially retained by the new owners.

In the Alitalia crisis, the voice of some interested parties was neglected. This was the voice of Italian taxpayers, who subsidised the company for several years. Before the last loan of 900 million euros, data by Mediobanca showed that the Italian government pumped some 7.4 billion euros into the company from 1974 to 2014. If back in May 2017 Alitalia directors had to consider the interests of all controlling stakeholders, they would not have filed for a procedure that resulted in further, meaningful losses for one of the controllers of the company, without this resulting in any significant benefit for any of the other parties who had a legally enforceable interest in the company.

Taxpayers are by far the most significant stakeholders in Alitalia. According to the most recent available data in the "Relazione Illustrativa ex art. 2446/2447..."
The company has debts of 3.215 billion euros. The main creditors of the company are:

- Commercial creditors who are owed 819 million euros, out of which 624 million euros are owed to “suppliers” and almost 118 to other airline operators;
- Financial investors, who are owed 604 million euros in bonds and other obligations, and 59 million for financial derivatives;
- Banks and other financial institutions for up to 386 million euros in loans, out of which 100 million euros are owed to Etihad Airways;
- Leaseholders (mainly for the aircrafts) for 133 million euros;
- Employees and the state for unpaid taxes for 58.5 million euros.

Almost all of these creditors – with the significant exception of employees and the state – would prefer a procedure that prolongs the comatose state of the company backed by further financial support from the government. This is particularly valid for the financial investors, who hold unsecured obligations from the company, and for unsecured suppliers, who are granted a timely and preferential payment for their goods and services provided during the corporate distress procedure. Secured creditors and leaseholders are on balance unaffected by the decision to opt for a longer, administrative procedure instead of a quick, efficient sale of the company (or part of it).

Nevertheless, the course of action undertaken to rescue and sell Alitalia is against the risk bearer interests of a significant portion of stakeholders. These include the same workers who voted against the company-union agreement knowing that a rejection of the proposal would have resulted in liquidation of the company. Their voice was equally not considered in the eve of the filing.

---

129 Ibid 4.18.
130 Ibid 4.20.
131 Ibid 4.17.
132 Ibid 4.18 and 4.19.
133 Ibid 4.21, 4.22.
The existence of an eligibility requirement based on the RCP standard would have allowed the panel of experts to consider their position and suggest a course of action, which would have been more in line with the governance structure of Alitalia.

Finally, it might also be contended that similar considerations apply to other cases involving the turnaround of companies operating in the transport industry. For instance, the RCP criterion would have been useful in the egregious case of Eastern Airlines, which filed for Chapter 11 (and eventually sold its remaining assets) at a time when ‘it was clear to just about everyone that Eastern should be sold.’

According to one of the hoariest chestnuts of the law, ‘hard cases make bad law’. Should we therefore infer the need for regulatory changes from arguably exceptional cases? This question should evidently be answered in the negative. However, it is submitted that the cases described in the previous section are not exceptional. The cases that hit the headlines represent the pinnacle of a trend that affects the whole industry (Bildisco, for instance, was a company with less than 100 employees).

It therefore makes sense to call for regulatory changes in the eligibility requirements for the enforcement of corporate distress remedies. These improvements – primarily the introduction of a “RCP eligibility test” – are needed to valorise the expectations of the parties who have controlling interests against a distressed debtor.

The suggested regulatory changes are substantial and not simply procedural. They promote transparency, as the proposed procedure should apply for the opening of all but an informal turnaround procedure. They may also promote efficiency if the submission procedure is automated and based on standard forms. Nevertheless, they should not affect the nature of the majority of the

---

134 Skeel (n 60) 921. For a different view on this case: Altman and Hotchkiss (n 68) 220-221 arguing that Eastern managers rightly chose to file for Chapter 11 in a last bid to ensure the wider interest of all stakeholders.
existing petitions, which could still be submitted by relying on the complementary “insolvency standard”.

In the next section the author investigates whether the theory proposed in this study is to be preferred over alternative approaches to the interaction between contract and corporate distress law.

6.5 “WELTH MAXIMISATION OF STAKEHOLDERS’ INTERESTS”: A CRITICAL ASSESSMENT

How does the WMSI theory proposed in this thesis compare to other proposals that deal with finding the dividing line between contract law and insolvency (rectius: corporate distress) remedies?

Schillig (2014)\textsuperscript{135} argues that financial innovation and the increasing complexities of capital structures recommend a recalibration and reconsideration of the dividing line between contract and insolvency law. He therefore suggests a “waiver contractual approach” pursuant to which the existence of certain circumstances would allow parties who \textit{ex-ante} (i.e. before the commencement of any formal procedure) decided to opt-out of mandatory insolvency (rectius: corporate distress) remedies to enforce their agreement.

Schillig contends that this switch from mandatory to contractual explains much of current practice, including pre-pack administrations, the treatment of \textit{ipso facto} clauses and the English jurisprudence on the anti-deprivation principle. He observes – in line with the findings of this thesis – that whenever market-driven realignment successfully operates, mandatory law should ‘retreat to providing the structural rules necessary to facilitate private ordering’.\textsuperscript{136} Alternatively, the risk that mandatory laws aggravate the problems they were meant to address increases.\textsuperscript{137}

In the author’s opinion, Schillig’s theory suffers from three limitations. The first is its scope: while the theory is persuasive for financial transactions and in liquid markets, it may prove inadequate whenever these assumptions are not


\textsuperscript{136} Ibid 38.

\textsuperscript{137} Ibid 14.
met. Secondly, Schillig based its theory on the conventional assumption that parties can contractually negotiate their rights and waivers. It has already been observed here and elsewhere that the validity of this point is open to criticism.

Finally, in Schillig’s theory the separation between contract and corporate distressed remedies is extremely blurred. Mandatory remedies always remain in the background and can be invoked whenever parties fail to agree on private solutions, with the potential of affecting the predictability of the legal system.

---

138 Schillig in fact argued that financial innovations allowed ‘debt and trading investors as well as directors and executives’ to promote market-driven realignments: Schillig (n 135) 10.

139 See above section 2.2 of this thesis.

140 Look at the same section for the literature on the topic.

141 The author recognises that the ‘new optimal balance between mandatory provisions and default rules [...] may change over time with the development of new lending practices and financial products’: Schillig (n 135) 14.
Paterson (2014-2016)\textsuperscript{142} suggests to rethink corporate insolvency theory in the light of the developments in the financial market. She argues that corporate distress law has two primary purposes: (i) to facilitate the reallocation of capital whenever financial debtors wanted to retrench their liabilities or call in credits against distressed debtors (“insolvency law”);\textsuperscript{143} (ii) to encourage early restructuring so that capital is allocated to companies best able to use it (“restructuring law”).\textsuperscript{144} While the focus in insolvency procedures is on maximising the amount of capital that can be re-deployed in the economy, in restructuring procedures the law should help parties to resolve holdouts problems.\textsuperscript{145}

Paterson argues that an efficient market mechanism could be used to distinguish between viable companies with the wrong capital structure that deserve to be rescued and those with more profound problems that should therefore be liquidated.\textsuperscript{146} The mechanism, however, operates only with reference to large and larger mid-cap companies and it only distinguishes the roles of corporate distress law (rescue or liquidation) without providing guidance on the contract/corporate distress divide.

The WMSI theory allows for further conclusions, as it offers two criteria (insolvency and RCP) to distinguish contract law from corporate distress-

---

\textsuperscript{142} Paterson (n 69); S Paterson, ‘Rethinking Corporate Bankruptcy Theory in the Twenty-First Century’ (2016) 36(4) OJLS 697.

\textsuperscript{143} Paterson (n 69) 18.

\textsuperscript{144} Ibid. Paterson uses the word of “restructuring” as a synonym of “rescue” while this thesis adopts a different meaning for each of these terms.

\textsuperscript{145} Ibid 4 and 16.

\textsuperscript{146} Paterson (n 142) 702.
governed cases and is potentially capable of dealing with a wider array of companies.

**Balz (2017)** contends that the distinction between insolvency and preventive restructuring frameworks rests in the ability of the debtor to stop negotiations and exit proceedings. His taxonomy has been criticised because rescue would not be recognised as ‘*something peculiar that deserves a special treatment*’.

The author disagrees on this criticism: not recognising rescue as an autonomous value of corporate distress law does not mean to not recognise that corporate distress procedure can achieve that goal. Under the theory proposed in this thesis, one of the primary outcomes of corporate distress procedures should be to maximise the prevailing interests of the affected stakeholders. Whether this occurs by means of rescue or liquidation practices is of little concern.

Where Balz's theory is unpersuasive is in using insolvency as the main criterion to differentiate contract from corporate distress procedures. **Chapter five** and particularly **section 5.2** evidenced the reasons that suggest not to rely solely on that concept as an eligibility criterion.

**Eidenmüller (2016-2018)** argues that insolvency proceedings are only those that address the creditors’ TCP problems. The collective nature should be reserved to those proceedings governed by corporate distress rules. As observed by Madaus, this conclusion is inaccurate: restructuring proceedings

---

147 Paterson did not specifically address in her papers the trouble of distinguishing corporate distress procedures from contract law workouts. She suggested that ‘*the market may impose its own solution to this challenge*’; Paterson (n 69) 18.

148 Paterson’s theories are based on a study of Anglo-American large corporations affected by changes in the finance market.


152 Eidenmüller (n 151) 71. For a distinction between common pool problems and anti-commons, see below ft. 156 and, more generally, sub-section 1.3(a).

153 Madaus (n 150).
can be collective even if governed by contract law tenets. Additionally, as explained below, the assumption that insolvency proceedings address only TCP problems (as generally understood in the literature) is questionable.

It is also to be observed that the purpose of Eidenmüller papers was not to offer a new conceptualisation of corporate insolvency law. His goal was to determine the features that cross-border insolvency proceedings should have to merit immediate and universal recognition. This may help explaining why his theory looks unconvincing to the author of this thesis.

More recently, Madaus (2018) proposed a doctrinal approach that offered a “clear” distinction between insolvency and restructuring law.154 Madaus argues that while insolvency and restructuring law share a common economic function (debt-cancellation for non-performing loans), ‘there is a clear line of distinction between insolvency and restructuring procedures’.155

154 Ibid. Madaus’ understanding of the notion of restructuring as encompassing only measures that allow the legal entity of the debtor to survive or avoid an insolvency process (ftn 2) is consistent with the definition adopted in this work in sub-section 1.3(b).

155 Madaus (n 150) 3.
Under Madaus’ proposal, where insolvency proceedings are designed to address TCP problems, restructuring workouts address only the anti-common side of the equation. Insolvency proceedings are governed by insolvency rules while restructuring workouts by restructuring (contract) law and are carried out under judicial assistance. The dividing line between restructuring workouts and insolvency proceedings is the existence of a situation of insolvency.

The author agrees with Madaus’ claims that restructuring law should be governed by contract law principles and rules and should have no collective effect unless where otherwise allowed by the law. However, this work does not find the need to use a new taxonomy (“restructuring law”) to define what is essentially contract law.

More importantly, the author disagrees on two important aspects: (i) the dividing line between restructuring and insolvency law; and (ii) the content of what Madaus calls insolvency law and this thesis defines as corporate distress law. The second aspect has been addressed in sub-section 6.3(b) and below in this section, while the criticism now focuses on the first point.

Madaus argues that, because the dividing line between restructuring and insolvency law should be the existence of a situation of insolvency, the

156 In line with the literature in the field, Madaus argues that common pool problems arise whenever parties face a problem of overusing the assets (e.g. there are not enough fish in the pond to satisfy the needs of all fishermen), while anti-commons emerge whenever parties are underusing the assets (e.g. one party can prevent access to the pond to all fishermen, despite the existence of enough fish to satisfy the needs of each of them). On this distinction: MA Heller, ‘The Tragedy of Anticommons: Property in the Transition from Marx to Markets’ (1998) 111 Harv. L. Rev. 621; LA Fennell, ‘Commons, Anticommons, Semicommons’ University of Chicago Public Law & Legal Theory Working Paper No. 261/2009 (2009) <https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1065&context=public_law_and_legal_theory> accessed 17 September 2018.
problems addressed by these laws would not overlap unless in marginal, exceptional cases. In line with traditional law and economics theories, he argues that the insolvency of the debtor creates TCP problems.\textsuperscript{157} Both conclusions are fallacious for the considerations expressed below.

In “restructuring” cases, parties may need to address TCP problems. Companies usually undertake turnaround processes if they face a situation of crisis that may lead to financial and economic distress. TCP problems may not be actual as the debtor is still meeting its obligations as they fall due but are usually real and looming above any restructuring process. If the parties agree on a restructuring plan, the content of this plan is influenced not only by the need to overcome holdout problems (generally known in the literature as anti-common issues), but also future potential insolvency problems (generally known in the literature as TCP issues).

Equally, in “insolvency” cases, debtors and creditors may face anti-common problems (while, according to Madaus, they should not). For instance, in the case of a liquidation of a real estate business, over-secured creditors may have an incentive to sell the assets as soon as possible, even if the market is depressed and the property is seriously under-valued (as during the recent financial crisis). On the contrary, under-secured or unsecured claimants may put into practice delaying practices in the hope of a recovery of the market that covered the additional costs associated with delaying the procedure. This is clearly an anti-common-type situation.

English courts held that the obligations of a receiver do not extend to postpone a power of sale.\textsuperscript{158} However, on other occasions the same courts ruled that office-holders shall consider anti-common issues in insolvency procedures, even when conducted in the main interest of one creditor and liquidation-oriented.\textsuperscript{159}

\textsuperscript{157} Madaus (n 150). 6.
\textsuperscript{159} Medforth v Blake [2000] Ch. 86 (CA). This was a case where a receiver continued to carry the debtor’s business but failed to obtain bulk discounts for the purchaser of pig feed. The Court of
The **WMSI theory** represents a more comprehensive, even if not necessarily simpler attempt to address the shortcomings of the above-mentioned theories.

Under the proposed conceptualisation, corporate distress law should be designed to recognise the risk bearers’ power to influence those liquidation or rescue decisions that have the potential to maximise the wealth of all stakeholders. Corporate distress remedies oriented towards the maximisation of company’s assets or the best allocation of capital to those who could make a better use of it should operate whenever parties face RCP or solvency problems. Contract law rules should apply whenever parties can still find contractual solutions to their RCP dilemmas or solvency issues.

The theory, therefore, is not based on a distinction between common and anti-common problems: the RCP notion used in this work is wide enough to encompass common, anti-common and semi-common situations. Equally, it is not based on a distinction between solvent and insolvent entities. The dividing line between contract and corporate distress remedies is not determined by the nature of the issue addressed by the law.

Finally, it is not based on the assumption that creditors act to maximise the value of the debtor’s assets. As risk bearer rights are difficult to define and

---


change over time, the WMSI theory suggests that the only objective stakeholders could agree on is the overall maximisation of stakeholders’ wealth.

Therefore, the dividing line between contract and mandatory remedies is determined by the magnitude of the issue (either a dilemma or a problem) faced by the stakeholders and by their ability to reach a wealth maximisation agreement without deviating from contract law principles. Accordingly, the WMSI theory does not face the same shortcomings evidenced with reference to Madaus’ taxonomy.

It might be argued that the theory proposed in this study could lead to nonsensical results. If corporate distress law empowers the majority of stakeholders to unilaterally amend contracts and bind dissenting parties, the emergence of RCP dilemmas would lead inevitably to the opening of a corporate distress procedure. Nobody would have any incentive to negotiate a restructuring agreement in the realm of contract law.

This thesis acknowledges this problematic aspect and therefore suggests two solutions. First, at corporate distress level, it recommends the introduction of a deviation from contract law rights (by means of priorities, preferential treatments, set-offs, etc.) only whenever it appears necessary to preserve confidence in the market. Secondly, at contract level, it recommends the relaxation of certain principles. For instance, despite the principle of freedom of contract, parties might be allowed to renegotiate contract terms in case of significant and unexpected changes of circumstance and, should the negotiations fail, authorize the panel to resolve the dispute by determining the new content of the contract.

---

162 Think, for instance, at the effect that an environmental disaster may have on the value of the company, the claims of third parties (including tort claimants and the state) and the interest of the society.

163 This was the argument originally used to justify the enforcement of ipso facto clauses in certain financial contracts; see sub-section 2.2(a)(i).

164 A similar provision is included in s.313 of the German Civil Code, where such power is bestowed on judges. The introduction of such provision, however, may prove problematic in the U.S., where the Constitution prohibits federal states from using their contract law powers to pass laws that would relieve a party of their obligation to pay under a contract. See the ‘Contract Clause’ in art. 1, s.10, cl.1: ‘No State shall [...] pass any [...] Law impairing the Obligation of Contracts [...]’.
These considerations suggest that the WMSI theory is preferable over the other competing taxonomies that analyse the interaction between contract and corporate distress law. Insofar, however, the Anglo-American legislators have not moved towards adopting the approach suggested in this work primarily because of a lack of comprehensive studies on the consequences arising from this alternative taxonomy.

In the next section the author investigates the factors that promote the introduction of the RCP standard into law and those factors which limit the findings of this study.

6.6 “Wealth Maximisation of Stakeholders’ Interests”: Impact and Limits

So far, this thesis has recommended an approach to the definition of the limits of corporate distress law that recognises significant leeway to the parties involved in the procedure. The introduction of the RCP eligibility criterion is expected to facilitate the submission of petitions from both the company and its managers, as well as from any other interested party. The assessment of the financial and operational conditions of the debtor and the decision on the corporate distress application is attributed to an eligibility panel made of people familiar with these procedures.

Supervision and control from regulatory entities or independent parties is reduced to a minimum. Courts and regulatory bodies retain a monitoring role, but they are allowed to exercise their powers only in case of abuse or fraud. Such a de-regulatory or de minimis approach is in line with an established legal and business Anglo-American culture, even if the creation of a new infrastructure of panels of experts may require some initial commitment from the governments.

It has been observed that these countries ‘have a great tradition of private rule-making to facilitate groups of persons reaching a common end.’

---

chapter two of this thesis has supported this view and the suggested approach fits into this tradition.

De-regulation without control can lead to a strategic use of corporate distress remedies. By now it should be clear that the author is not supportive of this line of thinking according to which policies and rules should simply promote a level playing field for businesses. Policies need to establish a direction: the maximisation of wealth of those who have legally enforceable interests in the debtor, in particular if this leads to value-creation for society as a whole. This should reduce the risk of strategic filings.

This section discusses the factors that are more likely to promote or thwart the adoption of this model from both the legislator and the industry.

6.6(a) Promoting Success: Addressing Behavioural Biases in the Decision-Making Process

Insofar, this chapter has suggested that the RCP eligibility criterion that worked alongside the traditional, insolvency test should be introduced into the Anglo-American statutory framework to determine the enforceability of corporate distress provisions. Such a standard would fit well within the current statutory framework, as it would promote the procedural efficiency and fairness goals that underpin the Anglo-American tradition and the principles that support the dominant corporate distress law heuristics discussed in chapters two to four. The analysis of the cases of Continental166 and Alitalia167 have also implied that the RCP standard could work in practice.

Shifting insolvency to the proposed corporate distress system based on the RCP standard is admittedly a dramatic step, however promising it may appear on paper. So why has this standard not yet been proposed, discussed and introduced into the law? Could such a proposal ever be approved by either Parliament or the Congress?

Part of the answer may lie in the limits, limitations and delimitations of this study, which will be discussed in the next sub-section. However, another part of

166 See above sub-section 6.2(a).
167 See above sub-section 6.4(e).
the answer may lie in the existence of behavioural biases in the decision-making process.

Behavioural biases\(^{168}\) are those attitudes that affect the decision-making process and that may push a person (in this case, the legislator) to deviate from optimal practices to pursue sub-optimal ones. By drawing on behavioural studies, this section discusses the biases that may affect the introduction of the RCP eligibility criterion into the law of the RCP eligibility criterion [\textit{sub-section 6.6(a)(i)}] and suggests strategies to overcome them [\textit{sub-section 6.6(a)(ii)}]. The focus is on decision-making and the choices adopted at the institutional, legislative level.\(^{169}\)

6.6(a)(i) Biases in Real-World Decision-Making\(^{170}\)

Behavioural scholarship brings together insights from different disciplines such as economics,\(^{171}\) psychology,\(^{172}\) political science,\(^{173}\) law\(^{174}\) and sociology to

\(^{168}\)Behavioural studies have been subject to extensive criticism for their inability to explain some of their findings with reference to specific circumstances and case studies: see generally E Zamir, 'Loss Aversion and the Law' (2012) 65 Vand. L. Rev. 829, 841-42. Nevertheless, this thesis supports the majority view that people’s preferences, choices and judgments do generally depend on the biases analysed in \textit{sub-section 6.6(a)(i)}.

\(^{169}\)This is usually described as the “macro” level, as opposed to the “micro” level that looks at the actions, attitudes and decisions of creditors, corporations and other stakeholders. “Micro” level parties should have the primary interest to promote their welfare and well-being over any opposite consideration. They are not expected to look at the long-term implications of their behaviour. Legislatures, on the contrary, should be motivated by the need to promote the long-term welfare of the country. Hence it is their behaviour and not the one of micro players that is considered in this section. See Mevorach (n 83) 49.

\(^{170}\)For this portion of the thesis, the author is heavily indebted to Mevorach studies as reported in chapter 2 of \textit{The Future of Cross-Border Insolvency. Overcoming Biases and Closing Gaps} (OUP: Oxford, 2018).


study and predict the human behaviour under specific circumstances. As ‘legal thinking largely follows common sense morality’,\textsuperscript{175} it is contended that the conclusions of behavioural scholarship studies on the general population can be applied – with minimal yet relevant distinctions – to decision makers.

The efficacy of law and of policy recommendations often depends on its accounting for relevant patterns of human behaviour.\textsuperscript{176} A more informed understanding of legislature’s attitudes and biases may increase the well-being of society, provided that the recommendations are designed to promote value-enhancing and welfare-increasing solutions, as it is the case submitted in this thesis.

To discuss de-biasing strategies,\textsuperscript{177} it is necessary to identify the biases and reasons that induce the legislators to deviate from welfare-increasing behaviour.

The notion of heuristics\textsuperscript{178} and biases in judgment and decision-making was first introduced in the Seventies\textsuperscript{179} to account for deviations in real-life choices from optimal, value-maximising solutions. The literature that followed\textsuperscript{180}


\textsuperscript{175} Zamir (n 168) 833.


\textsuperscript{178} Rules of thumb or mental shortcuts relied upon by people in making judgments or choices.

\textsuperscript{179} A Tversky and D Kahneman, ‘Judgment under Uncertainty: Heuristic and Biases’ (1974) 185 Science 1124; D Kahneman and A Tversky, ‘Prospect Theory: An Analysis of Decisions under Risk’ (1979) 47 Econometrica 263 (arguing that the rational choice theory predominant in economics and influential in law according to which people chose to act in a way that maximise their expected utility is flawed).

\textsuperscript{180} See generally the papers on prisoner’s dilemma, loss aversion, endowment effect, status quo bias and bounded willpower mentioned in this thesis. In 1992 Tversky and Kahneman presented a modified version of their original, prospect theory: A Tversky and D Kahneman,
reinstated the view that people’s choices was dependent upon the way in which they framed the alternatives in front of them. However, behavioural scholars also demonstrated that deviations from optimal behaviour can be predicted, as they are determined by a mix of the following biases.

The first is the existence of a situation that has been described as the "prisoner’s dilemma", i.e. where the parties recognise that self-interested actions would fail to achieve a socially optimal result but, nevertheless, they are bound to betray the common good for a (potential) individual larger gain.

In the context of this study, decision makers may prefer an un-regulated approach to the definition of the requirements to file for corporate distress remedies even if they realise that this would result in strategic filings and practices of dubious legitimacy, such as “phoenix” filings. They may adopt what have been described as sub-optimal solutions in the hope that a larger number of companies from other jurisdictions would make use of their statutory framework to turn around their business.

This less restrictive approach promotes the expertise of the judiciary and the domestic legal economy of interested parties, such as lawyers and corporate distress practitioners. Unilateral changes may be perceived as giving competitive advantages to other jurisdictions which – such as Singapore and Dubai – are competing for the market of the same legal services.

---

182 See detailed discussion in sub-section 5.4(a) and literature in ftn 218, chapter five of this thesis.
183 In a typical “phoenix syndrome” scenario, an entrepreneur who controls the financially distressed Company A registers Company B, to which the assets of Company A are transferred in what appears to be fraudulent conveyance against the creditors of company A. Finch and Milman (n 1) 377-380 (discussing the nature, fairness and frequency of phoenix trading). See also: R Tomasic, ‘Phoenix Companies and Corporate Regulatory Challenges’ (1996) 6 Australian J. Corp. L. 461; Y Rotem, ‘Small Business Financial Distress and the “Phoenix Syndrome”: A Re-evaluation’ (2013) 22 Int’l Insol. Rev. 1.
Another element to be considered is people’s **loss aversion** attitude.\(^\text{184}\) This term describes people’s inclination to perceive outcomes not in terms of final states of wealth and welfare, but in terms of losses and gains (“prospect theory”).\(^\text{185}\) Numerous psychological studies have proven that people are more influenced by the potential losses arising from their choices rather than the probability and magnitude of potential gains\(^\text{186}\) in relation to a common baseline or reference point.\(^\text{187}\)

While people can have different loss aversion attitudes, governments as a rule of thumb are generally less risk-seeking than the general population, especially if they promote a conservative manifesto. As a result, the law (including corporate distress remedies) tends more readily and effectively to rectify unjustified losses than help people recover gains that they failed to obtain.\(^\text{188}\) In other words, it provides more instruments to maximise the return of contractual creditors rather than to promote the best use of capital.

Additionally, risk-averse attitudes may be magnified by the fact that more radical reforms tend to be approved at the beginning of the legislature, when the government is still enjoying popularity from the recent elections. In this period, governments want to promote and approve reforms that affect the general population, in the hope that the negative externalities arising from their enactments have been forgotten in time for the next general election.


\(^{185}\) See Tversky and Kahneman (n 180) 298.

\(^{186}\) See generally: Zamir (n 168). According to Mevorach, the subjective impact of losses is roughly twice that of gains: Mevorach (n 83) 56. This however appears to be a gross generalisation, especially when applied to the action of complex bodies such as governmental entities. The estimate is based on Tversky and Kahneman evidentiary conclusion that monetary losses loom larger than gains by a factor of 2.25: Tversky and Kahneman (n 180) 311.


\(^{188}\) Zamir (n 168) 832.
Due to the strong lobbying activity of corporate and professional bodies, reforms that affect the interest of businesses and groups numerously represented in the Congress or Parliament are usually postponed to the end of the legislature, where the reforming impetus of the government usually gives way to other, more contingent political considerations (i.e. not falling out with potentially rich and influential electoral supporters). Ambiguity and lack of statistical probabilities,\textsuperscript{189} as well as failed attempts in the past\textsuperscript{190} also have the potential to influence the loss aversion attitude of decision makers.

In the context of this study, loss aversion attitudes explain governments’ unwillingness to introduce significant changes into the law without the support of large, influential portions of the affected stakeholders or hard evidence of the expected benefits. Similarly, known biases that contribute to explain not the aversion, but why significant statutory reforms are few and far between, are the \textit{status quo bias}\textsuperscript{191} and the \textit{endowment effect},\textsuperscript{192} as first described by U.S. Supreme Court Oliver Wendell Holmes in 1897.\textsuperscript{193}

The first concept refers to people’s preference not to change their state of affairs. The second undermines the Coasean assumption that items have equal worth whether gained or lost,\textsuperscript{194} as it describes the situation whereby


\textsuperscript{191} Kahneman and Tversky (n 184) 348 (describing an experiment in which the majority of the surveyed subjects preferred to stay in their imaginary job despite of the alternative offer); W Samuelson and R Zeckhauser, ‘Status Quo Bias in Decision Making’ (1988) 1 J. Risk & Uncertainty 7; Kahneman (n 184) 197-199; RB Korobkin, ‘The Status Quo Bias and Contract Default Rules’ (1998) 83 Cornell L. Rev. 608.


\textsuperscript{193} ‘It is in the nature of a man’s mind. A thing which you enjoyed and used as your own for a long time, whether property or opinion, takes root in your being and cannot be torn away without your resenting the act and trying to defend yourself, however you came by it. The law can ask no better justification than the deepest instincts of man’: Kahneman (n 184) 204.

\textsuperscript{194} Mevorach (n 83) 57. See also: R Korobkin, ‘Wrestling with the Endowment Effect, or How to Do Law and Economics without the Coase Theorem’ in E. Zamir and D. Teichman (eds.), \textit{The Oxford Handbook of Behavioural Economics and the Law} (OUP: Oxford, 2014); D Kahneman and
individuals value things that they already own more than those which they do not own yet.\textsuperscript{195} These concepts are analysed together because their effect on behavioural choices is similar.

These aspects (and particularly the \textit{status quo} bias) explain the tendency (of people and decision makers alike) not to opt out of default arrangements,\textsuperscript{196} as the perceived disadvantages introduced by a new situation loom larger than the advantages.\textsuperscript{197} As a result, these biases may result in postponement of normative changes, as the decision makers do not objectively assess the positives and negatives arising from a regulatory change.\textsuperscript{198}

The endowment effect narrative has been criticised by some economists, who reported that discrepancies between one’s willingness to pay (‘WTP’) and willingness to accept (‘WTA’) a price diminishes with experience and in a market setting.\textsuperscript{199} It is also not true that people always fail to take actions or prefer to remain inactive. However, when they act, it is not always the case that rational considerations prevail over other elements. Studies in cognitive psychology have proven that under certain circumstances, people act against their own long-term interest.\textsuperscript{200}

This last bias has been labelled as \textit{"bounded willpower"} and the situation is best illustrated by the example of people who continue to smoke or abuse others, ‘Experimental Tests of the Endowment Effect and the Coase Theorem’ (1990) 98 J. Pol. Econ. 1325.

\textsuperscript{195} It is hardly surprising to observe that Coase theories do not work in corporate distress cases. As Skeel observed, ‘\textit{\textbf{b}ankruptcy isn’t exactly a place one expects to see the Coase theorem in action}’ due to the fact that it is an area of law full of intricate regulation and judicial intervention: Skeel (n 60) 949.

\textsuperscript{196} Mevorach (n 83) 81 (arguing that the transformation of modified universalism into customary international law (‘CIL’) would favour its adoption and consistency of interpretation throughout the world as CIL operates as a default, opt-out rule). See also: BC Madrian and DF Shea, ‘The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior’ (2001) 116 Q.J. Econ. 1149; Zamir (n 168) 839.

\textsuperscript{197} Samuelson and Zeckhauser (n 191).


\textsuperscript{199} P Knez and others, ‘Individual Rationality, Market Rationality, and Value Estimation’ (1985) 75 Am. Econ. Rev. 397; DL Coursey and others, ‘The Disparity Between Willingness to Accept and Willingness to Pay Measures of Value’ (1987) 102 Q.J. Econ. 679. In reply to their observations, Kahneman, Knetsh and Thaler conducted a new series of experiments to determine if the endowment effect applied in market contexts: Kahneman (n 194).

alcohol despite being aware of the negative consequences arising from their behaviour. Similarly, common knowledge and experimental studies show that people are more sensitive to changes when they benefit from direct, self-advantages rather than when they act in the interest of third parties (a bias known as "bounded self-interest").

6.6(a)(ii) Addressing Behavioural Biases

Where sub-section 6.6(a)(i) has evidenced the biases that influence Anglo-American decision makers, it is now time to suggest strategies to overcome them.

First and foremost, it looms the problem of how to counteract the prisoner’s dilemma bias. If people perceive that their actions, despite being directed to promote the common good, will be exploited by other participants for their own benefit and to the detriment of the game-changer, then the change is unlikely to occur in first place. However, it might be possible to minimize the negative woes associated with change if it is shown to decision makers that any regulatory change would lead to a domino-effect of similar changes around the world.

This peer effect\(^\text{201}\) is not unheard of in the legal field, particularly with reference to corporate distress practice. The history on the adoption and implementation of the UNCITRAL Model Law and its Guide\(^\text{202}\) is illustrative of this peer effect tendency.

The UNCITRAL Model Law represents a soft-law instrument that deals with the recognition of foreign proceedings and co-operation with foreign authorities in


cross-border corporate distress cases. Despite the criticisms,\textsuperscript{203} it offers a template of a law that the states can implement in their own legal systems with as few modifications as possible.

When enacted in 1997, it represented a significant step forward even when compared to the then most advanced laws in the field.\textsuperscript{204} The immediate result of the implementation of the UNCITRAL Model Law in domestic jurisdictions is a loss of sovereignty on cross-border corporate distress matters by states and the judiciary (if the main proceedings were located in a different country). Decision makers may therefore have feared – and probably did fear – that the adoption of the UNCITRAL Model Law would have resulted in competitive advantages for other countries.

However, the take-up rate of signatories has significantly and rapidly increased since the United States (2005) and the United Kingdom (2006) implemented the UNCITRAL Model Law in their systems.\textsuperscript{205} Before 2006, only eight jurisdictions had adopted a legislation based on the Model Law. Nowadays, the Model Law has been implemented in forty-six jurisdictions,\textsuperscript{206} including Australia, Canada, New Zealand and Singapore. This suggests that the United States and the United Kingdom played a leading role in determining the best policies and practices in the area of corporate distress. Countries from all over the world look at the changes in the law of these leading countries and – to a large extent – adopt the Anglo-American innovations into their statutes. Why should it be different if the U.S. and England introduced a new eligibility criterion based on the RCP standard?

To ensure uniformity and to strengthen the peer-effect, influential international institutions should back the Anglo-American regulatory agenda. This has been the case for the UNCITRAL Model Law. Its implementation into national law has

\textsuperscript{203} The UNCITRAL Model Law has been described as ‘an exercise in realism and the art of possible’: IF Fletcher, Insolvency in Private International Law (2\textsuperscript{nd} edn, OUP: Oxford, 2005) 453.

\textsuperscript{204} Mevorach (n 83) 40.

\textsuperscript{205} For a positive view of the adoption of the Model Law, see Mevorach (n 83) 75. For a more pessimist analysis, see SC Mohan, ‘Cross-Border Insolvency Problems: Is the UNCITRAL Model Law the Answer?’ (2012) 21(3) Int’l Insol. Rev. 199.

was made a condition for the supply of financial support by the International Monetary Fund (‘IMF’) to several countries.207

Additionally, the Financial Stability Board (‘FSB’), in cooperation with the IMF, has developed international standards – this draws on the lines of the UNCITRAL Model Law – for the resolution of cross-border insolvencies of systemically important financial institutions.208 More recently, a Judicial Insolvency Network (‘JIN’) from several jurisdictions has actively promoted communication and co-operation among courts in cross-border corporate distress cases, along the lines of the recommendations included in the UNCITRAL Model Law and Guide.

Finally, political science literature on public choice seems to assume that law replicates the strengths of interest groups: ‘what goes in the process is precisely what comes out, once it is suitably mixed in the legislative blender’.209 However, decisions and roles of single personalities (or, as in this case, states) sometimes may play a rather relevant, but always unnoticed role.

Moving to the analysis of the strategies to counter-act loss-aversion biases, it has been observed that loss-averse bodies more frequently choose risky options (such as to introduce far-reaching reforms) when they are required to adopt a positive action to prevent the realisation of net losses.210

The loss-aversion inclination could be limited if bills were framed on the work of commissions of experts, who are better placed to rigorously evaluate evidence from the industry and determine the impacts of recommended

---

207 This appears to have been the case for Greece, Japan and South Korea: Mohan (n 205) 207-08.
reforms. The IA 1986, which built on the Cork Report (1982),\textsuperscript{211} and the Bankruptcy Reform Act 1978,\textsuperscript{212} are examples of how ambiguity can be diminished and loss-averse tensions mitigated by exhaustive, preliminary works. Loss-aversion attitudes could therefore be counteracted if the conceptualisation proposed in this thesis was subject to open consultation before being translated into a bill.

It is also possible to address the negative externalities arising from the \textit{status quo} bias and endowment effect. \textit{Status quo} is not an objective concept: what matters the most is how interested parties (in this case, decision makers) \textit{perceive} reality.\textsuperscript{213} It is submitted that two strategies are possible to overcome these biases.

The first strategy, which has already been suggested in the past,\textsuperscript{214} is to present the suggested reforms as options that could increase gains rather than avoid losses. Alternatively, they could also be presented as the continuation of an established policy in the area, rather than a significant departure from previous strategy. This may aptly apply to the proposed regulatory changes, as they would not affect the pillars and fundamental goals of the Anglo-American corporate distress framework.

It has been demonstrated in the past\textsuperscript{215} that people tend to adopt strategies that they perceive as conformed to the existing \textit{status quo} as possible. The first strategy would not address this attitude, while the second approach could – admittedly, in a surreptitious way – present regulatory changes not only as gains, but also as a continuation or minor departures from the existing \textit{status quo}.

With reference to bounded willpower and self-interest, studies have demonstrated that an improvement in the flow of information and the


\textsuperscript{212} The Act culminated seven years of work by the Congress, Lawyers and the Commission on the Bankruptcy Laws of the United States (created by Congress on 24 July 1970).

\textsuperscript{213} Mevorach (n 83) 58.

\textsuperscript{214} Ibid 58.

\textsuperscript{215} Samuelson and Zeckhauser (n 191), showing that when participants were asked to choose the colour of their new car, the opted for one that was arbitrarily framed as the \textit{status quo}. 374
establishment of clear sanctions for lack of co-operation can result - in TCP scenarios - in the reduction of excess appropriation of resources and greater contribution to the public good.\textsuperscript{216} This suggests and reiterates the importance of establishing mechanisms that ensure the highest possible level of trust among the participants in the regulatory reform process and the public opinion.

\textbf{Sub-section 6.6(a)} has shown the important normative implications that have to be considered before designing a strategy aimed at reframing current corporate distress perceptions. A hearing in front of the Department for Business, Energy and Industrial Strategy (‘BEIS’) or an article in an influential law journal would probably not be able, in themselves, to attract not only sufficient, but also the right attention to promote the proposals included in this study. The way in which this project is presented to the legal community can significantly affect its chances of being implemented.\textsuperscript{217}

The nature of the proposal and the need to overcome established decision-making biases suggest an approach that promotes a debate and the achievement of a wide consensus on a reform proposal first at the level of the academic community, and secondly within the body of practitioners. If the Anglo-American corporate distress community supported this call for a change, there could be legitimate expectations to overcome the biases evidenced above.

\textbf{6.6(b) Avoiding Failure: Limits, Limitations and Delimitations of this Study}

\textit{«The power of a theory is directly proportional to the diversity of situations it can explain. All theories, however, have limits»}\textsuperscript{218}

\textbf{6.6(b)(i) Limits}

This research is \textbf{limited} by certain factors.

\textsuperscript{216} A Falk and others, ‘Appropriating the Commons: A Theoretical Explanation’ in E. Ostrom and others (eds), \textit{The Drama of the Commons} (The National Academies Press, 2002).

\textsuperscript{217} Among others: A Tversky and D Kahneman, ‘The Framing of Decisions and the Psychology of Choice’ (1981) 211 Science 453 (describing the different intake of a medical treatment depending on whether the data was presented in terms of expected death or survival).

First and foremost, few studies have been conducted on the topic and their focus has primarily been on preventing strategic filings or suggesting regulatory reforms. The papers that have discussed the normative underpinning of the Anglo-American corporate insolvency law and its interaction with contract law are few and far between.

From a methodological point of view, even if this study adopts a normative approach, it analyses a series of corporate distress cases. Relevant cases have been selected on the basis of the availability of data, their relevance for the topics debated in those chapters of this work and their role for the evolution of the corporate distress practice.

The proposed WMSI theory should apply across the whole corporate spectrum and, particularly, to MSME procedures because it is primarily in cases involving relatively small debtors that shareholders and employees are the real risk bearers of the company.

The dynamics of the filings affecting small and medium companies have been investigated elsewhere, as reported throughout this thesis. Large filings provide richer and more easily accessible information about the issues at play in corporate insolvency procedures. This reliance on large procedures for evidentiary purposes, while not being in itself representative of the whole industry, should nevertheless be capable of providing conclusions that go beyond the considered cases.

Finally, this thesis covers literature and case law published before 1 September 2018.

6.6(b)(ii) Limitations

This study also suffers from some additional limitations, i.e. potential weaknesses that could not be addressed by the author throughout the research and that may potentially affect its conclusions.

Leaving aside the bias determined by the researcher’s background, the primary limitation of this paper is the adoption of a legal perspective to corporate distress despite the need to make use of concepts conceived in other disciplines.
Purely economic, sociological or behavioural approaches are not considered for the purposes of this study. However, some of the conclusions of these studies - especially behavioural\textsuperscript{219} and corporate governance\textsuperscript{220} ones – have been considered to investigate the attitude and influence that certain stakeholders play in the corporate distress market.\textsuperscript{221}

While this thesis elaborates on these notions, it is not the purpose of this study to question the validity of commonly accepted conclusions in the disciplines mentioned above. In general, where possible and appropriate, this paper has privileged legal over alternative explanations of its key concepts.

Furthermore, it is possible that some of the conclusions of this paper may not find favourable application in civil law countries. This may primarily be ascribed to the lesser degree of discretion that civil law judiciaries enjoy, especially when compared to the wider latitude exercised by their common law colleagues. The dynamics of cross-border cases should also be subject to additional research in order to determine the adjustments (if any) that are needed to implement the WMSI theory in an international environment.

Lastly, the WMSI theory relies on the activism of stakeholders, especially communities, tort claimants and business competitors who have insofar played a marginal or no role in corporate distress procedures. To address this issue, Anglo-American policymakers

\begin{quote}
 should promote policy choices that encourage fairness in the allocation of benefits from the commons; grant autonomy to users for crafting, implementing and enforcing institutional arrangements [...] institutionalize low-cost mechanisms for the adjudication of disputes; [and] promote accountability.\textsuperscript{222}
\end{quote}

As a result, the factors that influence cooperation in RCP dilemmas have to be investigated and described in plain terms to allow the governments of these

\textsuperscript{220} Section 6.4 of this work.
\textsuperscript{222} Agrawal (n 213) 71.
countries to tune their laws to promote their involvement in corporate distress procedures.223

6.6(b)(iii) Delimitations

This paper is also limited by its scope. While acknowledging that the subject of the “foundations” of corporate distress law is significantly more complex, this thesis focused primarily on the analysis of the “limits” of this area of law. This has resulted in additional, consequential decisions.

The first ramification affects the methodology of this work and, in particular, its reliance on theoretical and doctrinal methods. This applied doctrinal methodology,224 rather than socio/legal interdisciplinary approach, is, however, justified by the nature of the research questions and it is in line with the expected contribution that this work makes.

The second ramification deals with the subject of this research. This thesis is concerned with the analysis of corporate cases only. Personal bankruptcies are not included in its scope, while reference to municipalities is only incidental. Despite the existence of “systemic” individual cases (and their increasing number and relevance for the corporate distress community),225 this would have excessively broadened the scope of this research, thus affecting the validity and soundness of its conclusions.

The third ramification is that this work, despite recognizing the potential implications that other disciplines (e.g. tax issues226 and employment law) have

---

223 Scholars in the field of psychology have already conducted similar studies: among others, see Kopelman (n 218).
224 See above section 1.5 of this thesis.
225 See, for instance, Curtis Jackson, aka ’50 Cents’, who filed for bankruptcy in 2015. The rapper’s appearance in U.S. bankruptcy courts triggered a lot of criticism (and extensive debate in the public opinion) over the laxity of filing requirements, the underlying reasons of this choice (i.e. to avoid the execution of a civil judgment against him) and the life style paraded by the allegedly bankrupt debtor during and after the proceeding. It also appeared that the rapper, who rose to prominence in 2003 with his debut studio album “Get Rich or Die Tryin’”, filed for bankruptcy to avoid an award for punitive damages in a trial against Ms. Leviston: DJ Cohen, ’50 Cent: You Love Him in a Bentley, But Would You Love Him on a Bus? 50's Creditors Have 21 Questions, and They're All About U.S. Bankruptcy Law’ Weil Bankruptcy Blog (2 February 2016) <https://business-finance-restructuring.weil.com/chapter-11-plans/50-cent-you-love-him-in-a-bentley-but-would-you-love-him-on-a-bus-50s-creditors-have-21-questions-and-theyre-all-about-u-s-bankruptcy-law/> accessed 17 September 2018.
226 For an analysis of the tax issues in turnaround cases arising from formal rescue and informal restructuring procedures in England and the U.S.: P Ridgway and others, Tax Issues in
on corporate distress practice, does not address these concerns. This is because the author believes that the effects of these rules on corporate distress cases should depend on the considerations which determine the scope and limits of corporate distress law and not the other way around.

While this paper considered judicial decisions from different jurisdictions, it did not adopt a comparative approach. This research focused on Anglo-American laws and issues. Foreign cases, laws and approaches were considered only if they informed the development of this area of law in the considered countries.

The decision to concentrate the research on the case law and statutes from England and the U.S. has been taken after careful consideration. These jurisdictions are characterised by lenient and flexible eligibility requirements for the enforcement of corporate distress rules and their courts are willing to rule on cases which only have a limited connection with these jurisdictions.\(^{227}\) They also provide a voluminous amount of easily accessible data, primarily with reference to in-court judicial rescue and liquidation procedures.

The decisions in all these cases tend to influence the evolution of a multitude of systems of laws.\(^{228}\) This also promotes the establishment of a customary international law\(^{229}\) or approach to corporate distress cases, since it has been

---


\(^{227}\) For instance, in the U.S. in *Re Global Ocean Carriers Ltd* 251 B.R. (Bankr. D. Del. 2000), the court held that it was sufficient to establish jurisdiction under s.1098(1) 11 U.S. Code the circumstance that a debtor had a small deposit in a U.S. bank account. However, in *Re McTague*, 198 B.R. 428 (Bankr. W.D.N.Y. 1996) it was held that placing property in the U.S. for the sole purpose of becoming eligible to file for insolvency may be treated as evidence of “bad faith” thus justifying a dismissal of a filing on that basis.

In England in *Re DTEK Finance BV* [2015] EWHC 1164 (Ch), [2015] WL 1839043 the Chancery Division of the High Court considered that the change in the governing law to English law created “sufficient connection” with the country to give an English court the authority to approve a scheme of arrangement. The scheme was proposed by a Dutch company which was part of a group that carried on an energy business in Ukraine, and which sought to renegotiate the value and maturity of loan notes governed by New York law.


observed that to shape the evolution of international law, not all states are created equal.\textsuperscript{230}

Finally, England and the United States are two countries separated out by a common law,\textsuperscript{231} with the result that each jurisdiction has developed a discrete but connected system of law and cases. English and American courts do not adopt the same approach to statutory interpretation and have a different understanding of the notion and relevance of the doctrine of precedent. For historical and constitutional reasons (i.e. lack of a federal system, powers of the Supreme Court, etc.), English judges adopt a stricter approach than their American colleagues, in general and in corporate distress cases as well. Yet, dialogue is constant, as the recent cases of \textit{Lehman} and \textit{Nortel} prove.

Lastly, it shall be observed that to conceptually design a system of laws and principles that meets the autonomy, legal predictability and inclusivity objectives, it would be necessary to carry out an extensive analysis of all the existing laws and provisions. This very same approach has been successfully adopted in recent times by Vanessa Finch (and David Milman),\textsuperscript{232} who challenged the adequacy of some of the existing corporate distress provisions and practices on the basis of four criteria: accountability, expertise, efficiency and fairness.

Due to the magnitude of work that such a research would require, the author reserves for himself the possibility of conducting at a later stage a theoretical analysis of whether existing laws meet the eligibility criteria mentioned above. Such an analysis would follow the structure of a similar research carried out by the author with reference to the treatment of executory contracts in English insolvency law.\textsuperscript{233}

\begin{flushright}
\textsuperscript{230} P Malanczuk, \textit{Akehurst’s Modern Introduction to International Law} (7\textsuperscript{th} edn, Routledge: London, 1997).
\textsuperscript{231} G Moss and others, ‘Giving Effect to Debt Compromise Arrangements – Binding the Minority or Out of the Money Classes of Creditors’ in Christopher Mallon and others (eds), \textit{The Law and Practice of Restructuring in the U.K. and U.S.} (2\textsuperscript{nd} edn, OUP: Oxford, 2017) 151. The authors relate their witicism to George Bernard Shaw’s quip: ‘\textit{England and America, two countries separated by common language}’.
\textsuperscript{232} Finch and Milman (n 1).
\end{flushright}
6.7 CONCLUDING REMARKS

The idea of corporate distress law being a safety net is based on a pivotal underpinning, shared by this text: markets are far from perfect, especially in downwards trends or in periods of financial crisis. As a result, corporate distress law (which is otherwise procedural in nature) should act as a “safety net”, that is should prevent (secured) creditors in a weak economy from collectively precipitating a downward spiral leading to a total economic collapse.

This chapter tested the validity of this claim by proposing and testing the introduction of a new eligibility criterion based on the RCP concept and by critically evaluating the WMSI theory against alternative taxonomies. Currently, neither in the U.S. nor in England admissibility to a corporate distress procedure is subject to an eligibility test that considers the effect of the decision to file on the controlling stakeholders. The risk bearer interests of some stakeholders affected by the decision and the relative relevance of their claims are generally neglected.

The RCP standard represents an attempt to introduce such evaluation and the de-constructivist analysis carried out in this chapter shows that the standard has the potential to improve the existing normative framework.

The promising results of this de-constructivist analysis suggest that the RCP standard should become one of the two criteria (alongside insolvency) which determine the enforceability of corporate distress remedies. This is because, overall, it performs in a more satisfactory manner than the criteria discussed in chapter five. In other words, the RCP standard has the potential to determine when general law remedies should give way to corporate distress ones. This could only be possible, however, within a new corporate framework which

234 Against: JW Bowers, according to whom ‘markets seem to be the only available devices which really do solve the problems of financial distress. [...] [M]arkets are efficient and bankruptcy procedures are not. That is the [...] implication of the only scientific empirical evidence’ ['Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses' (1994) 72 Wash. U. L.Q. 955, 976].

considers, protects and promotes the risk bearer interests of those who control the company.
«All models are flawed. In trying to capture merely the essence of a problem rather than the problem’s complexity, models suffer from incompleteness. But depending on the assumptions made in simplifying a complex reality, a model need not be inaccurate. A good model can stand a relaxation of its premises»

Stakeholders and scholars disagree on what constitutes the “proper function” of the corporate distress system: is it to promote the maximisation of creditors’ return, the autonomy of the parties or some overarching principles such as fairness and equality? The WMSI theory suggested in this thesis, coupled with the RCP and insolvency eligibility standards, allows the players to take any of these courses of action on the basis of the circumstances of the case, without preliminarily committing to a specific conceptual framework. This theory also addresses the major public policy concern that has justified this thesis, i.e. the lack of proper, statutory protection for those risk bearers who control distressed companies.

More importantly, this theory provides a more informed and refined approach to determine when, to what extent and if at all corporate distress rules, principles and judicial and business practices should depart from the common law of contract.

This thesis suggests that enforceability of corporate distress remedies and adoption of a particular course of action (i.e. assets’ or capital maximisation) should be dependent upon: a) the nature and characteristics of the dilemma faced by the debtor and its creditors (rather than on the need to promote specific policy goals); and b) the inability of the parties to reach an agreement on how to address solvency issues.

It is therefore argued that whenever parties face RCP or solvency dilemmas but are able to negotiate an agreement that pursues the best interest of all stakeholders (by means of consensual winding-ups, informal workouts or other

---

restructuring procedures), there should be no derogation from general contract law standards.

In hybrid procedures (such as pre-packs, schemes of arrangement or CVAs), statutory intervention and derogation from the general law of contracts should be kept to a minimum. In any case, when parties are incapable of reaching an agreement in the best interest of all stakeholders (RCP or solvency problems), the theory proposed in this thesis justifies the adoption and statutory enforcement of corporate distress remedies that derogate from the general law of contract.

This thesis does not adopt a “panacea” approach. It does not suggest that there is a correct, best or optimal way to address RCP and solvency situations. At the same time, it proposes some innovative solutions and a new conceptualisation of the law of corporate distress to ponder, protect and promote the interests of all stakeholders during hard times.

This study therefore argues and demonstrates that unitary, all-embracing models of the law of corporate distress (such as those discussed in chapters two to four) should be – where possible – avoided. It criticises current eligibility standards, suggests an alternative criterion and observes that to pursue the social goals that the parties expect from the corporate distress procedure self-imposed, bottom-up solutions may work better than state-imposed ones (chapters five and six). The inclusive, bottom-up RCP approach should ensure that the “service paradox”\(^2\) is avoided, especially in cases where the definition of the social goals of the procedure is problematic.

Reference to a revised rather than traditional common pool notion is justified upon the fact that the use of the traditional standard in existing insolvency procedures can produce sub-optimal results. It may allow informed creditors to

---

\(^2\) The “service paradox” has been defined as the condition in which the optimal solution is the less satisfactory for those who are supposed to be the beneficiary of the procedure: PD Aligica and PJ Boettke, Challenging Institutional Analysis and Development: The Bloomington School (Routledge: London, 2009) 33. In the case of corporate distress law, this thesis has clarified the need to consider the social goals of all those who have a controlling interest in the debtor. We would experience a “service paradox” situation whenever the law incentivises the use of procedures, which promote the interests of the debtor alone or those of a small category of claimants strictly linked with the debtor.
exploit their informational advantages over no or less-adjusting ones. It may be also incapable of considering, protecting and promoting the interests of residual-risk takers.

A basic governance principle highlighted by law and economics theorists (such as Baird and Jackson) is that those who profit from a transaction should also bear the consequences in case of failure. This thesis has demonstrated that the current Anglo-American corporate distress systems are not designed to achieve this objective.

These legal systems do not define clearly the conditions that shall exist for a company to file for corporate distress remedies. This situation prompts the adoption of sub-optimal and procedurally inefficient decisions from the people in charge of turnaround, rescue or liquidation procedures, as the cases discussed in this thesis demonstrate. In the period before the filing, decisions are taken by people (directors and shareholders) who are frequently out-of-money and have no residual interest in the company. This promotes the assumption of risky choices (such as gambling for the resurrection of the company),\(^3\) that are frequently detrimental to the interests of those who really control the company at that time. In the period following the filing, decisions are primarily taken for the benefit of in-money contractual creditors, thus ignoring the interests of other stakeholders.

In other words, the current system favours the externalisation of risk onto third parties. As these third parties have not yet been capable of acting in a concerted and co-ordinated way to lobby their interests in front of the legislator, there is a strong tendency in favour of maintaining the status quo despite its sub-optimal outcomes.

The judiciary tends to support this marginalization of key players. For instance, in the recent case of *Epic System v Lewis*,\(^4\) the Supreme Court held that when

---

\(^3\) In 1973, FedEx founder Frederick Smith was so desperate and short of cash to rely on gambling in Las Vegas to fund his company. He managed to turn the remaining $5,000 in the company's account to $27,000, thus allowing the company to buy enough time to find a solution with its creditors. By 1976, FedEx produced its first profit of $3.6 million. For a summary of these events, see: R Frock, *Changing How the World Does Business: FedEx's Incredible Journey to Success – The Inside Story* (Berrett-Koehler: San Francisco, 2006).

\(^4\) *Epic System Corp. v Lewis*, No. 16-285, 2018 WL 2292444 (U.S. May 21, 2018).
contrasting the 1925 Federal Arbitration Act (which allows employers to bar collective legal actions by employees if the latter sign employment agreements to arbitrate) and the 1935 National Labor Relations Act (which protects the rights of workers to act together against illegal actions from their employers), the former prevails.

The decision, by a 5-4 vote, has been vigorously criticised by left-wing politicians.\(^5\) It means that corporations can block workers from suing in a class suit for major violations of their rights, as workers are unlikely to take individual actions against large employers such as *Ernest & Young LLP*, *Epic Systems Corp.* and *Murphy Oil USA, Inc.* (the parties in the dispute) for a variety of reasons (cost, imbalance of power, lack of information, etc.). It also shows a lack of consideration for the voice and contributions that could come from these stakeholders, who are all but incentivised to actively exercise their controlling interests in the corporation.

Building on the literature that suggested a re-conceptualisation of insolvency as the law of corporate distress,\(^6\) this thesis argues for relying on corporate governance and principle-based theories to identify the controlling stakeholders of distressed corporations. Corporate distress law should not be considered as a liquidation or rescue tool, but as a problem-solving procedure aimed at achieving the optimally efficient and fair result for the benefit of the true controllers of the corporation facing RCP or solvency problems.

This work also argues for the opportunity to develop strategies to evaluate the portion of the rents created by risk bearers, as rights in corporate distress situations should not always be determined on the basis of the nominal value of the claim.

---

\(^5\) E Warren (Dem) (@SenWarren) 'In a decision written by Justice Gorsuch, the Supreme Court has ruled that corporations can block workers from suing together over major violations of their rights, like sexual harassment, discrimination, & wage theft. Congress should act to reverse this terrible decision’ (22 May 2018, 9:58 PM). Tweet.

There is a wide range of literature that suggests that stakeholders rather than shareholders are the residual “owners” of the company. However, for the purposes of this thesis there is no need to push the boundaries that far. Corporate distress law should not re-define who the owners of the company are. These are corporate governance issues that – if re-considered in corporate distress cases only – may result in partial and unsatisfactory outcomes, as well as in the creation of an incentive to file and behave strategically.

Corporate distress law should simply recognise the existence of residual risk bearers as the group who can claim legally enforceable (including risk bearer) expectations against the distressed company.

The law should also acknowledge that risk bearers are not a homogeneous group. The decisions of the people responsible for the corporate distress procedure should not necessarily correspond with the interests of the majority (in number or share) of risk bearers. These people should carefully consider the balance of interests of all the parties involved and the law should sanction any behaviour that grossly or fraudulently disregards the collective interest of the debtor.

As risk bearers are not on equal footing, decisions should weight their controlling rights. It might therefore be possible that the preferred course of action favours a minority (in number) of stakeholders if these decisions are in line with the goals of the procedure and the directions issued by the eligibility panel upon admission. If properly considered, these decisions should allocate the risk of future losses to those who will gain the most from potential profits.

For instance, a shareholder who owns the controlling stake in a small company and who is also a director or an employee of the same company is arguably

---

7 Blair argues that the limited liability principle contradicts the assumption that shareholders are the only residual claimant of a company: MM Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century (The Brookings Institution: Washington D.C. 1995) 27.

8 Such is reality, as empirically observed by LoPucki and Whitford: LM LoPucki and WC Whitford, ‘Corporate Governance in the Reorganization of Large, Publicly Held Companies’ (Jan. 1993) 141(3) U. Pa. L. Rev. 669, 673 (who demonstrated – albeit admittedly in a study only on forty-three large, public companies that filed and completed a Chapter 11 reorganisation between 1979 and 1988 – that in Chapter 11 neither assumption of shareholder control nor that of creditor control is correct).

9 This is the same pillar of the normative solution suggested by LoPucki and Whitford (n 8) 787.
among those who will suffer the most from the failure of the business. Similarly, the interests of employees who made company-specific investments and who developed highly-specialised skills with limited appeal from other companies or competitors should rank higher than commodity suppliers. The protection of their expectations may justify deviations from principles such as APR or rateable distribution of assets.

Ancillary to these considerations is the question of whether directors have a duty under the law (and not simply a moral obligation) to consider the interests and expectations of quasi-owners of the company. While common sense would lead to an affirmative answer, law should not be based on common sense only. However, as shown in section 4.3 of this thesis, other commentators and the judiciary have proven the existence of a general duty to consider the effects of directors’ decisions on the company’s risk bearers whenever the company faces corporate distress problems.

Finally, this thesis rejects the mainstream narrative according to which, in order to assess the limits of corporate distress law, it is necessary to determine those cases where contractual tenets prevail over corporate distress ones and vice versa. The same situation can be handled either with or without resort to corporate distress remedies. The ontological difference between corporate and corporate distress law is that, while the first deals only occasionally with RCP or solvency dilemmas, the latter is primarily designed to provide a forum and rules to address RCP and solvency problems.

In the author’s view, there is no need to press for radical changes to the law or to the management of corporate distress procedures, or to develop a new business or legal culture.

The proposed measures are expected to enhance inclusivity in corporate distress procedures (by giving a right of audience to stakeholders who would

---

11 This duty exists even outside corporate distress cases: see Omnicare, Inc. v Laborers Dist. Council Const. Indus. Pension Fund, 135 S. Ct. 1318, 191 L. Ed. 2d 253 (2015) where the Supreme Court held that Congress adopted § 11 of the Securities Act of 1933, concerning registration statements for public offerings of securities, to ensure that issuers tell the whole truth to investors. For that reason, literal accuracy is not enough: an issuer must as well desist from misleading investors by saying one thing and holding back another.
otherwise have been ignored) and the autonomy of the parties (by considering statutory remedies as a last resort solution to RCP dilemmas). It is also submitted that the implementation of a problem-informed approach to corporate distress would result in the long-run in higher levels of predictability in the legal and commercial communities, as well as in a reduction of time and complexities of existing procedures.

As the World Bank and the economic literature on the subject prove, these changes should result in higher return rates for creditors, as well as in lenders being more willing to lend. If this is the case, this thesis would have produced meaningful changes and impact on the lives of many people in the jurisdictions of this study and – subject to further research – of a potentially larger audience.

Instead of offering a single solution (the WMSI theory) to a single problem (RCP issues in corporate distress cases), this thesis offers a new conceptualisation of the approach to corporate distress and it suggests new mechanisms by which stakeholders may extricate themselves from RCP and solvency problems.

7.1 Suggestions for Further Research

There are some aspects linked to the core subject of this research that would benefit from further research.

One of them is the concept of risk bearer interest. The author has suggested that such interest should be codified at least with reference to corporate distress situations, in order to give proper guidance to the parties affected by the company’s distress and the corporate distress procedure. Whether and to what extent these rights should be recognised outside of corporate distress cases and influence corporate decisions is a matter that has not been addressed in this thesis as it fell outside its scope.

Another aspect is the study of mechanisms to promote trust among stakeholders. It has been proven that successful solutions devised by “appropriators” (alias controlling stakeholders) in TCP or RCP situations shared some common characteristics. In these successful cases, the majority of the
participants had similar information and the person or group of people in charge to develop a strategy had a good reputation and was interested in maintaining that record. This finding suggests that there is no need to rely on or promote the use of statutory remedies if the stakeholders can address RCP dilemmas on a contractual basis. The participants in the corporate distress framework should promote contractual over regulatory approaches by building communication and trust among the participants.

Linked to this point, it is suggested that further research should be undertaken to investigate means that promote cooperation and timely actions among stakeholders, including artificial intelligence. It is a truism to say that organizing stakeholders so that they would act in a collective manner is an uncertain and complex effort. This is especially true when the parties face a RCP dilemma and a selfish stakeholder may realize that by acting first he or she might receive a higher return. Selfish, opportunistic behaviour is also promoted by the fact that individuals attribute less value to higher benefits that they expect to receive in the distant future compared to lower but certain benefits that they expect to receive in the immediate future.

Any system that wished to maximise the wealth of those stakeholders who have legally enforceable interests against the debtor shall consider that individuals’ actions are affected by at least four variables: expected benefits, expected costs, internal norms and discount rates. The preferred solution should be tested against these factual findings, as it should prove not theoretically “optimal” but empirically successful. On the basis of some behavioural studies conducted by Ostrom, it is submitted that such system should incentivize the participation of all affected stakeholders, include monitoring systems (and sanctions for those who breach the rules) preferably administered by the participants themselves, and feature conflict-resolution mechanisms.

---

13 Ibid 34.
14 Ibid 90.
BIBLIOGRAPHY

Books and Chapters

- Asch E, ‘Effects on Group Pressure upon the Modification and Distortion of Judgments’ in H Guetzkow (ed), *Groups, Leadership and Men; Research in Human Relations* (Carnegie Press: Lancaster, 1951)
- **Bomey N**, *Detroit Resurrected: To Bankruptcy and Back* (W.W. Norton & Co., Inc.: New York, 2016)
- **Bromley DW**, *Making the Commons Work: Theory, Practice, and Policy* (Institute for Contemporary Studies: San Francisco, 1992)
- **Bufford SL** and others, *International Insolvency* (Federal Judicial Center 2001)
- **Capinski M** and Zastawniak T, *Credit Risk* (CUP: Cambridge, 2016)
- **Chandler AD, Jr.**, *Scale and Scope. The Dynamics of Industrial Capitalism* (Belknap Harvard University Press: Cambridge, MA, 1990)


Gross K, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University: New Haven, 1997)
- Hess and others (eds), The Implementation of the New Insolvency Regulation: Improving Cooperation and Mutual Trust (Hart Publishing: Baden-Baden, 2017)
- Keay A, Directors’ Duties (Jordan Publishing: Bristol 2009)
- Libecap GD, Contracting for Property Rights (CUP: Cambridge, 1989)
- Mitchell RB, ‘Heterogeneities at two levels: States, non-state actors and international oil pollution’ in R Keohane and E Ostrom (eds), *Local Commons and Global Interdependence; Heterogeneity and Cooperation in Two Domains* (Sage: London, 1995)


- Wessels B, ‘Cross-Border Insolvency Agreements: What are they and are they here to stay?’, in Faber and others (eds), *Insolventie en Overeenkomst* (Wolters Kluwer: Alphen aan den Rijn, 2012)


Journal Articles


Adler BE, ‘Finance’s Theoretical Divide and the Proper Role of Insolvency Rules’ (1994) 67 S. Cal. L. Rev. 1107


Aghion P and others, ‘The Economics of Bankruptcy Reform’ (Oct. 1992) 8(3) J.L. Econ. & Org. 523


Alces KA, ‘Strategic Governance’ (2008) 50 Ariz. L. Rev. 1053

Alchian AA and Demsetz H, ‘Production, Information Costs, and Economic Organisation’ (1972) AER 777

Allaj E, 'Risk measuring under liquidity risk' (2017) 24(3) Applied Mathematical Finance 246


Allison D, 'The Supreme Court Decision in Eurosail' (2013) 10(5) Int. C.R. 288


Anderson H, 'Six of the Best: The Record of the Supreme Court in the Insolvency Cases Decided in its First Four Years' (2014) J. Bus. Law 194

Anderson H, 'What is the Purpose of Insolvency Proceedings?' (2016) 8 J. Bus. Law 670


Arsalidou D, 'Directors’ Fiduciary Duties to Shareholders: the Platt and Peskin Cases' (2002) 23(2) Comp. Law. 61


Ayotte K and Skeel DA Jr., 'Bankruptcy or Bailouts?' (2010) 35 J. Corp. L. 469
- Ayotte K and Skeel DA, Jr., 'Bankruptcy Law as a Liquidity Provider' (Fall 2013) 80(4) U. Chi. L. Rev. 1557
- Ayotte KM and Morrison ER, 'Creditor Control and Conflict in Chapter 11' (July 2009) 1(2) J, Legal Analysis 511
- Ayres N, 'The Eurosiel Ship has Sailed... and Left Muddied Waters in its Wake' (2014) 7(2) C.R. & I. 66
- Baird DG, 'Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren' (Summer 1987) 54(3) U. Chi. L. Rev. 815


• Bebchuck LA and Chung HF, 'Bargaining and the Division of Value in Corporate Reorganization' (1992) 8(2) J.L. Econ. & Org. 253


• Benartzi S and Thaler RH, 'Myopic Loss Aversion and the Equity Premium Puzzle' (1995) 110 Q.J. Econ. 73

• Benson M, 'Promoting a Culture of Corporate Restructuring in Australia: Some Suggestions' (2015) 12(2) Int. C.R. 104

• Bergamini E and others, 'Restructuring the Alitalia Business Model' (2010) 16(1) Journal of Air Transport Management 16

• Beria P and others, 'Alitalia: The Failure of a National Carrier' (2011) 17(4) Journal of Air Transport Management 215

• Berle AA Jr., 'For Whom Corporate Managers are Trustees: A Note' (1932) 45 Harv. L. Rev. 1365

• Bernoulli D, 'Exposition of a New theory on the Measurement of Risk' (1738), reprinted in (1954) 22 Econometrica 23 (Louise Sommer trans.)


• Betker BL, 'Management's Incentives, Equity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcies' (Apr. 1995) 68(2) J. Bus. 161

• Bharath S and Shumway T, 'Forecasting default with the Merton distance to default model' (2008) 21(3) Rev. Financial Stud. 1339

• Black J, 'The Emergence of Risk Based Regulation and the New Public Risk Management in the UK' (2005) PL 512


- Browning G, 'Using Bankruptcy to Reject Labor Contracts’ (1984) 70(2) ABA 60
- Brudney V, 'Corporate Bondholders and Debtor Opportunism: In Bad Times and Good' (1992) 105 Harv. L. Rev. 1821
- Budnitz ME, 'Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, Or Should the Meeting Be Canceled Altogether?’ (1990) 58 Geo. Wash. L. Rev. 1214
- Campbell RB, Jr. and Frost CW, 'Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)' (2007) 32(3) J. Corp. L. 491
- Ciriacy-Wantrup SV and Bishop RC, 'Common Property as a Concept in Natural Resources Policy' (1975) 15(4) Natural Resources Journal 713
- Cohen MR, 'The Basis of Contracts' (1933) 46 Harv. L. Rev. 533
- Coursey DL and others, 'The Disparity Between Willingness to Accept and Willingness to Pay Measures of Value' (1987) 102 Q.J. Econ. 679


• Daigle KH and Maloney MT, 'Residual Claims in Bankruptcy: An Agency Theory Explanation' (Apr. 1994) 37(1) J.L. & Econ. 157


• de Barondes R, 'Fiduciary Duties of Officers and Directors of Distressed Corporations' (1998) 7 Geo. Mason L. Rev. 45


• de Weijs RJ, 'Harmonisation of European Insolvency Law and the Need to Tackle Two common Problems: Common Pool and Anticommons' (2012) 21 Int. Insolv. Rev. 67

• de Weijs RJ, 'Too Big to Fail as a Game of Chicken with the State: What Insolvency Law Theory Has to Say About TBTF and Vice Versa' (2013) 14 EBOR L. Rev. 201


- Duncan NJ and Hutchinson T, ‘Defining and Describing What We Do: Doctrinal Legal Research’ (2012) 17(1) Deakin L. Rev. 83
- Edmister R, ‘An empirical test of financial ratio analysis for small business failure prediction’ (1972) 7(2) JFQA 1477
- Elhauge E, ‘Sacrificing Corporate Profits in the Public Interest’ (2005) 80 N.Y.U. L. Rev. 733
- Ellesberg D, ‘Risk, Ambiguity and the Savage Axioms’ (1961) 75(4) Q.J. Econ. 643
- Erlanger H and others, ‘Foreword: Is It Time for a New Legal Realism’ (2005) Wis. L. Rev. 335


▪ **Feldman Y and others**, ‘Reference Points and Contractual Choices: An Experimental Examination’ (Sept. 2013) 10(3) J. Empirical Legal Stud. 512

▪ **Fennell LA**, ‘Homeownership 2.0’ (2008) 102 Nw. U. L. Rev. 1047

▪ **Finch V**, ‘Directors’ Duties Towards Creditors’ (1989) 10(1) Comp. Law. 23


▪ **Finch V**, ‘Pre-packaged Administration and the Construction of Propriety’ (2011) 11(1) J.C.L.S. 1

▪ **Fisher R**, ‘*Eurosail* and Balance Sheet Insolvency: Are We Any Clearer?’ (2013) 6(4) C.R. & I. 83


▪ **Fletcher IF and Wessels B**, ‘A Final Step in Shaping Rules for Cooperation in International Insolvency Cases’ (2012) 9(5) Int. C.R. 283

▪ **Flynn DM and Farid M**, ‘The Intentional Use of Chapter XI: Lingering Versus Immediate Filing’ (1991) 12(1) SMJ 63

▪ **Frisby S**, ‘Making a Silk Purse Out of a Pig’s Ear’ (2000) 63(3) M.L.R. 413


• Garvey GT and Swan PT, ‘The Economics of Corporate Governance: Beyond the Marshallian Firm’ (1994) 1 J. Corp. Fin. 139


• Griffiths M and others, ‘BNY Corporate Trustee Services Ltd v Eurosail UK 2007-3BL and others: The High Court Clarifies the Balance Sheet Insolvency Test’ (2011) 8(2) Int. C.R. 152


• Guidotti R, ‘Emersione della Crisi e Opportunità di Risanamento’ (24 November 2016) IlCaso.it
- Gullifer L, “‘Sales’ on Retention of Title Terms: Is the English Law Analysis Broken?” (2017) 133(Apr) L.Q.R. 244
- Hannigan Tl and others, ‘Competition and competitiveness in the US airline industry’ (2015) 25(2) Competitiveness Review 134
- Hardin G, ‘The Tragedy of the Commons’ (1968) 162 Science 1243
- Hartman RF, ‘Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?’ (1993) 50 Wash. & Lee L. Rev. 1761
- Helms C, ‘Corporate Short-Termism: Causes and Remedies’ (2012) 23(2) I.C.C.L.R. 45
- Henderson D, ‘Inability to Pay Debts: Where Are We Now?’ (2011) 24(4) Insolv. Int. 54
- Kahneman D, ‘New Challenges to the Rationality Assumption’ (March 1994) JITE 18


Knez P and others, ‘Individual Rationality, Market Rationality, and Value Estimation’ (1985) 75 Am. Econ. Rev. 397

• Korobkin DR, ‘Contractarianism and the Normative Foundations of Bankruptcy Law’ (1992) 71 Tex. L. Rev. 541
• Korobkin DR, ‘The Role of Normative Theory in Bankruptcy Debates’ (1996) 82 Iowa L. Rev. 75
• Korobkin RB and Guthrie C, ‘Heuristic and Biases at the Bargaining Table’ (2004) 87 Marq. L. Rev. 795
• Korobkin RB and Ulen TS, ‘Law and Behavioural Science: Removing the Rationality Assumption from Law and Economics’ (2000) 88 Cal. L. Rev. 1051
• Leslie S, ‘Changes Made to Insolvency Legislation on 1 October 2015’ (2015) 5 CRI 210
• Lévy L, ‘Arbitration and Bankruptcy: Bankruptcy or Arbitration?’ (2011) 5 D.R.I. 103
- **Longhofer SD**, ‘Absolute Priority Rule Violations, Credit Rationing, and Efficiency’ (July 1997) 6(3) JFI 249
- **LoPucki LM and Whitford WC**, ‘Bargaining over Equity’s Share in the Bankruptcy Reorganisation of Large, Publicly Held Companies’ (1990) 139(1) U. Pa. L. Rev. 125
- LoPucki LM and Whitford WC, ‘Corporate Governance in the Reorganization of Large, Publicly Held Companies’ (Jan. 1993) 141(3) U. Pa. L. Rev. 669


• Lubben SJ, ‘The Board’s Duty to Keep Its Options Open’ (2015) U. Ill. L. Rev. 817


• Macaulay S, ‘Contracts, New Legal Realism, and Improving the Navigation of The Yellow Submarine’ (2005) 80 Tul. L. Rev. 1161


• Mamutse B and Fogleman V, ‘Improving the Treatment of Environmental Claims in Insolvency’ (2013) 5 J.B.L. 486


Mayhew LH, ‘Institutions of Representation: Civil Justice and the Public’ (1975) 9 L. and Soc’y Rev. 401

McAdams RH, ‘Beyond the Prisoner’s Dilemma; Coordination, Game Theory and the Law’ (2009) 82(2) S. Cal. L. Rev. 209


• Miles TJ and Sunstein CR, ‘The New Legal Realism’ (2008) 75(2) U. Chi. L. Rev. 83
• Millet R, ‘Cross-Border Insolvency and Arbitration: A Collision of Spheres?’ (2011) 5 D.R.I. 113
• Milman D, ‘Test of Commercial Insolvency Rejected’ (1983) 4 Comp. Law. 231
• Mirzai N, ‘Ipso facto clauses: should they be enforceable under Pt 5.3A?’ (2011) 19(4) Insolv. L.J. 4
• Montgomery DW, ‘Markets in Licenses and Efficient Pollution Control Programs’ (1972) 5 J. Econ. Theory 395
- Morrison ER and others, ‘Rolling Back the Repo Safe Harbors’ (2014) 69(4) Bus. Law. 1015
- Mucciarelli F, ‘Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension’ (2013) 14 EBOR L. Rev. 175
- Nadelman KH, ‘Bankruptcy Treaties’ (1944) 93 U. Pa. L. Rev. 58, 59
- Oi WY, ‘Labor as a Quasi-Fixed Factor’ (1962) 70(6) J. Political Econ. 538
- Opie H, ‘Kinsela and Anor v Kinsela Pty Ltd (in liq.)’ (1986) 15 Melbourne Univ. L. Rev. 762
- Paterson S, ‘Rethinking Corporate Bankruptcy Theory in the Twenty-First Century’ (2016) 36(4) OJLS 697
- Pound R, ‘Law in Books and Law in Action’ (1910) 44 Am. L. Rev. 12
- Rabin M, ‘Psychology and Economics’ (March 1998) 36 J. Econ. Lit. 11
- Roe MJ, ‘Corporate Short-Termism – In the Boardroom and in the Courtroom’ (2013) 68(4) Bus. Law. 977
- Roe MJ and Joo-Hee Chung, ‘How the Chrysler Reorganization Differed from Prior Practice’ (2013) 5(2) J. Legal Analysis 399
- Schillig M, ‘Corporate Insolvency Law in the Twenty-First Century: State Imposed or Market Based?’ (2014) J.C.L.S. 1
• Schwarcz SL, ‘Rethinking a Corporation’s Obligations to Creditors’ (1996) 17(3) Cardozo L. Rev. 647
• Schwartz A, ‘Contracting About Bankruptcy’ (1997) 13(1) J. L. Econ. & Org. 1227
• Scott RE, ‘Through Bankruptcy with the Creditors’ Bargain Heuristic’ (Spring 1986) 53(2) U. Chi. L. Rev. 690
• Shanker MG, ‘The Abuse and Use of Federal Bankruptcy Power’ (Fall 1975) 26(3) Case W. Res. L. Rev. 3
• Shumway T, ‘Forecasting bankruptcy more accurately: a simple hazard model’ (2001) 74 J. Bus. 101
• Singh R, ‘Jon Moulton Makes U-Turn on Pre-Packs’, Accountancy Age (18 June 2010)
• Sjostrand E, 'Effects of Insolvency proceedings in the Context of the EC Insolvency Regulation' (2009) 2(6) C.R. & I. 249

• Skeel DA, Jr., 'Rethinking the Line Between Corporate Law and Corporate Bankruptcy' (1993) 72 Texas L. Rev. 471

• Skeel DA, Jr., 'Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware' (1998) 1 Del. L. Rev. 1

• Skeel DA, Jr., ‘What’s So Bad about Delaware?’ (2001) 54 Vand. L. Rev. 309

• Skeel DA, Jr., 'Creditors’ Ball: The “New” New Corporate Governance in Chapter 11’ (Dec. 2003) 152(2) U. Pa. L. Rev. 917


• Skeel DA, Jr. and Jackson TH, 'Transaction Consistency and the New Finance in Bankruptcy' (2012) 112 Col. L. Rev. 152

• Smith HE, ‘Semicommon Property Rights and Scattering in the Open Fields’ (2000) 29 J. Legal Stud. 131

• Smith HE, ‘Governing the Tele-Semcommons’ (2005) 22 Yale J. on Reg. 289


• Solomon SMD, ‘Uncomfortable Embrace: Federal Corporate Ownership in the Midst of the Financial Crisis’ (2011) 95 Minn. L. Rev. 1733

• Sternberg E, ‘The Defects of Stakeholder Theory’ (1997) 5(1) Corporate Governance 3

• Stout LA, ‘Bad and Not-So-Bad Arguments for Shareholder Primacy’ (2002) 75 S. Cal. L. Rev. 1189


• Sullivan CR and Thaler RH, 'Libertarian Paternalism Is Not an Oxymoron’ (Autumn 2003) 70(4) U. Chi. L. Rev. 1159


• Taffler RJ and Tisshaw H, ‘Going, going, gone - four factors which predict’ (1977) 88(1003) Accountancy 50


• Toube F and Rumley J, ‘A Brave New World? Should the UK Ban Ipso-Facto Clauses in Non-Executory Contracts?’ (2018) 31(3) Insolv. Int. 78

• Triantis G, ‘The interplay Between Liquidation and Reorganisation in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines’ (1996) 16 Int’l Rev. Law & Econ. 101

• Trubek LG, ‘Crossing Boundaries: Legal Education and the Challenge of the “New Public Interest Law”’ (2005) Wis. L. Rev. 455

• Tversky A and Fox CR, ‘Ambiguity, Aversion and Comparative Ignorance’ (1995) 110(3) Q.J. Econ. 585


• Vaccari E, ‘OW Bunker: A Common Law Perspective on Multilateral Cooperation in Insolvency-Related Cases’ (2017) 7 I.C.C.L.R. 245

• Vaccari E, ‘Municipal Bankruptcy Law: A Solution Which Should Not Become a Problem’ (2017) 5 NIBLEJ 02

• Vaccari E, ‘The Ammanati Affair: Seven Centuries Old, and Not Feeling the Age’ (2018) 93(3) Chi.-Kent L. Rev. 831


- Walton P, ‘Pre-packaged Administration — Trick or Treat?’ (2006) 19 Insolv. Int. 113
- Walton P, ‘When is Pre-Packaged Administration Appropriate? — A Theoretical Consideration’ (2011) 20 Nott. L.J. 1
- Walton P, ‘“Inability to Pay Debts”: Beyond the Point of No Return?’ (2013) 2 J. Bus. Law 212
- Warburton AJ, ‘Understanding the Bankruptcies of Chrysler and General Motors: A Primer’ (2009) 60 Syracuse L. Rev. 531
- Warren E, ‘Bankruptcy Policy’ (Summer 1987) 54(3) U. Chi. L. Rev. 775
- Warren E, ‘The Untenable Case for Repeal of Chapter 11’ (Nov. 1992) 102(2) Yale L.J. 437
- Wee MS, ‘Misconceptions About the “unable to pay its debts” Ground of Winding Up’ (2014) L.Q.R. 648
- Wee MS, ‘Understanding Commercial Insolvency and its Justifications as a Test for Winding Up’ (2015) 1 LMCLQ 62
- West MS, ‘Life After Bildisco: Section 1113 and the Duty to Bargain in Good Faith’ (1986) 47 Ohio St. L.J. 65


Weston IF, ‘Some Economic Fundamentals for an Analysis of Bankruptcy’ (1977) 41 Law & Contemp. Probs 47


Wright ND and others, ‘Manipulating the Contribution of Approach-Avoidance to the Perturbation of Economic Choice by Valence’ (2013) 7 Frontiers in Neuroscience 1


Reports, Working and Consultancy Papers

- American Bankruptcy Institute’s Report of the Commission to Study the Reform of Chapter 11
- Arthurs HW, Law and Learning: Report to the Social Sciences and Humanities Research Council of Canada by the Consultative Group on Research and Education in Law (Information Division, Social Sciences and Humanities Research Council of Canada: Ottawa, 1983)
- **Company Legislation and Regulatory Framework Committee**, Final Report (Singapore, 2002)
- **Conway L.**, *Phoenix Trading and Liability of Directors* (House of Commons, 28 March 2017), Paper no. CPB 4083
- **Corporations and Market Advisory Committee**, ‘Rehabilitating Large and Complex Enterprises in Financial Difficulties’ (Canberra, 2004)
- **Cosh A and Hughes A.**, *British Enterprise: Thriving or Surviving?* (ESRC Centre for Business Research: Cambridge, 2007)
- Graham T CBE, *Graham Review into Pre-Pack Administration: Report to The Rt Hon Vince Cable MP* (The Insolvency Service, 16 June 2014)
- Jackson TH, ‘Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization or Liquidation of Large Financial Institutions’ (Hover Institution, Stanford University 2014)
- Kahan M and Rock EB, ‘When the Government is the Controlling Stakeholder’ (2011) *Faculty Scholarship* Paper 316
- Legal Committee of the Companies and Securities Advisory Committee, ‘Corporate Voluntary Administration - Report’ (Canberra, 1998)
- Legal Department of the International Monetary Fund, *Orderly & Effective Insolvency procedures: Key Issues* (Washington D.C. 1999)
Ministry of Law, ‘Summary of Feedback from the Public Consultation on the insolvency Law Review Committee (ILRC) Report and Minlaw’s Response’ (Singapore, 2014)

Moorhouse A, Data on Lending to UK SMEs (Bank of England, March 2015)


Parliamentary Joint Committee on Corporations and Financial Services, ‘Corporate Insolvency Laws: a Stocktake’ (Canberra, 2004)


Rhodes C, Business Statistics (HC 2017-06152, 28 December 2017)


Newsclips and Articles

Alderman L, ‘Alitalia Files for Bankruptcy, but Italy Balks at a Third Bailout’ The New York Times (New York, 2 May 2017)

Anna.Aero Staff, ‘Would Alitalia be missed in Italy? Only has 9% of international seats this summer; EasyJet, Ryanair and Vueling could take up domestic slack’ Anna.Aero (10 May 2017)


Babington D and Vagnoni G, ‘UPDATE 3- Italy agrees sale of Alitalia to CAI consortium’ Reuters (London, 19 November 2008)


Beall P, ‘‘The Big Wink:’ How $1.8 billion loan boosted company’s founder’ Palm Beach Post (Palm Beach, 12 January 2016)


\textbf{Brickley P}, ‘Voya Sues Over Millennium Health $1.8 Billion Financing’ \textit{The Wall Street Journal} (New York, 10 December 2015)

\textbf{Butler S}, ‘How Philip Green’s family made millions as value of BHS plummeted’ \textit{The Guardian} (London, 25 April 2016)


\textbf{Carvlin E}, ‘Detroit Uses COPs to Shift Pension Burden and Set a Few Records’ \textit{The Bond Buyer} (New York, 28 December 2005)

\textbf{Ciancio A}, ‘Alitalia risks crash landing before new takeoff” \textit{La Stampa} (Torino, 2 May 2017)


\textbf{Coppola G}, ‘How to lease a $50,000 BMW for $54 a month’ \textit{Bloomberg News} (New York, 17 May 2018)


\textbf{Finnerty J}, ‘Car recycling: how much of your old car is reused’ \textit{Auto Express} (London, 14 April 2016)


\textbf{Gelles D and Tett G}, ‘From behind bars, Madoff spins his story’ \textit{Financial Times} (London, 8 April 2011)

\textbf{Griffiths K}, ‘Carillion auditors under fire’ \textit{The Times} (London, 16 January 2018)


\textbf{Herman M}, ‘ Abuse of pre-pack deals ‘could turn Britain into an insolvency brothel’ \textit{The Times} (London, 18 January 2010)
- **JATO Press Release**, ‘Global car sales up by 2.4% in 2017 due to soaring demand in Europe, Asia-Pacific and Latin America’ (20 February 2018)
- **Jith M**, ‘Goodbye Tesla, This. Is. Singapore.’ OneShift.com (Singapore, 31 January 2018)
- **Key A**, ‘EasyJet agrees employment terms to save 1,000 Air Berlin jobs’ City A.M. (London, 3 November 2017)
- **Kwan Yuk P**, ‘Tesla shares sink following disclosures about fatal crash’ Financial Times (New York, 2 April 2018)
- **McGrath C and Stinson N**, ‘Collapse of Virgin Train East Coast deal leaves taxpayers £2BILLION out of pocket’ Express.co.uk (London, 17 May 2018)
- **Meredith S**, ‘Facebook-Cambridge Analytica: A timeline of the data hijacking scandal’ CNBC (New York, 10 April 2018)
- **Odell M and Rovnick N**, ‘BA Agrees Deal with Union to Close Final Salary Pension Scheme’ Financial Times (London, 8 December 2017)
- **Payne S**, ‘East Coast collapse gives a boost to UK Rail privatisation’ Financial Times (London, 16 May 2018)
- **Pogliotti G**, ‘Alitalia, la dote del prestito lievita di 300 milioni e il rimborso slitta a settembre’ Il Sole 24 Ore (Milano, 13 October 2017)
- **Ram A and Kuckler H**, ‘Cambridge Analytica shuts down and blames ’media siege” Financial Times (London, 2 May 2018)
- **Raymond N**, ‘Johnson & Johnson ordered to pay $417m to woman claiming to have developed ovarian cancer from baby powder’ The Independent (London, 22 August 2017)
- **Reuters Staff**, ‘Italy kicks off Alitalia sale process’ Reuters (London, 18 May 2017)
- **Rogers A**, ‘Cambridge Analytica shuts down following Facebook data scandal’ City A.M. (London, 2 May 2018)
- Schmitt E, ‘People Express Flights End on a Note of Regret’ The New York Times (New York, 1 February 1987)
- Scott B, ‘Private Equity Defends Pre-packs’ Real Business (30 January 2012)
- Simson C, ‘UN To Take On Murky Intersection of Arbitration & Insolvency’ Law360 (6 December 2016)
- Smale K, ‘Arup to act as DfT adviser in East Coast franchise collapse’ New Civil Engineer (London, 17 May 2018)
- Unnamed, ‘Directors put Cambridge Analytica into administration’ Company Rescue (London, 8 May 2018)
- Unnamed, ‘Italian Government Wants to Renationalize Alitalia Airline’ (The Local, 19 July 2018)
- Water R and Bullock N, ‘Tesla stock slides 6% after Elon Musk’s ‘bonhead’ analyst call’ Financial Times (San Francisco and New York, 3 May 2018)
- Wessels B, ‘2017-09-doc11 1st CERIL Statement on Transaction avoidance laws’ Prof. Dr. Bob Wessels (27 September 2017)
- Westbrook JL, ‘The End of Bankruptcy’ Credit Slip (29 May 2018)

Miscellaneous


 Financial Reporting Council, The UK Corporate Governance Code (July 2018)


 Flink L (CEO of Blackrock), ‘Letter to the CEOs of S&P 500’ (March 2014)


 OECD (2018), Non-Financial corporations debt to surplus ratio (indicator)