



Corporate Rescue at the Crossroads:
An Empirical and Comparative Examination
of Pre-packaged Administration in the U.K.

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Declaration

I, Alfonso Salvatore Nocilla, confirm that the work presented is my own.

Where information has been derived from other sources, I confirm that this has been indicated in the thesis.

A handwritten signature consisting of a stylized, cursive letter 'A' with a horizontal stroke extending to the left.

Thesis Abstract

This thesis draws on new datasets of insolvency proceedings in two countries to examine corporate insolvency law in the United Kingdom (“U.K.”) from a comparative and quantitative empirical perspective. The primary focus is on pre-packaged administrations (“pre-packs”) carried out pursuant to Schedule B1 of the Insolvency Act 1986, as amended by the Enterprise Act 2002. In a pre-pack, an insolvent debtor company negotiates the sale of substantially all its assets on a going concern basis prior to initiating administration proceedings. Once administration proceedings are initiated, the pre-arranged deal is implemented and the sale is completed in short order. This thesis argues that pre-packs tend to give too much control to a debtor’s incumbent managers and secured creditors, and that this power imbalance often leads to worse outcomes for the debtor’s other stakeholders.

This thesis begins by examining the key problems with pre-packs from a theoretical perspective, comparing them with similar processes in other countries, namely, sales under the Companies’ Creditors Arrangement Act¹ in Canada (“liquidating CCAAs”) and quick sales under Section 363 of the Bankruptcy Code² (“363 sales”) in the United States (“U.S.”). In particular, this thesis argues that the speed, lack of transparency and limited stakeholder participation inherent in these processes create opportunities for secured creditors to influence the actions of an insolvent debtor’s senior managers, effectively aligning the interests of the secured creditors with those of management and leading to suboptimal outcomes for the debtor’s stakeholders as a group. The thesis examines originally collected quantitative data on pre-packs and liquidating CCAAs, as well as data on 363 sales collected by other scholars, to illustrate correlations between these processes and suboptimal outcomes for many stakeholders in insolvency. The thesis concludes by recommending reforms of the pre-pack, liquidating CCAA and 363 sales regimes to address the shortcomings of these processes and ensure that they will further, rather than undermine, the normative goals of insolvency law.

¹ RSC 1985, c C-36, as amended.

² 11 USC §§ 101 *et seq.*

Impact Statement

This thesis has implications both for insolvency law policy generally and for specific features of the corporate insolvency regimes of the U.K., Canada and the U.S. The thesis is significant in three ways. Firstly, it is based on the largest and most detailed quantitative empirical study to date of U.K. administration proceedings. It is the first such project to examine cases across all three U.K. jurisdictions – namely, England and Wales, Scotland, and Northern Ireland – and, with over 2,500 cases examined across dozens of variables, it dwarfs the numbers of cases and variables tracked in previous studies. The creation of this database in itself represents an important contribution to knowledge of the actual functioning of the U.K.'s corporate insolvency regime and the impact that different types of formal insolvency processes – namely, administrations, pre-packs and the now-abolished administrative receiverships – have had on insolvent debtor companies and their stakeholders. Likewise, the originally collected data on liquidating CCAAs in Canada makes an important contribution to the scholarship there, given the mere handful of quantitative studies on liquidating CCAAs that have been carried out to date. While the thesis does not include original quantitative research on 363 sales in the U.S., it synthesises several disparate lines of scholarship on Chapter 11 of the Bankruptcy Code and situates 363 sales within the broader framework and history of U.S. reorganization law, permitting meaningful comparisons to be made with pre-packs in the U.K. and liquidating CCAAs in Canada.

Secondly, in examining the results of this quantitative study and comparing the data among the U.K., Canada and the U.S., this thesis links the real-world outcomes of the cases under examination to a particular conception of the fundamental goals of insolvency law. Specifically, this thesis argues that there are important correlations between the suboptimal outcomes of the foregoing sales processes and the key features of those processes that undermine the proper goals of insolvency law, as the latter are conceived of in this thesis. In short, the design and structure of these processes are such that they tend to cause unnecessary and disproportionate harm to the weakest stakeholders in insolvency, namely preferential and unsecured creditors.

Thirdly, and finally, the foregoing analyses and conclusions motivate the reform proposals set out in this thesis with respect to pre-packs, liquidating CCAAs and 363 sales. These proposals will assist policymakers in the U.K., Canada and the U.S. in improving the functioning of the corporate insolvency

regimes in each of these countries. Addressing the shortcomings of these sales processes could be expected to improve outcomes for stakeholders, enhance public confidence in the integrity of the insolvency system, and to have positive downstream effects on the behaviour of parties in insolvency proceedings, yielding benefits in the corporate insolvency and commercial finance spheres more generally in each of the U.K., Canada and the U.S..

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INTRODUCTION

Businesses that fail do not necessarily default on their obligations, nor do those that have defaulted necessarily become insolvent.³ Rather, when most businesses begin to struggle, they will respond to their difficulties in one of two general ways: either they will reorganize their operations and finances; or they will shutter their doors, liquidate their assets, and distribute the proceeds to their creditors. In both cases, all of the required steps can be taken without ever actually invoking formal insolvency proceedings.⁴

Insolvency is very different. When a business becomes insolvent, unique issues arise that would not exist absent the peculiar factual circumstances of a debtor's insolvency:⁵

...corporate insolvency law is seen as dealing with that peculiar set of social, commercial and legal circumstances which arise when a company becomes insolvent. Insolvency law is regarded as laying down the fair terms of cooperation amongst all the parties affected by these peculiar circumstances.

When a debtor becomes insolvent, the value of its assets is insufficient to satisfy all of the numerous, diverse and competing claims against the debtor. If these competing claims cannot be resolved privately, then there is no alternative but to initiate formal insolvency proceedings in order to resolve them. In such cases, insolvency law provides the rules and framework within which parties affected by the debtor's insolvency will reckon with various difficult decisions about their and the debtor's future. Ideally, participants in the insolvency process will begin inquiring into the key causes of the debtor's insolvency, and whether the debtor or its underlying business can be saved. If a rescue seems possible, the parties must then determine how best to facilitate the rescue, which may mean compromising various claims against the debtor in order to enhance the likelihood of success. If it seems that the business cannot be saved, then the most efficient means of maximising the proceeds from the sale of the debtor's assets and of distributing the proceeds among the debtor's claimants must be identified. Necessarily, some claimants will not be paid in full, or at all, and their claims may be extinguished at the conclusion of the insolvency proceedings. In short, the law must decide who will bear the brunt of the losses flowing from the debtor's insolvency:⁶

³ Douglas G Baird, "Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren" (1987) 54 U Chi L Rev 815, 829.

⁴ Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (OUP 2005) 62-67.

⁵ *ibid* 2-3.

⁶ Philip R Wood, "The Bankruptcy Ladder of Priorities and the Inequalities of Life" (2011) 40 Hofstra L Rev 93.

Bankruptcy law is the profound motivator of commercial and financial law because, if there is not enough brandy and biscuits on the raft, the law is at its most ruthless in having to choose who to pay.

The foregoing decisions are inherently controversial. The decision to prioritize one group of claimants over another, with the result that some claims may be compromised or extinguished during the insolvency process, reflects the fundamental values and principles underlying the insolvency regime. Unless the underlying goals of the insolvency regime are clearly defined, the law risks being arbitrary, resulting in both injustice and commercial uncertainty. Moreover, in the absence of a clearly defined set of goals, it is difficult, if not impossible, to meaningfully assess the relative merits and drawbacks of different features of the insolvency regime, and to identify and address shortcomings.

This thesis begins by examining the existing scholarship on insolvency theory and positing a set of fundamental goals that all insolvency regimes ought to pursue. With these goals in mind, the thesis then examines a particular type of U.K. insolvency proceeding, namely, pre-packs. The thesis argues that pre-packs, in their current form, have the potential to undermine the fundamental goals of insolvency law, leading to worse outcomes for stakeholders in insolvency. It compares pre-packs to similar procedures in other countries, namely, liquidating CCAAs in Canada and 363 sales in the U.S., arguing that these procedures are functionally equivalent for several reasons. Firstly, each procedure is an abridged form of the full reorganization procedure in each country, that is, standard administration in the U.K. and a traditional CCAA or Chapter 11 proceeding with a formal plan, in Canada and the U.S., respectively. Secondly, each procedure is typically negotiated by a small group of secured creditors and the debtor's senior managers before initiating proceedings, and the deal is then implemented without giving the other creditors of the debtor an opportunity to review and vote upon its terms.⁷ Thirdly, each procedure typically involves a sale of all or substantially all of the assets of the debtor on a going concern basis. In all three countries, commentators have concluded that these procedures strongly resemble receiverships because they focus on selling the debtor's assets as quickly as possible, thereby providing secured creditors with a

⁷ In these regards, although a traditional CCAA plan shares many characteristics of a scheme of arrangement under Parts 26 and 27 of the Companies Act 2006 in the U.K., a liquidating CCAA far more closely resembles a U.K. pre-pack because: (1) there is usually no formal plan or "scheme" of arrangement in a liquidating CCAA; (2) a liquidating CCAA is fundamentally a sale and not an "arrangement" or reorganization; and (3) most of the creditors are excluded from the negotiations leading to the sale. In those cases where a liquidating CCAA includes a formal plan, the plan usually only sets out a process for distributing the sales proceeds to the debtor's creditors.

swift recovery.⁸ Indeed, pre-packs, 363 sales and liquidating CCAAs all give rise to similar problems, both from a normative perspective – having regard to the fundamental goals of insolvency law – and with respect to the actual outcomes generated by these procedures for stakeholders. In these regards, the thesis examines originally collected quantitative data on over 2,000 administration and 500 administrative receivership cases in the U.K., concluding that pre-packs tend to be correlated with lower realisations overall and worse outcomes for preferential and unsecured creditors than post-Enterprise Act administration. A similar but smaller study of liquidating CCAAs in Canada, along with a survey of studies conducted by other researchers on 363 sales in the U.S., lead to similar conclusions. The thesis concludes by setting our proposed reforms to the pre-pack, liquidating CCAA and 363 sales regimes in order to address the shortcomings of those processes and improve transparency, stakeholder participation, and overall outcomes.

The thesis is organized as follows. Chapter 1 begins by examining the main scholarly debates surrounding the role and purposes of corporate insolvency law. It considers the various divergent lines of scholarship on insolvency theory, arguing that the major competing theories fail to fully explain and justify important features of insolvency law. In particular, the major theories fail to provide a satisfactory explanation and justification for the imposition of a formal corporate insolvency regime, that is, a collective and compulsory process for the resolution of the problems that arise uniquely in the circumstances of the factual insolvency of debtor companies. The thesis then distils several basic goals that every insolvency system ought to pursue, arguing that the major theories of insolvency reflect these goals to varying extents, even if they ultimately fall short of providing a comprehensive explanation of insolvency. The upshot of this analysis is a reaffirmation of the three fundamental goals of insolvency law posited by Riz Mokal, namely, the following goals:⁹

⁸ See: Adrian J Walters, “Statutory Erosion of Secured Creditors’ Rights: Some Insights from the United Kingdom” (2015) U Ill L Rev 543 (“...prepacks are little more than a functional substitute for receivership sales”); Mark J Roe and David Skeel, “Assessing the Chrysler Bankruptcy” (2010) 108 Mich L Rev 727, 767 (stating that the Chrysler 363 sale “eerily” resembled a nineteenth century equity receivership); Roderick J Wood, “Rescue and Liquidation in Restructuring Law” (2012) 53 Can Bus L J 407, 412 (“[t]he fact that courts in CCAA proceedings are applying receivership law when dealing with liquidating sales clearly brings home the point that the processes used in CCAA liquidations are mimicking those in receivership proceedings”).

⁹ As discussed in further detail in Chapter 1, I rely here on Mokal’s formulation of the basic goals of insolvency law, see Mokal (n 4). However, it is not necessary for the arguments in this thesis to adopt Mokal’s larger theory of insolvency law – on the contrary, I do not adopt a particular model of insolvency

- 1) the preservation and maximisation the value of insolvent enterprises;
- 2) the fair treatment of all stakeholders, including especially the fair distribution of the debtor's assets, or the proceeds from sales of the debtor's assets, among the stakeholders; and
- 3) the investigation of the causes of insolvency, so as to minimise harm and abuse.

It is argued that the foregoing conception of the fundamental goals of insolvency law is consistent with, and indeed synthesizes and summarizes, the widely accepted principles of insolvency law expressed in international statements such as UNCITRAL's *Legislative Guide on Insolvency Law*¹⁰ and the World Bank's *Principles For Effective Insolvency and Creditor/Debtor Regimes*.¹¹ This formulation represents the best available heuristic for explaining, analysing and evaluating existing corporate insolvency regimes in the U.K. and abroad.

Chapter 2 provides an overview of the U.K.'s corporate insolvency regime, with particular emphasis on the reforms to the administration procedure under the Insolvency Act 1986 that were introduced by the Enterprise Act 2002. These reforms abolished the old administrative receivership model in which a single powerful secured creditor controlled the rescue process, replacing it along with the pre-Enterprise Act administration procedure with a new, more robust administration procedure ostensibly aimed at fostering company rescue and dispersed creditor control. The chapter goes on to examine the rise of pre-packs following the Enterprise Act reforms, arguing that pre-packs by their nature favour incumbent management and the secured creditors of insolvent debtor companies, which would seem to undermine the stated goals of the Enterprise Act. The chapter discusses the implications of the rise of pre-packs in light of the theoretical discussion in Chapter 1 and the goals of the Enterprise Act. In so doing, the chapter also

law, such as Mokal's Authentic Consent Model, nor any other model. Rather, my approach in this thesis is a minimalist one from the perspective of insolvency law theory: my aim is to assess the current pre-pack regime in the U.K. with reference to certain baseline, fundamental goals of insolvency law. For a critique of Mokal's Authentic Consent Model, see Anthony Duggan, "Contractarianism and the Law of Corporate Insolvency" (2005) 42 CBLJ 463 (arguing that Mokal elides his model with Jackson's model of insolvency law and consequently, arrives at many of the same policy positions as Jackson in the end). For a response, see Rizwaan J Mokal, "Contractarianism, Contractualism, and the Law of Corporate Insolvency" (2007) Sing JLS 51.

¹⁰ United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law* <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> 9-14, accessed 21 July 2019.

¹¹ The World Bank, *Principles For Effective Insolvency and Creditor/Debtor Regimes* (2016) <<http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf>> accessed 21 July 2019.

compares pre-packs to liquidating CCAs and 363 sales, arguing that all of these procedures are functionally equivalent and represent a trend away from traditional reorganizations towards quick sales that has emerged on both sides of the Atlantic.

Chapter 3 examines 363 sales with reference to the history and purposes of U.S. reorganization law, certain quantitative empirical studies on the outcomes of 363 sales, and recent reform efforts in the U.S. It argues that 363 sales are susceptible to abuses by debtors seeking to use the abridged sales process in order to circumvent the protections typically available to creditors in traditional Chapter 11 reorganizations. Where the interests of a debtor's secured creditors and its incumbent management align, the debtor may begin to act in ways that improve the positions of those parties at the expense of the debtor's other stakeholders. Particularly in a 363 sale, disaffected creditors will be hard pressed to scrutinise and challenge the terms of the proposed sale, as the process limits information flows and opportunities for creditors to participate in the process. Moreover, the speed of the 363 sale process increases the costs and challenges of stakeholders who were not involved in negotiating the deal to become involved in the process. These "outsider" stakeholders have only a short timeframe within which to seek a court order blocking the sale. In such cases, the objecting party must prove to the court that the proposed sale will be harmful – a difficult onus to overcome given the time constraints and informational asymmetries in 363 sales. Chapter 3 then evaluates the reforms proposed by the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.¹²

Chapter 4 sets out the methodology, analysis, and conclusions of a quantitative empirical study conducted by the author on over 2,000 administration cases in the U.K. As the largest study of its kind to date, the data gathered provide the basis for identifying correlations between pre-packs and outcomes for different types of stakeholders in insolvency, as compared with post-Enterprise Act administrations. A sample of 500 administrative receiverships that were initiated in 2002, the last full year before that procedure was abolished by the Enterprise Act 2002, is also examined. In particular, Chapter 4 tracks the following key variables, among others, across different types of procedures:

- total realisations generated by the process;

¹² *Final Report and Recommendations*, Commission to Study the Reform of Chapter 11 (American Bankruptcy Institute, 2014) 2 ["ABI Report"]. Online: <<https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h>> accessed 21 July 2019.

- returns to different classes of creditors (e.g. secured, preferential, and unsecured);
- survival rates of businesses (e.g. whether they continued to operate after 12, 24 and 36 months);
- the average length of time needed to complete the process (i.e. duration); and
- the incidence of sales to connected parties.

Although other studies have examined similar data, those studies had important limitations. For example, the quantitative study commissioned in connection with the Graham Report only examined data on a sample of 500 pre-packs and standard administrations conducted in 2010.¹³ Other researchers used even smaller samples of cases, or examined cases from the early years after the Enterprise Act reforms, which may well have biased as the reforms were still new and may not have been fully adopted by insolvency practitioners (IPs).¹⁴ The data set out in Chapter 4 are much more comprehensive.

In brief, Chapter 4 reaches two main conclusions. Firstly, post-Enterprise Act administration is undoubtedly an improvement over administrative receivership, as the former procedure yields better results across virtually all metrics. In particular, all forms of administration were correlated with significantly higher overall returns to creditors than administrative receiverships. This finding helps to resolve some of the lingering doubts in the scholarship regarding the necessity and efficacy of the Enterprise Act reforms – it is clear that administrative receiverships had to go. Secondly, although pre-packs tended to be completed more quickly than standard administrations, the study found that the cost savings from pre-packs were modest, at best. Meanwhile, pre-packs were correlated with significantly lower realisations than standard administrations, as well as marginally lower returns to preferential and unsecured creditors, while secured creditors tended to fare better overall. In short, the outcomes of pre-packs appear to run directly counter to the stated goals of the Enterprise Act to improve outcomes for preferential and unsecured creditors and to weaken the position of secured creditors as compared with pre-Enterprise Act administrations and administrative receiverships. These findings, along with the strong correlation identified between pre-packs

¹³ Peter Walton and Chris Umfrville, *Pre-Pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration, Final Report to the Graham Review* (University of Wolverhampton 2014) <<https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration>>, accessed 21 July 2019 [“Wolverhampton Report”].

¹⁴ See for example: Sandra Frisby, *A Preliminary Analysis of Pre-Packaged Administrations: Report to the Association of Business Recovery Professionals* (University of Nottingham 2007); John Armour and others, “The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK” (2012) 8 Rev L Econ 101.

and connected party sales, provide the backdrop against which comprehensive reforms of the pre-pack regime are proposed in the following chapter.¹⁵

Chapter 5 examines the recent policy responses to pre-packs following the publication of the Graham Report in 2014.¹⁶ This chapter discusses both the key findings and recommendations of the Graham Report. With respect to the Graham Report's findings, this chapter emphasizes the low distributions to unsecured creditors in pre-packs, the high incidence of connected party pre-packs, the high failure rate of businesses sold in pre-packs, and the rapid growth of pre-packs since courts began allowing them.¹⁷ The chapter then considers the Graham Report's key recommendations, namely the following: the creation of an independent "pre-pack pool" to review and opine upon the proposed sale terms prior to closing; a requirement for connected party purchasers to prepare a "viability review" of the new company, stating how it will survive for the next 12 months; the establishment of a set of "good principles of marketing" to which IPs should adhere in order to improve the quality of marketing in pre-packs and maximise returns for creditors; and rules for ensuring that valuations in pre-packs are fair.

By way of summary, Chapter 5 argues that the Graham Report's recommendations have fallen far short of addressing the significant problems posed by pre-packs, not in the least because the Graham Report urged that uptake of its recommendations by IPs be voluntary, and that no new legislation was needed. Several years after the Graham Report was published, it is clear that IPs and other market participants have not taken up the foregoing recommendations. To use one example, although a Pre-pack Pool ("Pool") was established in 2015, the rate of pre-packs voluntarily submitted by administrators to the Pool for its review and opinion has been abysmally low: only 28% of connected party pre-packs were

¹⁵ One objection to such comparisons is that companies that are candidates for pre-packs may simply be in more dire straits than companies that undergo standard administration proceedings, and as such, the worse outcomes in pre-packs are to be expected and may well represent the best that can be hoped for in poor circumstances. On the contrary, the findings of the U.K. study set out in Chapter 4 are that pre-packs yielded worse returns for preferential and unsecured creditors, but better returns for secured creditors, compared with standard administrations. If, indeed, companies that underwent pre-packs represented the "bottom of the barrel" of insolvent companies, we would expect to see lower returns across the board, but this is not reflected in the data.

¹⁶ Teresa Graham, *Graham Review into Pre-pack Administration: Report to The Rt. Hon. Vince Cable MP* (June 2014) ["Graham Report"]. Online: <<https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration>> accessed 21 July 2019.

¹⁷ See *Re Transbus International Ltd* [2004] EWHC 932 (Ch), holding that the administrator was permitted to sell the insolvent debtor's assets prior to approval of the administrator's proposal by the debtor's creditors.

submitted by the end of 2016, and this number dropped to 11% in 2017, even as the percentage of connected party pre-packs rose to 28% of all pre-packs in the same year. Chapter 4 goes on to examine other recent reform proposals from various scholars, concluding that these proposals also fall short of fully identifying and addressing the problems with pre-packs. The chapter concludes by proposing a more comprehensive set of reforms designed to ensure that pre-packs will uphold and further the fundamental goals of insolvency law and that the interests of weaker stakeholders – such as preferential and unsecured creditors, and other stakeholders who were not involved in negotiating the pre-pack – will be protected.

Chapter 6 replicates the study of U.K. cases discussed in Chapter 4 on a smaller scale for CCAA proceedings in Canada. In particular, Chapter 6 examines the quantitative outcomes of 77 CCAA proceedings initiated in 2012 and 2013, comparing the results of traditional, full reorganization proceedings with liquidating CCAs.¹⁸ Notwithstanding the small number of cases that contained all of the required data, Chapter 6 cautiously concludes that the total costs of liquidating CCAs, as a percentage of total returns, were only modestly lower than those of full CCAs, and that liquidating CCAs actually took longer to complete. At the same time, although liquidating CCAs were correlated with significantly higher returns to creditors overall, unsecured creditors fared far worse in liquidating CCAs than in reorganizations, while secured creditors fared particularly well in liquidating CCAs. Based on the foregoing findings and the theoretical problems raised with liquidating CCAs, Chapter 6 concludes by recommending broad reforms to the CCAA. Specifically, Chapter 6 recommends, firstly, the establishment of clearer and more comprehensive reporting requirements in CCAA cases, both to inform stakeholders and to assist policymakers. Secondly, it recommends the creation of a database for information on CCAA cases, similar to Companies House's online database in the U.K. Thirdly, the chapter recommends comprehensive amendments to the CCAA to clarify the appropriate legal tests and requirements for judicial approval of liquidating CCAs, as well as the applicable scheme for distributing sales proceeds among the creditors of the insolvent debtor.

The thesis concludes by reiterating the goals of insolvency law, weaving together the theoretical concerns with pre-packs, liquidating CCAs and 363 sales with the quantitative data on the outcomes of

¹⁸ These represent all of the CCAA cases initiated in 2012 and 2013. Although 77 cases may seem like a low number, many of the proceedings involved joint filings and were highly complex, and data collection often involved reviewing hundreds of pages of reports, court orders and motion materials.

these processes. It explains that these quick sale processes tend to undermine not only the normative aims of insolvency law, but also the stated goals of the applicable insolvency legislation in each of the countries examined in the thesis. Moreover, the quantitative data bear out the foregoing concerns, as many stakeholders – such as preferential and unsecured creditors – fare worse in quick sales than in traditional processes such as standard administrations, CCAA reorganizations, and Chapter 11 plan confirmations. In short, pre-packs, liquidating CCAs and 363 sales represent a trend away from traditional insolvency processes towards new and uncharted territory. Corporate insolvency law is at a crossroads, and the challenge for policymakers in many countries going forward will be identifying the specific features of quick sales processes that lead to suboptimal outcomes for insolvency stakeholders and crafting solutions that will best further the stated aims of the applicable legislation and the fundamental goals of insolvency law.

CHAPTER 1:
THE EVOLUTION OF CORPORATE INSOLVENCY THEORY

I. INTRODUCTION

Insolvency laws are inherently controversial. When a debtor is unable to pay its debts as they become due, or when its assets are insufficient to meet its liabilities, the law must choose who to pay.¹⁹ It must choose winners and losers.²⁰ Such choices can be especially difficult when insolvency results in lost jobs, underfunded pensions, and the termination of important customer and supplier relationships. It is perhaps no surprise, then, that scholars and policymakers continue to vigorously debate the role and purposes of corporate insolvency laws. Fundamentally, these debates revolve around the questions of which interests insolvency law ought to protect and how best to protect them. This chapter begins by examining Thomas Jackson's well-known account of insolvency law as a debt collection mechanism. It then turns to the various alternative accounts that have been offered in response to Jackson and weighs the relative merits and shortcomings of each of these accounts.

II. COMPETING ACCOUNTS OF CORPORATE INSOLVENCY LAW

Over the past thirty years, corporate insolvency law has evolved from a somewhat narrow and technical area into a highly developed, theoretically rich field of study. This evolution has not been an entirely peaceful one. Scholars continue to disagree as to the proper aims of insolvency law. These disagreements turn on fundamental normative claims that are at the heart of several different competing theories of insolvency. This chapter examines these competing theories, but takes a different approach than much of the existing scholarship. Specifically, this chapter argues that the traditional view of insolvency law theory as being divided predominantly between two schools of thought – those who follow Thomas Jackson, viewing insolvency law as focused on maximising recoveries for creditors, and those who

¹⁹ It is important to distinguish between cash flow insolvency, which refers to the debtor's inability to pay its debts as they become due, and balance sheet insolvency, in which the debtor's liabilities exceed the value of its assets. The former is the standard test for insolvency in most jurisdictions. As a matter of international best practices, the rationale for using the cash flow or liquidity test for determining insolvency is that it permits the commencement of insolvency proceedings while there is still time to attempt a restructuring. Delaying the recognition of insolvency (and therefore the availability of collective proceedings) until the debtor's liabilities exceed the value of its assets decreases the chance of preventing a race by the claimants to dismember the debtor, leading to diminished recoveries for all stakeholders. See UNCITRAL *Legislative Guide on Insolvency Law* (n 10).

²⁰ Philip R Wood, *Principles of International Insolvency* (2nd edn, Sweet & Maxwell 2007) 3.

subscribe to Elizabeth Warren's view that insolvency law should focus on protecting the interests of a broader constituency of stakeholders – is at best a limited heuristic. Rather, this chapter argues that each of these accounts points up different, but equally important, aspects of insolvency law. Many of the more problematic and inconsistent claims of these competing accounts can be abandoned, while still preserving their core normative claims. These core claims can be reconciled, thus providing a more robust and coherent framework for understanding corporate insolvency law than any of the major competing theories offer on their own.

A note on terminology should be made here. The term “rescue” is often used in the jurisprudence, but it is not always clearly defined. In this dissertation, the term is used broadly to denote any type of formal legal process which aims to preserve either a distressed entity or its underlying business so as to avoid the negative consequences of bankruptcy and the improvident liquidation of corporate assets. Such processes include, for example, proceedings under Chapter 11 of the U.S. Bankruptcy Code, the CCAA in Canada, and the Enterprise Act 2002 in the U.K. There is some debate over what precisely the term “rescue” means. In the U.K., the term is often taken to mean a rescue not of the distressed entity itself but of its underlying business, and while this may reflect current practice, it does not reflect the letter of the law. In particular, while the Cork Report of 1986 stated that insolvency law should not try to rescue insolvent companies, the Enterprise Act 2002 was clearly aimed at company rescue.²¹ In the U.S. and Canada, meanwhile, there is a growing trend toward using rescue statutes such as Chapter 11 and the CCAA in order to carry out sales of substantially all of the assets of insolvent entities, though this is controversial. Suffice it to say that each of the British, American and Canadian rescue regimes permit both the reorganization and liquidation of insolvent entities, though this is controversial.²² My view is that in general and for the reasons discussed in Chapter 2, statutes designed to reorganize insolvent entities should be used for that purpose, and no other.

²¹ Compare Insolvency Law Review Committee, *Insolvency Law and Practice* (Cmnd 8558 1982) para 193: “...society has no interest in the preservation or rehabilitation of the company as such, though it may have a legitimate concern in the preservation of the commercial enterprise”, with Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 398, citing the remarks of Lord McIntosh, HL Deb 29 July 2002, vol 638, col 766: “Company rescue is at the heart of the revised administration procedure. We want to make sure that viable companies do not go to the wall unnecessarily...”.

²² For a further discussion of the distinction between business and company rescue, see Sandra Frisby, “Insolvency Law and Insolvency Practice: Principles and Pragmatism Diverge?” (2011) 64 CLP 349, 363-8.

To the extent that rescue legislation was designed to ensure the survival of insolvent entities, it should not be used simply to sell off their assets, whether or not the underlying business survives.²³

1. Debt Collection Theory and the Creditors' Bargain

In the *Logic and Limits of Bankruptcy Law*, Thomas Jackson argues that “bankruptcy law, at its core, is debt-collection law.”²⁴ That is, insolvency law responds to a collective action problem that arises when a debtor cannot pay its creditors. This problem has various names – for example, the common pool problem or the creditors’ race – but the concept is simply that when a debtor cannot pay its creditors, each creditor has a strong incentive to seek to enforce its claims against the debtor before any other creditor does so. Left unchecked, the resulting creditors’ race would deplete the common pool of assets, leaving the creditors worse off as a group.²⁵ Accordingly, insolvency law imposes a “*collective and compulsory proceeding*” on creditors to prevent this race for the debtor’s assets.²⁶ Jackson argues that this collective and compulsory process is something to which all creditors would have reasonably consented, had they been given the chance to bargain from an appropriately defined *ex ante* position, because the process is in each creditor’s self-interest. The fact that the creditors would have so agreed is both a justification for the law’s imposition of a collective and compulsory process upon them and an illustration of Jackson’s claim that insolvency law is essentially designed to achieve one goal: it permits rationally self-interested parties to maximise their wealth.²⁷

²³ I have made similar arguments elsewhere in the context of Canadian insolvency law. See, for example, Alfonso Nocilla, “The History of the Companies’ Creditors Arrangement Act and the Future of Restructuring Law in Canada” (2014) 56 CBLJ 73.

²⁴ Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986) 3. Note that Jackson and other American scholars use the term “bankruptcy” broadly to encompass all bankruptcy and insolvency laws, including those governing corporate insolvency.

²⁵ *ibid* 10: “The basic problem that bankruptcy is designed to handle... is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse.”

²⁶ *ibid* 13. Jackson further argues that the collective debt-collection process also benefits creditors by reducing their individual co-ordination and monitoring costs, see 16.

²⁷ *ibid* 5: “...the remaining principal role of bankruptcy law... is to permit the owners of assets to use those assets in a way that is most productive to them *as a group* in the face of incentives by individual owners to maximize their own positions.” There is an inconsistency here in Jackson’s account, which is discussed further below. Specifically, Jackson vacillates between claiming that insolvency law is better for creditors both *individually* and *as a group* than an individual collection process would be. This is plainly not the case for every creditor, since the creditor who is able to enforce its claim most quickly will prefer an individual collection process, all things being equal.

Jackson's view of insolvency law as essentially a debt collection device, motivated by the individual self-interest of creditors, has significant policy implications. The first and perhaps most controversial of these is that insolvency law must remain neutral with respect to creditors' non-insolvency entitlements. Jackson argues that insolvency law should not have distributional goals because such goals undermine its basic purposes:²⁸

... the establishment of new entitlements in bankruptcy conflicts with the collectivization goal. Such changes create incentives for particular holders of rights in assets to resort to bankruptcy in order to gain for themselves the advantages of those changes, even when a bankruptcy proceeding would not be in the collective interest of the investor group. These incentives are predictable and counterproductive because they reintroduce the fundamental problem that bankruptcy law is designed to resolve: individual self-interest undermining the interests of the group. These changes are better made *generally* instead of in bankruptcy only.

Jackson acknowledges that this view of insolvency is not, strictly speaking, concerned with the interests of involuntary creditors, such as tort claimants or retired employees. Rather, this view is concerned with maximising the value of the insolvent estate for the creditors as a whole. Jackson and Robert Scott elaborated on this point in an article published after *Logic and Limits*:²⁹

... tort claimants, retired employees, residents of the community, and other affected third parties might well be considered "victims" of business failure and bankruptcy... Because these parties do not have an opportunity to protect themselves with security, it can be argued that they "deserve" a distribution of the assets in bankruptcy in the same way that flood victims deserve assistance.

It is not our goal in this Article to assess the normative appeal of this vision. For our purposes here, it is important only to see that whatever the merits of the claim that society owes such victims protection against disaster, this protection does not derive from the consensual arrangements that would underlie any *ex ante* creditors' bargain... In fact, it may in some sense be analytically correct to suggest that the problems that animate distribution to nonconsensual victims of common disasters are not "bankruptcy" problems.

Jackson and Scott further explained that redistribution *per se* is not necessarily inconsistent with insolvency law's wealth maximisation goal. On the contrary, certain redistributions may be appropriate to the extent that they seek to implement the creditors' bargain and maximise the value of the insolvent estate:³⁰

The uncertain genesis of particular bankruptcy redistributions means that broad generalizations about the costs and benefits of redistribution in bankruptcy are virtually meaningless. A more fruitful approach is to assess the effects of particular

²⁸ *ibid* 21.

²⁹ Thomas H Jackson and Robert E Scott, "On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain" (1989) 75 Va L Rev 155, 177-178.

³⁰ *ibid* 163.

redistributions given certain plausible assumptions. The issue then becomes whether any bankruptcy redistributions can be seen as the means of implementing, rather than undermining, the original distribution implicit in the ex ante bargain.

This more nuanced approach avoids the pitfall of viewing redistribution and wealth maximisation as necessarily inconsistent – the two goals can, in fact, be complementary in the manner described above.³¹

It follows from the foregoing that reorganizing insolvent entities is appropriate to the extent that doing so maximises returns for creditors. However, to the extent that insolvency law tries to keep distressed entities alive merely to benefit certain interests, for example by preserving jobs or supplier relationships, then the law fails to maximise the value of the asset pool:³²

There is, in other words, no correlation between whether firms should stay in business and solving a common pool problem. If it is important for firms to stay in business because of the jobs they save or because of their importance to their communities, that policy should be implemented as a matter of general law... *The only question of relevance for bankruptcy is the most appropriate deployment for the group of the firm's assets given the initial entitlements.*

In this sense, an insolvency reorganization can be understood as a sale of the insolvent debtor's assets to its existing stakeholders rather than to third parties, on the basis that the assets are worth more kept together in the existing entity than if they were sold to third parties.³³

The foregoing justification for insolvency reorganization can be further illuminated by distinguishing between financial and economic distress. A debtor is merely *financially* distressed when it is either cash-flow or balance-sheet insolvent but its underlying business remains viable. In such circumstances, the business has greater value as a going concern than it would if it were broken up and sold piecemeal, i.e. through a liquidation. In contrast, a debtor is *economically* distressed when its business is unviable – that is, its assets would be worth more if they were sold piecemeal than if the business continued to operate.³⁴ To the extent that an insolvency regime permits economically distressed companies to continue to operate, the regime generates deadweight losses. Assets that could be put to greater use elsewhere become trapped in doomed enterprises, which continue to lose money each day that they continue in operation.

³¹ *ibid*, fn 16.

³² Jackson (n 24) 210 (emphasis added).

³³ *ibid* 214: "The underlying justification for a reorganization process, seen in terms of bankruptcy as a collective debt-collection device, must be that the assets are worth more to the claimants themselves than they would be to third parties." And 223: "There is no reason why [a modified version of] chapter 7 could not be used as the vehicle to sell the firm as a going concern in the same way that companies go public."

³⁴ Mokal (n 4) 195.

Critically, that money belongs not to the insolvent debtors, but to all those holding claims against them.³⁵ It follows that an effective and efficient insolvency regime must: (a) encourage the reorganization of financially distressed debtors, thereby avoiding improvident liquidations that would destroy value; (b) encourage liquidation of economically distressed debtors as quickly as practicable, so as to mitigate further losses and permit the redeployment of assets to more productive ends; and (c) provide mechanisms for easy conversion from reorganization to liquidation proceedings, if the insolvent debtor's circumstances change:³⁶

The determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which proceedings will be sought. As a matter of practice, however, at the time of commencement of either reorganization or liquidation, it is often impossible to make a final evaluation as to the financial viability of the business. . . This inefficiency can be overcome, to some extent, by providing linkages between the two proceedings, with a view to allowing conversion of one type of proceeding to the other in certain specific circumstances, and by including devices designed to prevent abuse of insolvency proceedings, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation.

At the same time, it is important to appreciate that investigating the causes of distress and deciding whether to reorganize or liquidate a distressed company is not an exact science. Jackson focuses squarely on maximising returns to creditors, by asking whether a reorganization will yield greater value than an immediate sale. But this is a highly abstract approach, and in practice a more nuanced analysis that includes a careful investigation of the causes of insolvency is most appropriate:³⁷

A firm in financial distress may be economically efficient but suffer from changing markets. In such cases, the best option may be to devise a plan that allows the firm to keep operating where there is a current or expected future market for its output. This may be the optimal strategy when there is no current higher value use, thereby saving efficient but financially distressed firms. However, when the firm is economically inefficient and change in governance practice will not remedy its financial distress, the best outcome may be to liquidate and release the capital to higher value uses. For some scholars, the issue is exclusively whether creditors receive greater value in a restructuring than they would in liquidation, and net gain or efficiency is not part of the inquiry. Yet radically changing the governance practices can generate value for the firm. It is important to ascertain the reasons for the corporation's financial distress in order to best fashion and evaluate remedies.

³⁵ *ibid.* See also Rizwaan J Mokal, "Administrative Receivership and Administration – An Analysis" (2004) 57 CLP 355, 358-359.

³⁶ UNCITRAL (n 10) 18.

³⁷ Janis Sarra, *Creditor Rights and the Public Interest: Restructuring Insolvent Corporations* (University of Toronto Press 2003) 52.

2. Logical Shortcomings of Debt Collection Theory

Insolvency scholars have criticized Jackson's account on several grounds. Firstly, it is evident that the creditors' bargain model, as Jackson conceives it, fails as both an explanation and a justification for a collective and compulsory insolvency process. In this regard, David Carlson argues that the model is a tautology because Jackson's hypothetical creditors are equal in all respects. That is, the model merely tells us that totally equal and self-interested creditors would agree to a process that treats all of them equally.³⁸ Moreover, it is plain that such a model tells us nothing about what real-world creditors would do. Put simply, real-world creditors are not equal in all respects. Setting aside the fact that real-world creditors may have different priorities under non-insolvency law, they also differ in their relative resources, abilities to collect, knowledge, relationship with the debtor, etc.³⁹ On Carlson's view, then, Jackson's model has no explanatory or justificatory power.

In contrast, Riz Mokal argues that Jackson fully intends the creditors in his model to be real-world creditors. In fact, Jackson needs them to be real-world creditors, with all of their differences, in order both to explain and justify the collective insolvency process. In particular, Mokal argues that Jackson's creditors are bargaining from the position of "Natural Ignorance":⁴⁰

Natural Ignorance allows parties to know whether they are secured or unsecured, faster at collecting debts or friendlier with the debtor or better at bargaining than other creditors. This knowledge shapes the process of (the notional) negotiations...

It is important to remember not only the brute fact, testified to by their text, that the progenitors of the [creditors' bargain model] explicitly base their model on Natural Ignorance, but also that acknowledging their adherence to it is the only way in which to explain certain highly important aspects of their model.

But conceived of in this way, Jackson's model cannot explain or justify critical aspects of insolvency law. For instance, it does not explain the automatic stay, because creditors who are purely self-interested and possess different resources, knowledge, and abilities relative to each other, would not all agree to the automatic stay. In addition, even if the creditors somehow did agree to the stay, their agreement – which would be based solely on each creditor's individual self-interest – would not justify imposing the stay. This is because such an agreement would merely reflect the creditors' preferences, based upon their individual

³⁸ David G Carlson, "Philosophy in Bankruptcy" (1987) 85 Mich L Rev 1341, 1355.

³⁹ *ibid* 1348-1349.

⁴⁰ Mokal (n 9) 68.

circumstances, at some *ex ante* point in time. Those preferences would change from time to time depending upon changes in the creditors' relative knowledge, abilities and circumstances. But there is nothing special about the *ex ante* point in time at which Jackson's creditors conclude their hypothetical bargain. Accordingly, Jackson's model cannot explain why the creditors' consent has moral significance and ought to bind them even if their preferences change.⁴¹ This points up the fact that Jackson's model merely reflects, and does not correct for, the inequalities of the creditors at an arbitrary point in time.⁴²

It is clear from Jackson's work following *Logic and Limits* that he intended the creditors' bargain model to reflect what real-world creditors would do, precisely because the bargain is supposed to have normative force:⁴³

A central premise underlying this creditors' bargain conceptualization is that a system of state law entitlements (including priorities among secured and unsecured creditors) is already in place and that parties know what their priority positions will be... If we assume that commercial parties are rational and self-interested, this hypothetical bargain analysis provides indirect evidence of what real world parties would, in fact, agree to. *The hypothetical bargain thus yields a normative criterion, grounded on principles of autonomy, for evaluating the legitimacy of the bankruptcy process.*

Accordingly, Mokal's critique seems both more accurate and more damaging to the model than Carlson's.⁴⁴ At all events, the point here is that regardless of which interpretation of the model we accept, the model fails to explain or justify insolvency law.

Despite Debt Collection Theory's shortcomings, it has featured prominently in the insolvency scholarship over the past thirty years. It would be difficult to overstate Jackson's influence, particularly within the Law and Economics scholarship, where other scholars such as Douglas Baird have continued to propound various forms of Debt Collection Theory.⁴⁵ In response, several scholars have advanced alternative accounts of insolvency law.

⁴¹ For further discussion, see Mokal (n 4) 41-43.

⁴² Rizwaan J Mokal, "The Authentic Consent Model: contractarianism, Creditors' Bargain, and corporate liquidation" (2001) LS 400, 429: "The problem is that, in any contractarian theory of *justice*: 'The arbitrariness of the world must be corrected for by adjusting the circumstances of the initial contractual situation.' But Jackson's *ex ante* position happily reflects that arbitrariness."

⁴³ Jackson and Scott (n 29) 160 (emphasis added).

⁴⁴ That said, Mokal seems to agree with Carlson that insofar as Jackson's creditors are taken to be fictional, the model tells us nothing about what real creditors would do. See Mokal (n 4) 40, fn 47, and especially 53, fn 84.

⁴⁵ See, for example, Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles*, (2nd edn, CUP 2009) 33: "The creditor wealth maximisation vision has been highly influential and has been put into legislative effect in some jurisdictions..."

3. Loss Distribution Theory

In a seminal article written shortly after *Logic and Limits*, Warren both criticized Debt Collection Theory as an overly narrow account of insolvency law and advanced her own, broader account:⁴⁶

I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing – and sometimes conflicting – values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, "How shall the losses be distributed?"

In Warren's view, insolvency law is fundamentally different from debtor-creditor law. The latter deals primarily with collection matters and makes no provision for extinguishing the legitimate claims of creditors, whereas the former deploys "very different legal devices such as discharge of debt and distribution of unavoidable losses."⁴⁷ These differences reflect the fact that debtor-creditor law is merely concerned with default, whereas insolvency is "sharply focused on the consequences of a debtor's imminent collapse."⁴⁸

Warren's distinction between debtor-creditor law and insolvency law forms the crux of her disagreement with proponents of Debt Collection Theory. The decision to enforce some rights in insolvency, such as those of secured creditors, often means extinguishing the rights of others, such as unsecured creditors.⁴⁹ In Warren's view, then, insolvency law is inherently distributional. Accordingly, in holding that insolvency law should remain neutral with respect to distributional questions, Debt Collection Theory implicitly endorses the distributional schemes of non-insolvency law without justification.⁵⁰ Warren concludes that Debt Collection Theory merely obscures insolvency law's distributional nature, and thus benefits secured creditors at unsecured creditors' expense:⁵¹

Baird is at pains to avoid the economic lingo, but he cannot escape the conclusions that the only value he protects is economic wealth maximization for the bankrupt estate. As Baird has used it... collectivism is nothing but a veil to conceal his relentless push for single-value economic rationality, an excuse to impose a distributional scheme without justifying it, and incidentally, a way to work in a damn

⁴⁶ Elizabeth Warren, "Bankruptcy Policy" (1987) 54 U Chi L Rev 775, 777. It should be noted that Warren's article responds specifically to Douglas Baird, however many of her comments apply equally to Jackson. See 776, fn 2.

⁴⁷ *ibid* 782.

⁴⁸ *ibid* 785.

⁴⁹ *ibid* 789.

⁵⁰ *ibid* 800: "[Baird] necessarily uses – even if he does not discuss – distributional principles. Moreover, Baird endorses the wholesale use of the state law distributional scheme, but he does not defend the distributional rationale of that scheme, nor does he address the possibility that the state scheme was designed to resolve questions significantly different from those to which he applies it."

⁵¹ *ibid* 802-3.

good deal for secured creditors. By focusing on an economic rationale – without defending this exclusive focus – Baird eliminates without discussion or proof any other values that may be served by bankruptcy.

As a descriptive account, Loss Distribution Theory tracks insolvency law and practice much better than Debt Collection Theory. For example, the U.S. Bankruptcy Code alters all sorts of creditor entitlements, and indeed creates new ones. These distributional decisions reflect “the fundamental purpose of reorganization... to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.”⁵² Similarly, Canada’s Bankruptcy and Insolvency Act⁵³ (BIA) and CCAA both create super-priority charges over the debtor’s assets in favour of debtor-in-possession (DIP) lenders, and to a limited extent for employees, pensioners and critical suppliers.⁵⁴ Recently, the Supreme Court of Canada articulated the broader view of insolvency law reflected in these distributional schemes:⁵⁵

Reorganization serves the public interest by facilitating the survival of companies supplying goods or services crucial to the health of the economy or saving large numbers of jobs. Insolvency could be so widely felt as to impact stakeholders other than creditors and employees.

This view of insolvency law is consistent with the statements of the Senate in its report following a major review of Canadian insolvency legislation in 2003, with the underlying theme being that insolvency law should seek to avoid or mitigate the losses flowing from insolvency as much as possible.⁵⁶ In addition, Roy Goode notes that British insolvency law also has broader aims than merely maximising returns for creditors:⁵⁷

But there are values to be protected that go beyond the interests of those with accrued rights at the commencement of the insolvency process... To focus so exclusively on maximising returns to creditors is to ignore the fact that there may be different ways of protecting creditors, some of which will also benefit other interests, such as those of employees, shareholders and the local community, and in so doing may even advance creditors’ interests.

⁵² *NLRB v Bildisco & Bildisco*, 465 US 513, 528 (1984).

⁵³ RSC 1985 c B-3.

⁵⁴ The last of these charges only exists under the CCAA.

⁵⁵ *Century Services Inc v Canada (Attorney General)*, 2010 SCC 60 para 18. See also para 15: “The purpose of the CCAA... is to permit the debtor to carry on business and, where possible, avoid the social and economic costs of liquidating its assets.”

⁵⁶ Senate, Standing Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangement Act* (November 2003) 9: “Bankruptcy and insolvency situations usually have devastating effects for everyone affected: the consumer or corporate debtor, family and friends, communities, unpaid suppliers, uncompensated – and perhaps unemployed – employees, creditors and shareholders, among others.”

⁵⁷ See Goode (n 21) 73.

All of this suggests that insolvency law is fundamentally distributional, and this undermines Debt Collection Theory's explanatory purchase. It is perhaps no surprise, then, that scholars holding diverging views of insolvency law nonetheless agree that Debt Collection Theory is problematic.⁵⁸

Having said this, Warren admits that her theory is incomplete.⁵⁹ There is no clear way of balancing the different and sometimes competing interests that Warren wishes to take into account in insolvency. In addition, to the extent that it advocates the pursuit of distributional goals favouring parties that may have no legal rights in insolvency, and at the expense of creditors holding valid claims against an insolvent debtor's assets, Loss Distribution Theory risks becoming indeterminate and arbitrary.⁶⁰

The world is a messy and complicated place, where justice is often hard to find. But it does not follow that bankruptcy policy should be vague and mysterious and that nothing more can be said other than that bankruptcy judges have a general mandate to do equity, but not too much equity... A panegyric on the virtues of equitable jurisprudence is neither a theory nor an adequate substitute for a theory.

In this regard, Loss Distribution Theory has been compared unfavourably to certain values-based and communitarian accounts of insolvency.⁶¹

Eclecticism runs the danger of seeing all arguments as valid and, as a result, guidance for practical decision-making is lacking and confusion results. If an identification of the objectives of insolvency law is desired so as to provide a framework within which judges and legislators can act, then the multi-value/eclectic, even more than the communitarian, approach is guilty of settling untrammelled discretions on such individuals and allowing them freely to choose from and combine an indeterminately long list of vaguely stated ingredients.

In my view, although Loss Distribution Theory shares some of these problems with the values-based and communitarian accounts, it is still important to distinguish between each of these accounts. The latter accounts, as advanced chiefly by Donald Korobkin and Karen Gross, have very different premises and aims than Loss Distribution Theory, which lead them to make untenable claims about the role and purposes of insolvency law. It will be helpful to consider these differences before returning to the question of whether Loss Distribution Theory can address the above problems.

⁵⁸ See, for example: Theodore Eisenberg, "A Bankruptcy Machine that Would Go of Itself" (1987) 39 Stan L Rev 1519; Charles W Adams, "An Economic Justification for Corporate Reorganizations" (1991) Hofstra L Rev 117; Finch (n 45) 32-40.

⁵⁹ Warren (n 46) 811: "I have offered a dirty, complex, elastic, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision."

⁶⁰ Baird (n 3) 834.

⁶¹ Finch (n 45) 48.

4. Values-Based and Communitarian Accounts of Insolvency

Like Warren, Korobkin distinguishes between debt collection law and insolvency. Korobkin sees debt collection law as an enforcement mechanism for creditors – it has a much narrower focus than insolvency law and does not specifically respond to financial distress.⁶² But from here, Korobkin's account departs significantly from Warren's. Korobkin sees insolvency as "a distinct system for responding to the problem of financial distress, understood as involving a crisis in values."⁶³ In his view, insolvency law is not so much concerned with economic issues as it is with the values of participants in financial distress:⁶⁴

Under the value-based account, bankruptcy law creates conditions for a discourse in which the aims of the estate as enterprise are defined and redefined. Loosely speaking, it accomplishes a kind of "group therapy": the values of the participants in financial distress are rehabilitated into a coherent and informed vision of what the estate as enterprise shall exist to do. The value-based account thus explains bankruptcy law as a system with varied contours and dimensions, having the distinct function of facilitating the expression and recognition of those diverse values important in dealing with financial distress.

In short, Korobkin argues that insolvency law should focus as much on the broad moral, political and social problems that arise in cases of financial distress as on the economic problems.⁶⁵ Insolvency law provides a forum for participants in financial distress to express their "conflicting and incommensurable values" so that the rehabilitated debtor can "realiz[e] its potential as a fully dimensional personality."⁶⁶ It follows that insolvency law should alter creditors' non-insolvency entitlements as required in order to accomplish these goals.⁶⁷

The foregoing quotations highlight the significant differences between Korobkin's account and Loss Distribution Theory. Although Loss Distribution Theory views insolvency law's goals more broadly than Debt Collection Theory, Loss Distribution Theory does not focus equally on economic, social, moral and political concerns, as Korobkin does. Rather, Loss Distribution Theory focuses on the economic consequences of insolvency law's distributional choices.⁶⁸

⁶² Donald R Korobkin, "Rehabilitating Values: A Jurisprudence of Bankruptcy" (1991) 91 Colum L Rev 717,766-7.

⁶³ *ibid* 766.

⁶⁴ *ibid* 722.

⁶⁵ *ibid* 762: "Bankruptcy law is a response to the problem of financial distress – not only as an economic, but as a moral, political, personal and social problem that affects its participants."

⁶⁶ *ibid* 772.

⁶⁷ *ibid* 768.

⁶⁸ Elizabeth Warren, "Bankruptcy Policymaking In An Imperfect World" (1993) 92 Mich L Rev 336, 356.

... it remains the case that the protection of parties without legal rights also reflects a more profound economic reality: the parties with formal legal rights never completely internalize the full costs of a business failure. Any attempt to avoid haphazard liquidation helps offset the losses imposed on parties to whom the costs have been externalized as well.

Put another way, it is one thing to say, as Loss Distribution Theory does, that insolvency law should consider the broad economic consequences of corporate insolvency. It is quite another thing to say, as Korobkin does, that the owners of insolvent companies should pay for “group therapy” for a potentially infinite number of individuals whose values are affected in one way or another by insolvency. In this regard, James Bowers offers a pointed critique of Korobkin’s account:⁶⁹

Bankruptcy law is concerned mostly with phenomena such as lending, borrowing, financial losses, stocks, bonds, contracts, payments, and security interests. Surely most people would grant that they can easily be classed as economic. Skepticism whether economic theory has anything to contribute to the understanding of legal policies regulating these concededly “economic” activities thus seems misplaced when bankruptcy or collection law is the subject of concern.

It is noteworthy that Bowers also criticizes Debt Collection Theory, and particularly the creditors’ bargain model, for making what Bowers sees as fundamental errors in economic modelling.⁷⁰ The point is simply that one need not reject all economic approaches in order to make sense of insolvency law, as Korobkin does.

Bowers’ critique also helps to distinguish Korobkin’s values-based theory from Karen Gross’ communitarian account of insolvency. In Gross’ view, while insolvency law should consider community interests, such interests often can be understood in economic terms:⁷¹

First, saying that community interests are important and must be taken into account in the bankruptcy process does *not* mean that the other interests that bankruptcy seeks to protect, such as those of creditors and equityholders, are forgotten. Thus, recognizing the import of community does *not* mean, a fortiori, that community interests trump other interests. Second, consideration of community is *not* necessarily a noneconomic decision and is also not, per se, economically inefficient. *Taking community interests seriously is not synonymous with rejecting all economic modeling; what it reflects is a desire for a different, more expansive economic model.*

⁶⁹ James W Bowers, “Whither What Hits the Fan?: Murphy’s Law, Bankruptcy Theory, And the Elementary Economics of Loss Distribution” (1991) 26 Ga L Rev 27, 69.

⁷⁰ James W Bowers, “Groping and Coping in the Shadow of Murphy’s Law: Bankruptcy Theory and the Elementary Economics of Failure” (1990) 88 Mich L Rev 2097, 2111-13.

⁷¹ Karen Gross, “Taking Community Interests Into Account in Bankruptcy: An Essay” (1994) 72 Wash U L Q 1031, 1032-33 (emphasis added).

That said, Gross vacillates over the usefulness of economic models:⁷²

Perhaps more importantly, even if some community interests could never be measured in economic terms, that does not mean, a fortiori, that they lack value. It is certainly possible that there are things of value that we cannot quantify. For me, their nonquantification does not make them unimportant to our world. The inability to translate the interests of community into money... does not mean that they lack worth. Instead, it means that we have to consider “worth” in both economic and noneconomic terms.

This points up an unresolved inconsistency in Gross’ account which appears repeatedly in her work.⁷³ As such, while Gross departs from Korobkin by recognizing the importance of economic analyses of insolvency law, she seems unable to reconcile this view with her claim that insolvency law must also recognize noneconomic values. Again, in contrast, Loss Distribution Theory claims that insolvency law must balance competing *economic* interests:⁷⁴

A policy that focuses on the values to be protected in a bankruptcy distribution scheme and on the effective implementation of these values assists the decision-making process even if it does not dictate specific answers. This approach illuminates the critical questions. The distributional objectives of bankruptcy cannot be considered without inquiries into many issues, including who may be hurt by a business failure, how they may be hurt, whether the hurt can be avoided, at what cost it can be avoided... who can best bear the costs of business failure, and who expected to bear the costs of business failure – just to name a few. These questions are normative, and each contains essential empirical questions as well.

Based on the above, we can view the major accounts of insolvency law on a spectrum, with Debt Collection Theory and other Law and Economics accounts at one end, and values-based and communitarian accounts at the other. Of the latter, Korobkin’s values-based account occupies a place at the extreme end of the spectrum opposite Debt Collection Theory, viewing economic theory as unhelpful in the analysis of insolvency issues and holding that insolvency law should consider a (potentially infinite) range of values. Gross’ communitarian account is therefore somewhat closer to the middle of the spectrum, in holding that a broad economic model is analytically helpful. Again, however, there is an unresolved inconsistency here in Gross’ account. Loss Distribution Theory is yet closer to the middle of the spectrum, insofar as it views the competing values that insolvency law must balance in economic terms.

⁷² *ibid* 1046.

⁷³ For example, see “In Forma Pauperis in Bankruptcy: Reflecting On and Beyond *United States v. Kras*” (1994) 2 Am Bankr Inst L Rev 57, 68: “Self-worth, preservation of dignity, and respect within and outside one’s family are hard to quantify. But, that does not make them unquantifiable... Stated most simply, I am suggesting an expansive interpretation of what it means to measure costs and benefits.”

⁷⁴ Warren (n 46) 796.

5. Contract Theories of Insolvency

In addition to the accounts discussed above, various scholars have developed several contract- and market-based accounts of insolvency law, which are often associated with Law and Economics and Debt Collection Theory. These accounts fall broadly under the umbrella of Contract Theory. For example, Robert Rasmussen proposes a “menu” approach to insolvency in which creditors would select their preferred insolvency process in their lending agreements:⁷⁵

For too long bankruptcy scholars have failed to realize that bankruptcy law is really part of contract law. The reorganization proceeding offered by federal bankruptcy law is simply a term in the fully contingent contract between a firm and each of its creditors. When the focus shifts from a firm in trouble to the contract that the firm would offer those deciding whether or not to extend credit to the firm in the first instance, many of our previously held conceptions about the nature of bankruptcy shift as well.

Similarly, Barry Adler argues that formal insolvency processes are inherently inefficient and should be replaced by a system that promotes optimal contracting between investors:⁷⁶

In a legal environment hospitable to all forms of contract, investors could agree efficiently to preserve a firm’s value without the aid of the costly, rule-based bankruptcy process. We do not observe such agreements in the United States because political compromises have produced a legal regime that discourages optimal contracts.

Specifically, Adler proposes that companies issue special kinds of securities called “chameleon equity” rather than traditional debt instruments. Holders of chameleon equity would be entitled to receive set payments from companies just as creditors are, but “would not be permitted to collect individually on an obligation in default.”⁷⁷ Instead, upon default, chameleon equity holders would gain voting control over the company and a portion of the company’s residual claim, and could then decide whether to reorganize or liquidate the company. Adler argues that such a system would permit companies and their creditors to solve the common pool problem and maximise value without incurring the costs of insolvency proceedings.

⁷⁵ Robert K Rasmussen, “Debtor’s Choice: A Menu Approach to Corporate Bankruptcy” (1992) 71 Tex L Rev 51, 121. See also, generally, Robert K Rasmussen and David A Skeel, Jr, “The Economic Analysis of Corporate Bankruptcy Law” (1995) 3 Am Bankr Inst L Rev 85.

⁷⁶ Barry E Adler, “Financial and Political Theories of American Corporate Bankruptcy” (1993) 45 Stan L Rev 311.

⁷⁷ *ibid* 323.

Variations on the above views remain popular.⁷⁸ However, Contract Theory has been criticized for failing to demonstrate that a contract-based insolvency system would improve outcomes for creditors generally, and to account for how real-world creditors actually behave. For example, Lynn LoPucki points out that most real-world insolvency contracting occurs between secured creditors who have redistributive motives:⁷⁹

Practitioners report extensive contracting for bankruptcy procedure in two kinds of transactions: workouts and asset securitizations. Failure of secured creditors to include unsecured creditors in the contracts for stay waivers in workouts suggests that the contracting parties are attempting to appropriate the expectancies of the unsecured creditors rather than to maximize social welfare. Failure to protect the future creditors of the originator in asset-securitization contracts suggests that redistribution of wealth may be the motivating force in those transactions as well. These tendencies of real-world bankruptcy contracting to seize on opportunities for redistribution do not bode well for the future of bankruptcy contracting.

In short, proponents of Contract Theory have not shown that a contract-based system would better maximise social welfare than existing insolvency processes. This is unsurprising for several reasons. Historically, Chapter 11 developed as a response to the myriad problems with the equity receivership, which was itself a creature of contract.⁸⁰ Moreover, even if we were to grant that a contract-based insolvency system would be more efficient than Chapter 11 in an ideal free market, this alone would not justify adopting such a system. Rather, Contract Theorists must show that their models would be superior to Chapter 11 in real-world imperfect markets:⁸¹

Distinguishing the misery and cost *inherent* in dealing with failing businesses from the misery and cost *added* by the way Chapter 11 deals with such businesses is an important but often ignored issue... Reorganizing was costly before bankruptcy law even dealt with reorganizations, and it will remain costly if we modify bankruptcy law or remove the reorganization process from bankruptcy.

Put another way, there are a variety of factors – economic, legal, political and otherwise – that will influence insolvency work-outs regardless of whether the state imposes a formal process. For example, Janis Sarra

⁷⁸ See, for example, Alan Schwartz, “A Normative Theory of Business Bankruptcy” (2005) 91 Va L Rev 1199, 1261-2: “... the state should supply a menu of bankruptcy procedures and permit parties, in their lending agreements, to contract for the particular procedure they expect will be optimal for them.” See also Michael Schillig, “Corporate Insolvency Law in the Twenty-First Century: State-Imposed or Market-Based?” (2014) 14 JCLS 1 (arguing that the “menu” approach solves an anti-commons problem in the negotiation of insolvency workouts).

⁷⁹ Lynn M LoPucki, “Contract Bankruptcy: A Reply to Alan Schwartz” (1999) 109 Yale LJ 317, 340-41.

⁸⁰ See Theodore Eisenberg, “Baseline Problems in Assessing Chapter 11” (1993) 43 U Tor LJ 633, 636-48.

⁸¹ *ibid* 633-4.

notes that pure Contract Theory ignores the fact that states already regulate economic activity in important ways:⁸²

Pure market theory fails to recognize the current reality of legal and economic regulation by the state via securities regulation and corporations and competition statutes. The state has intervened to assist corporations and to protect equity investors. The market is only one component that contributes to a system's ability to achieve the objective of successful restructuring of insolvent corporations, and a number of economic, legal, and political factors influence outcomes. . . . Insolvency law must be situated in the social and economic context in which corporations operate, recognizing that multiple factors affect restructuring decisions, beyond narrow assessment of commercial requirements on an individual case-by-case basis.

Accordingly, Contract Theory falls short as both a descriptive and normative account of insolvency law insofar as it fails to reflect real-world market imperfections and transaction costs. In fact, some versions of Contract Theory only seem workable in a very limited number of real-world cases:⁸³

The specificity of Adler's proposal necessarily limits his universe to a very small subset of bankruptcy cases. There probably are fewer than 100 Chapter 11 cases filed by publicly held corporations each year, and only a portion of those qualify for "chameleon equity." In the nearly 2000 Chapter 11 cases that have crossed my docket in nine years on the bench, I do not think that I have ever had such a case, and certainly have not had as many as ten.

In addition, John Armour has suggested that Contract Theory may impose prohibitive costs on parties. Specifically, in addition to creating multiple insolvency regimes that would increase legal and transactional costs, Contract Theory may commit parties to a process that later turns out, in fact, to be unsuited to their needs:⁸⁴

A more serious problem seems to be the threat of potential lock-in to suboptimal choices of insolvency procedure. The costs of specifying such a procedure *ex ante* may be prohibitive, as may be the opportunity costs if it turns out to be inappropriate. By providing firms with the ability to select amongst a wide range of insolvency regimes, the possibility of a severe mismatch between needs and applicable procedure is likely to be increased. Furthermore, firms' business, finance and organisational structure may change over time, and hence a chosen insolvency regime, even if appropriate at the outset, may cease to be so *ex post*.

⁸² Sarra (n 37) 36. See also Jay Lawrence Westbrook, "The Control of Wealth in Bankruptcy" (2004) 82 *Tex L Rev* 795, especially 857 (arguing that the only plausible form of contractualism requires a system of secured credit – "secured contractualism" – which contractarians have not contemplated and, moreover, which would raise questions about both the transactional efficiency of secured credit and the efficiency and fairness of an insolvency process managed by a secured creditor).

⁸³ Samuel L Bufford, "What is Right About Bankruptcy Law and Wrong About its Critics" (1994) 72 *Wash ULQ* 829, 839.

⁸⁴ John Armour, "The Law and Economics of Corporate Insolvency: A Review" in Reinout D Vriesendorp and others (eds), *Comparative and International Perspectives on Bankruptcy Law Reform in the Netherlands* (Boom Juridische uitgevers 2001) 127.

Finally, there is a sense in which Contract Theory is normatively problematic, namely in that it implicitly favours more powerful parties and repeat players in insolvency. Specifically, to the extent that different insolvency stakeholders possess different relative resources, knowledge and bargaining power, the insolvency processes to which they privately agree are likely to reflect those inequalities. Accordingly, in order to maintain any normative appeal, a contract-based insolvency model would require a system of background rules to prevent abusive behaviour and to respond to particular insolvency issues, over and above the basic rules of contract law. But this merely re-introduces the problem that Contract Theory purports to solve, namely, reducing state involvement so as to facilitate private ordering in insolvency.

6. Conclusions Regarding Competing Accounts of Corporate Insolvency Law

I have suggested that Loss Distribution Theory, though flawed, does a better job of explaining corporate insolvency law than the other major competing accounts. But this is just to say that Loss Distribution Theory accurately explains what insolvency law *does*, not what it *should do*. Loss Distribution Theory faces significant challenges as a normative account of insolvency.⁸⁵ As noted earlier, it is an incomplete theory because it does not provide an exhaustive, consistent set of principles to guide or evaluate insolvency decision-making.

One attempt to solve the above problem involves enumerating a non-exhaustive list of insolvency law's goals, based more or less on statutory interpretation and the leading case law. Both Warren and Janis Sarra have suggested this type of approach.⁸⁶ However, while this may limit the indeterminacy problem, Loss Distribution Theory still risks being arbitrary. Specifically, Loss Distribution Theory suggests that insolvency law should favour groups that do not have formal legal rights in insolvency, but there is no obvious reason why parties should enjoy rights in insolvency that they do not possess outside it:⁸⁷

Warren argues, for example, that bankruptcy law should favor those who are least able to bear the costs of a business failure. For this reason, she argues, employees rightly enjoy their limited priority under existing bankruptcy law. Warren, however, needs to explain why those who are least able to bear these costs should nevertheless bear them when the firm closes or fails outside bankruptcy. (Warren cannot be arguing that the costs should be distributed the

⁸⁵ Baird (n 3) 817: "Warren seems to derive what bankruptcy law ought to be from what it is, but one cannot derive the normative from the positive."

⁸⁶ See Warren (n 68) 357-361; Sarra (n 37) 106-108. I have argued in the past that such approaches, which focus on interests that are identifiable in economic terms, are an appropriate starting point for delineating insolvency law's scope. See Alfonso Nocilla, "Asset Sales Under the Companies' Creditors Arrangement Act" (LLM thesis, University of Western Ontario 2011).

⁸⁷ Baird (n 3) 817.

same way regardless of whether a bankruptcy petition is filed, because when losses are distributed the same way inside of bankruptcy as outside, distribution of losses is not a *bankruptcy* problem.)

Baird's objection points up a crucial ambiguity in Warren's account. Warren seems to argue that insolvency law should protect vulnerable groups *in general*. That is, Warren does not distinguish between potential harms that arise as a result of business failure generally and those that arise only in the insolvency context. Warren goes on to suggest that insolvency law should redistribute wealth so as to internalize the negative externalities generated by business failure, again, without distinguishing between insolvency and non-insolvency harms.⁸⁸ Even setting aside this distinction, Warren's answer is not very helpful, since compensation for loss is conceptually distinct from redistribution. Strictly speaking, then, this answer has little to do with insolvency law.

A better answer is to stipulate that insolvency law should only address problems that are peculiar to the circumstances of factual insolvency.⁸⁹ Redistribution in insolvency is appropriate if, and only if, it responds to problems that arise exclusively in the insolvency context. The rationale here is straightforward and follows similar lines as Baird's above objection. Most companies fail without ever entering formal insolvency proceedings, often resulting in losses to employees, customers, suppliers and communities. Accordingly, if the state wishes to intervene to address such losses, it should do so as a matter of general law and not insolvency law.⁹⁰ In short, by addressing such losses in insolvency, the state would shift the costs of compensating non-financial stakeholders of insolvent companies to private parties, i.e. the owners of those insolvent companies. Put another way, the state would be imposing a tax on those owners. Such an approach is questionable both morally and as a matter of social and economic policy. If such costs ought to be compensated as a matter of policy, it makes more sense for the state to pay rather than private parties, since imposing a tax on the financial stakeholders for the benefit of the non-financial stakeholders of *only* those distressed companies that enter formal insolvency proceedings would be arbitrary and may well destroy value. For example, creditors subject to such a regime would be less likely to forbear in times

⁸⁸ Warren (n 68) 356: "...the parties with formal legal rights never completely internalize the full costs of a business failure."

⁸⁹ See Mokal (n 4) 62.

⁹⁰ *ibid* 62-67, especially at 67: "If people who have not made direct financial contribution to the firm ought still to be given the right to decide what happens to the firm's assets, then this right should again be conferred on all similarly-placed parties. To create these rights only when the firm becomes subject to a formal insolvency proceeding is to make arbitrary distinctions."

of distress, and would instead seek to enforce their claims before the debtor enters formal insolvency proceedings. In addition, this indirect tax on creditors of insolvent companies would most likely be reflected in the increased cost and difficulty of obtaining credit, particularly for companies with significant liabilities on their balance sheets. In short, a policy of using insolvency law to shift costs to the owners of troubled companies for the benefit of non-financial stakeholders is likely to generate sub-optimal outcomes for all stakeholders. Notably, in such cases, the stakeholders who would lose the most are likely to be the most vulnerable ones to begin with, i.e. unsecured and undersecured claimants, as well as non-financial stakeholders. Moreover, the principle that insolvency law ought to address only those problems that are distinct to insolvency also helps to explain a variety of redistributive insolvency rules such as, for example, the wrongful trading provisions in British insolvency law:⁹¹

A better response would be to concede that the wrongful trading provisions are redistributive. They create new rights and liabilities, and upset the relative values of pre-insolvency rights. But this redistribution still serves maximization goals. The redistribution is principled, focussing on minimizing further loss once the firm enters the insolvency forum, and the quantum of the new rights created is determined with reference to this aim.

The above discussion points up some of the shortcomings of Loss Distribution Theory. As noted earlier, the other major accounts of insolvency law also suffer from important problems that undermine their explanatory and justificatory force. In short, no single theory provides a comprehensive account, but each highlights certain important aspects of insolvency law. In this regard, they are helpful in identifying insolvency law's underlying goals.

III. WHAT SHOULD CORPORATE INSOLVENCY LAW DO?

It is easy to divide insolvency law theorists into two basic camps: those, typically associated with Jackson and the Law and Economics school, who think that insolvency law is primarily concerned with maximising recoveries for creditors, narrowly defined; and those, sometimes termed 'progressives' and associated chiefly with Warren, who think that insolvency law should focus on protecting broader community interests:⁹²

When Thomas Jackson published *The Logic and Limits of Bankruptcy Law* in 1986 he framed virtually all bankruptcy scholarship that would follow for the next fifteen years... This 'creditors' bargain' approach has divided the world of bankruptcy academics into two camps: the 'Law and Economics' scholars who appear to adopt

⁹¹ *ibid* 304.

⁹² Marcus Cole, "Limiting Liability Through Bankruptcy" (2002) 70 U Cin L Rev 1245, 1251.

the creditors' bargain as the essential purpose of bankruptcy, and the 'Progressives' who contend that the purpose of bankruptcy is to promote social welfare, ordering and redistribution that is not politically feasible through other means. The common pool, according to the Progressives, should be shared by more claimants than the Law and Economics scholars are willing to acknowledge.

In my view, this approach is at best a starting point for understanding corporate insolvency law. As the discussion thus far has shown, there are considerable nuances within these two broad schools of thought, and it would be wrong to lump Loss Distribution Theory together with communitarianism, or Debt Collection Theory together with any given contractarian theory of insolvency. But it makes sense that many scholars begin their analyses of insolvency law by framing the theoretical debate in this straightforward manner. For example, Christopher Symes observes that Australian corporate insolvency law "developed without much thought for theories or visions".⁹³ Perhaps as a result, Australian insolvency law remains "in its infancy when discussing theoretical perspectives. It is impossible to describe an insolvency theory or theoretical framework that completely or convincingly explains the existing regime."⁹⁴ To some extent, this seems true of insolvency law in the U.K., U.S. and Canada, as well. Despite thirty years of intense scholarly attention, insolvency law theory in these countries continues to grapple with foundational questions, even as the law is evolving rapidly. In these circumstances, it is easy to oversimplify the various competing theories of insolvency law and to exaggerate their differences.

My view is that Debt Collection Theory and Loss Distribution Theory emphasize different, though not necessarily inconsistent, core purposes of insolvency law. Jackson's key insight was that insolvency law ought to preserve and maximise the value of the insolvent debtor's assets. This was the underlying reason why insolvency law imposed a collective and compulsory process on creditors – the process preserved value for creditors as a whole. But Jackson's account fell short in focusing too narrowly on creditors rather than considering the role of other stakeholders in insolvency, and in failing to recognize that insolvency law must also consider how to distribute the assets of the insolvent estate fairly among the stakeholders. Thus, Warren's account emphasized insolvency law's distributional character and the broad range of interests that may be affected by insolvency, even if it failed to provide a comprehensive framework for resolving conflicts among those different interests. Despite the shortcomings of Jackson's and Warren's

⁹³ Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status* (London: Ashgate 2008) 63.

⁹⁴ *ibid* 70.

respective accounts, then, they each offer important insights regarding insolvency law's role. In this regard, Roy Goode has argued that corporate insolvency law has three main goals:⁹⁵

- 1) to maximise returns to creditors;
- 2) to establish a fair and equitable system of claims ranking and asset distribution to creditors;
and
- 3) to identify the causes of failure.

While these goals seem generally reasonable, upon closer examination they are problematic for a number of reasons. Firstly, Mokal has suggested that the first and second goals overlap unnecessarily in that they both have distributional aims. A better formulation of the first goal is to say simply that insolvency law aims to preserve and maximise the value of the insolvent estate. This goal is analytically distinct from the distributional one. At the same time, this formulation distinguishes between value maximisation and preservation, the latter of which Goode does not mention.⁹⁶ Secondly, it is important to distinguish between *creditors* and other stakeholders of insolvent entities. In particular, I would suggest that insolvency law ought to do much more than merely maximise returns for creditors. As noted already, insolvency law often must consider a broad range of interests beyond those of creditors, not only because this is more likely to lead to fair results but because considering the interests of all stakeholders in insolvency is value-enhancing. Specifically, Sarra has suggested that providing a forum in which all stakeholders can be heard facilitates wealth maximisation for insolvent enterprises and their stakeholders as a whole:⁹⁷

There is growing scholarship that recognizes that modern economies are made up of enterprises reflective of interests broader than traditional creditors and shareholders. This theoretical approach is not aimed at any particular outcome, but rather represents an effort to move away from the narrow view that the policy objective of bankruptcy law is to maximize value in the interests of asset claimants... This approach suggests that bankruptcy and insolvency law should have as both policy objective and key policy instrument the establishment of a forum where all the interests can be heard regarding the possible restructuring of the insolvent corporation. Suppliers, employees, customers, and local government may all have an interest in the workout, even if that interest cannot be translated into current capital claims.

⁹⁵ Goode (n 21) 58: "Corporate insolvency law has three overriding objectives: to maximise the return to creditors; to establish a fair and equitable system for the ranking of claims and the distribution of assets among creditors, involving a limited redistribution of rights; and to provide a mechanism by which the causes of failure can be identified and those guilty of mismanagement brought to book and, where appropriate, deprived of the right to be involved in the management of other companies."

⁹⁶ See Rizwaan J Mokal, "What Liquidation Does For Secured Creditors, And What It Does For You" (2008) 71 MLR 699, 702 (preserving the value of insolvent estate is a "core insolvency law objective").

⁹⁷ Sarra (n 37) 47.

To be clear, Sarra does not advocate redistribution in insolvency as a general rule, nor does she favour any particular process, such as reorganization, over any other, such as liquidation. Rather, she is concerned with identifying and maximising value that might otherwise be lost in insolvency:⁹⁸

A policy objective of encouraging workouts where there is a viable business plan and support of the majority of creditors does not mandate rehabilitation at any cost. Similarly, one can endorse both the policy objective of effective debt collection and the notion that there should be limits on the period in which the debtor corporation can try to secure the support of creditors and other stakeholders for a restructuring plan that maximizes the value of their claims and allows for effective transfer of that value to creditors.

This “enterprise value maximisation model” – an expanded version of the traditional creditor-wealth maximisation model – seeks to capture the value of intangible and firm-specific investments in companies that would be lost if insolvency law were to focus too narrowly on maximising returns for creditors:⁹⁹

The generation of wealth by the corporation is enhanced when decision makers have an interest in the viability of the corporation. While there is considerable debate regarding who has an interest in a firm and what rights should be assigned to each class of interest, greater control and decision rights by investors, including creditors, can arguably enhance performance. . . The extension of this reasoning is that a measure of an effective decision-making process may be whether stakeholders have participation and decision-making rights, particularly where they have incentives to devise viable restructuring plans. Whether the plan involves conversion of debt to equity, deferral of claims, or further human capital contributions, it requires additional or continued investment by all of the constituent groups.

In its recent decision in *Century Services*, the Supreme Court of Canada endorsed this expanded model of corporate insolvency law:¹⁰⁰

... the court must often be cognizant of the various interests at stake in the reorganization, which can extend beyond those of the debtor and creditors to include employees, directors, shareholders, and even other parties doing business with the insolvent company. In addition, courts must recognize that on occasion the broader public interest will be engaged by aspects of the reorganization and may be a factor against which the decision of whether to allow a particular action will be weighed.

The Supreme Court went on to state that “chances for successful reorganizations are enhanced where participants achieve common ground and all stakeholders are treated as advantageously and fairly as the circumstances permit.”¹⁰¹ All of the foregoing underscores the fundamentally collective nature of insolvency

⁹⁸ *ibid* 38.

⁹⁹ *ibid* 53.

¹⁰⁰ *Century Services* (n 55) para 60.

¹⁰¹ *ibid* para 70.

law, as well as the potential for the law to engage the public interest – that is, interests beyond those of traditional creditors or shareholders.¹⁰² Based on the foregoing, we can reformulate Goode’s goals in the following way. Insolvency law seeks to:¹⁰³

- 1) preserve and maximise the value of insolvent enterprises;
- 2) establish a fair system of ranking and compromising claims, and of distributing assets, among all stakeholders; and
- 3) investigate the causes of insolvency so as to prevent future harm and abuse.

In addition, it is also critical to understand the means by which insolvency law pursues these goals. Firstly, as noted earlier, insolvency law imposes a compulsory and collective process on all claimants. The upshot of this is that insolvency cannot be an extension of debt collection law, strictly speaking, because the latter is an individual collection mechanism. Secondly, as discussed earlier, insolvency law is concerned with problems that are unique to the circumstances of factual insolvency.¹⁰⁴ I would suggest that the above goals are consistent with, and indeed encompass, the more detailed statements of insolvency law’s purposes made by the World Bank and UNCITRAL. It is helpful to consider these statements, as they form the international best practices standards for corporate insolvency regimes, known as the Insolvency and Creditor Rights (ICR) Standard. The ICR Standard is designed to assist countries in evaluating and improving their insolvency regimes, having regard to the critical importance of sound insolvency laws to

¹⁰² For a further discussion of the concept of the “public interest” in Canadian corporate insolvency law, see Sarra (n 37) 106; Jassmine Girgis, “Corporate Restructuring, the Evolution of Corporate Assets and the Public Interest” (2013) *Int’l Insolv Rev* 29; and Stanley E Edwards, “Reorganizations Under the Companies’ Creditors Arrangement Act” (1947), 25 *Can Bar Rev* 587. See also Andrew Keay, “Insolvency Law: A Matter of Public Interest?” (2000) 51 *NILQ* 509 (discussing the role of the public interest in U.K. insolvency law).

¹⁰³ This particular formulation is Riz Mokal’s, and I am indebted to him for emphasizing the important distinction here between the value-preservation and distribution goals.

¹⁰⁴ Of course, this claim implies that insolvency gives rise to unique problems. For an alternative view, see Barry E Adler, “A World Without Debt” (1994) 72 *Wash ULQ* 811: “...when I attempt to ‘isolate bankruptcy issues’ from other issues, I find no bankruptcy issues.” For a critique of this view, see Bufford (n 83), especially 838: “In short, bankruptcy reorganization is part of the safety net that prevents secured creditors in a weak economy from collectively precipitating a downward spiral leading to a total economic collapse.”

global financial stability.¹⁰⁵ It is widely accepted by scholars and policymakers.¹⁰⁶ Specifically, UNCITRAL's *Legislative Guide on Insolvency Law* states that an insolvency regime should:¹⁰⁷

- a. enhance market certainty and promote economic stability and growth;
- b. maximise the value of the insolvent debtor's assets;
- c. strike a balance between liquidation and reorganization;
- d. ensure equitable treatment of similarly situated creditors;
- e. provide for timely, efficient and impartial resolution of insolvency;
- f. preserve the insolvency estate to allow for equitable distribution to creditors;
- g. ensure a transparent and predictable process;
- h. recognize existing creditor rights and establish clear rules for ranking priority claims; and
- i. establish a framework for cross-border insolvency.

With respect to corporate rescue procedures, the objectives of maximising value and striking a balance between liquidation and reorganization are especially relevant. The *Guide* notes that these objectives are closely linked:¹⁰⁸

... a balance has to be struck between rapid liquidation and longer-term efforts to reorganize the business that may generate more value for creditors, between the need for new investment to preserve or improve the value of assets and the implications and cost of that new investment on existing stakeholders, and between the different roles allocated to the different stakeholders, in particular the discretion that can be exercised by the insolvency representative and the extent to which creditors can monitor the exercise of that discretion to safeguard the proceedings and ensure the maximization of value.

In particular, the *Guide* states that insolvency law should “prevent premature dismemberment of the debtor's assets by individual creditor actions to collect individual debts”, on the basis that such activity often destroys value.¹⁰⁹ These goals are echoed in the World Bank's *Principles For Effective Insolvency and Creditor/Debtor Regimes*.¹¹⁰ Implicit in these principles is the notion that insolvency law should provide a

¹⁰⁵ See <https://www.fsb.org/2011/01/cos_051201/> accessed 21 July 2019. The Standard was prepared in consultation with the International Monetary Fund.

¹⁰⁶ See, for example, Industry Canada, “Fresh Start: A Review of Canada's Insolvency Laws” <[https://www.ic.gc.ca/eic/site/cilp-pdci.nsf/vwapj/review_canada_insolvency_laws-eng.pdf/\\$file/review_canada_insolvency_laws-eng.pdf](https://www.ic.gc.ca/eic/site/cilp-pdci.nsf/vwapj/review_canada_insolvency_laws-eng.pdf/$file/review_canada_insolvency_laws-eng.pdf)> accessed 21 July 2019, 7; Roderick J Wood, *Bankruptcy and Insolvency Law* (Toronto: Irwin Law 2009) 4.

¹⁰⁷ UNCITRAL (n 10) 9-14.

¹⁰⁸ *ibid* 11.

¹⁰⁹ *ibid* 12.

¹¹⁰ World Bank (n 11).

collective remedy for all stakeholders of insolvent entities, not merely creditors. This is clear from the *Guide's* Introduction, which distinguishes between creditors and other types of stakeholders in insolvency.¹¹¹

The foregoing principles flesh out the three broad goals of insolvency law set out above. Taken together, these goals and principles provide a useful framework for understanding and assessing different insolvency systems which avoids the pitfalls of the major competing theories discussed in this chapter.

IV. CONCLUSION

This chapter has argued that the more problematic and inconsistent claims of Debt Collection Theory and Loss Distribution Theory can be stripped away, while still preserving their core claims about the nature and aims of insolvency law. In this way, a more robust and coherent framework for analysing the law can be developed. Within this framework, the goals of maximising the value of insolvent enterprises and protecting the interests of a broad group of stakeholders are not seen as mutually exclusive, and may actually be complementary in many cases. I have further argued that this framework is consistent with, and best reflects, the widely accepted principles of insolvency law and the international best practices set out in the ICR Standard. In Chapter 2, the framework set out here will be applied to the British, Canadian and American rescue regimes. In particular, Chapter 2 will consider the question of whether, and to what extent, pre-packs and similar procedures in the U.S. and Canada are consistent with corporate insolvency law's underlying goals and principles.

¹¹¹ Other types of stakeholders include, for example, suppliers of goods and services, as well as employees. See UNCITRAL (n 10) 9.

CHAPTER 2:
PRE-PACKS IN A THEORETICAL AND COMPARATIVE CONTEXT

I. INTRODUCTION

Chapter 1 set out a framework for corporate insolvency law that emphasized the following three overarching policy goals:¹¹²

- 4) the preservation and maximisation of the value of insolvent enterprises;
- 5) the fair treatment of all stakeholders, including especially the fair distribution of assets among them;
and
- 6) the investigation of the causes of insolvency, so as to minimise harm and abuse.

Chapter 1 explained that insolvency law pursues these goals primarily by imposing a collective and compulsory process upon all those holding potential claims against the insolvent company. In addition, I argued that in the foregoing way, insolvency law differs fundamentally from debt-collection law, as the latter merely provides a collection system for individual creditors.

This chapter applies the above framework to pre-packaged administrations under the Insolvency Act 1986, as amended by the Enterprise Act 2002, also known as pre-packs, and compares them with related procedures in the U.S. and Canada. I argue that these procedures may well undermine the basic goals of insolvency law because they tend to favour certain stakeholders, namely, senior secured creditors, at the expense of others. In particular, pre-packs give significant control over the insolvency process to senior creditors, thereby permitting them, at least in theory, to enjoy the benefits of a collective process even as they pursue what are effectively individual enforcement actions. In short, there is a risk that senior creditors may use pre-packs to shift costs to, and appropriate value from, other stakeholders. These worries appear to be borne out in recent empirical studies, raising important questions about the appropriateness of pre-packs and their role in the insolvency regime.

II. PRE-PACKS AND THEIR IMPLICATIONS

Pre-packs and related procedures in the U.S. and Canada represent a shift in corporate insolvency law away from reorganization, in which the insolvent debtor is rehabilitated and continues to operate, toward a realization model, in which substantially all of the debtor's assets are sold and the proceeds distributed

¹¹² As noted in Chapter 1, this is Mokal's formulation.

to its creditors, after which the debtor ceases to exist. The extent to which these new types of procedures further insolvency law's basic goals of maximising enterprise value, ensuring fair distributions among stakeholders, and investigating the causes of insolvency, is an important question. Before turning to this question, however, it is helpful to examine the structure of the U.K.'s corporate insolvency regime.

1. Administration and Administrative Receivership

U.K. law provides a number of formal procedures for resolving corporate insolvency. The main rescue mechanism is administration, which was first introduced in the Insolvency Act 1986 and later reformed in the Enterprise Act 2002. In an administration, an insolvency professional known as an administrator is appointed to manage the affairs and operations of the insolvent company. The administrator may be appointed in two ways: (a) by court order upon application of the debtor, its directors or one or more of its creditors; or (b) out-of-court, either by the debtor or its directors, or by the holder of a qualifying floating charge over the debtor's assets. Upon application to the court or the filing of a notice of intention to appoint an administrator, interim moratoria are imposed on any winding-up of the debtor, any actions to enforce security over the debtor's property, repossess its goods, enter any leased premises, or commence legal proceedings against the debtor, subject to leave of the court.¹¹³ These moratoria provide the debtor with breathing room in which to attempt a restructuring. They remain in effect unless and until the court dismisses the application to appoint an administrator (in the case of a court-appointed administrator), or an administrator is not appointed within 5 business days of either the court's approval of an application or the filing of a notice of intention to appoint one out-of-court.¹¹⁴ The administration process automatically terminates after 12 months from the date on which it took effect, subject to an extension by court order or the consent of the debtor's creditors.¹¹⁵ In the latter case, the extension cannot exceed 6 months.¹¹⁶

Upon appointment, the administrator effectively displaces incumbent management of the insolvent debtor. While the directors and managers often remain in place, the administrator takes control of the

¹¹³ Insolvency Act 1986, sch B1, paras 42-44.

¹¹⁴ *ibid* para 44.

¹¹⁵ *ibid* para 76(1) and (2). Note that "consent" means the consent of all of the secured creditors, as well as, generally, any unsecured creditors holding more than 50% of the unsecured debt who respond to the request for consent, see para 78(1).

¹¹⁶ *ibid* para 76(2)(b).

debtor's affairs, business and property.¹¹⁷ In this regard, the administrator has 3 main statutory obligations. Firstly, he must attempt to rescue the debtor company as a going concern.¹¹⁸ Secondly, if, in the administrator's opinion, this goal is "not reasonably practicable" or would be less beneficial to the creditors as a whole than a winding-up, then the administrator may wind-up the company.¹¹⁹ Thirdly, if neither of these objectives is reasonably practicable, and if doing so does not unnecessarily harm the interests of the creditors as a whole, the administrator may sell the debtor's assets and distribute the proceeds to the secured or preferential creditors.¹²⁰

It is important to understand the context in which the Enterprise Act reforms were introduced. As noted, the Insolvency Act 1986 contained administration provisions, but these differed from the current regime in several important respects. Firstly, administration under the Insolvency Act was not a stand-alone process, as any restructuring plan developed during administration had to be implemented through some other statutory procedure. Generally, this meant either a Company Voluntary Arrangement (CVA) under the Insolvency Act, a scheme of arrangement under the Companies Act 1985, or liquidation.¹²¹ Secondly, as a court-supervised process, administration under the Insolvency Act was seen as more expensive and time-consuming than other procedures.¹²² Thirdly, and perhaps most importantly, although administration under the Insolvency Act imposed moratoria on most types of enforcement actions, it did not prevent floating charge holders from appointing an administrative receiver. In particular, the petition to appoint an administrator could not be approved unless all floating charge holders consented to it. This was a major shortcoming of the regime, as it significantly curtailed an administrator's abilities and arguably created a conflict of interest:¹²³

Since an administrator can only be appointed if debenture-holders agree, this procedure cannot be viewed as offering the debtor protection from impatient creditors. The company will only succeed in appointing an administrator if these creditors agree. This leads to the conclusion that successful applications for

¹¹⁷ *ibid* paras 1(1), 59 and 69.

¹¹⁸ *ibid* para 3(1)(a).

¹¹⁹ *ibid* para 3(1)(b).

¹²⁰ *ibid* paras 3(1)(c) and 3(4).

¹²¹ Finch (n 45) 366, citing Harry Rajak, "The Challenges of Commercial Reorganization in Insolvency: Empirical Evidence from England" in Jacob Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford: Clarendon Press 1994).

¹²² Insolvency Service, *Company Voluntary Arrangements and Administration Orders: A Consultative Document* (HMSO 1993) 29.

¹²³ David C Webb, "An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain?" (1991) 43 *Oxford Econ Pap* 139, 152-153.

administration orders will either come from creditors or from the firm with the approval of creditors. Since the administrator himself has to meet with the approval of creditors we may expect that the administrator will, if appointed, like an administrative receiver, act in the interests of the creditors although nominally an agent of the creditors and the firm.

Moreover, since the administrator had no power to make distributions to creditors, floating charge holders had a further incentive not to consent to the appointment of an administrator, and to appoint an administrative receiver instead.¹²⁴ All of these factors weakened administration as a rescue mechanism and discouraged its use.¹²⁵ In 1986, however, these aspects of the administration regime were not widely seen as problematic. Rather, the Cork Committee, which recommended the 1986 administration process, thought that administrative receivership should be the primary mechanism for resolving corporate insolvency. Administration was merely intended to supplement the existing receivership model. Specifically, the Cork Committee recognized that not every insolvent company would have a creditor with a floating charge and sufficient resources and incentives to appoint a receiver, which meant that some companies would miss out on the purported benefits of receivership. The 1986 administration provisions were designed to extend the “benefits” of receivership to such companies:¹²⁶

There is, however, one aspect of the floating charge which we believe to have been of outstanding benefit to the general public and to society as a whole; we refer to the power to appoint a receiver and manager of the whole property and undertaking of a company. This power is enjoyed by the holder of any well-drawn floating charge, but by no other creditor.

[. . .]

Accordingly, we propose that in all cases, and whether or not there is a floating charge in existence, provision should be made to enable a person (whom we shall call an Administrator) to be appointed whenever the circumstances justify such a course, with all the powers normally conferred upon a receiver and manager appointed under a floating charge, including power to carry on the business of the company and to borrow for that purpose.

The distinction here between administration and administrative receivership is critical. In a receivership, the receiver takes legal control of the debtor, with the principal duty of selling the debtor's assets for the best possible price so as to satisfy the chargee's claim.¹²⁷ The receiver has no explicit obligation to attempt a rescue of the debtor, and creditors other than the chargee remain free to enforce

¹²⁴ Finch (n 45) 369.

¹²⁵ *ibid* 368.

¹²⁶ Insolvency Law Review Committee (n 21) 117. See also Mokal (n 35) 360-361.

¹²⁷ *ibid* 336.

their claims against the debtor. In short, by permitting creditors to act in their individual self-interest, the receivership model *prima facie* encouraged the liquidation of insolvent companies even if reorganization would generate more value.¹²⁸ It is precisely for this reason that the Enterprise Act reforms sought to replace administrative receivership with a stronger administration mechanism. The White Paper preceding the Enterprise Act reforms noted that since 1986, concerns had arisen that receivership was a destructive mechanism that “caus[ed] companies to fail unnecessarily”.¹²⁹ At the same time, the fact that the receiver was primarily accountable only to the chargee raised concerns that receiverships could not provide adequate transparency and accountability for all stakeholders of distressed companies.¹³⁰ The solution was to “tip the balance firmly in favour of collective insolvency proceedings” by introducing a new and more robust administration regime.¹³¹ Government ministers echoed these sentiments when the Enterprise Act was introduced in Parliament:¹³²

Company rescue is at the heart of the revised administration procedure. We want to make sure that viable companies do not go to the wall unnecessarily. That is why we are restricting administrative receivership and revising administration to focus on rescue and to make it more accessible to companies as well as their creditors. That is not just good for the companies themselves; it is also good for their suppliers, customers and employees.

Having said this, most insolvency scholars and practitioners continued to view administrative receivership favourably and opposed its abolition. For example, Armour and Frisby argued that by concentrating control in the hands of a single creditor, the receivership model had the potential to reduce monitoring and enforcement costs, to the benefit of all creditors:¹³³

Our principal claim is that giving *control* over the post-default decision-making process to the debenture-holder and his appointee the receiver can generate efficiencies... In order to make a decision whether or not to put the company into formal proceedings, it will be necessary for the bank to have made a decision that renegotiation is inappropriate. In doing so, it will have invested in information-gathering about the debtor’s business, and whether it should be sold as a going concern or on a break-up basis. The rights of control accorded to the debenture-holder mean that junior creditors are stayed from enforcing their claims against the firm’s assets during receivership, thereby preventing any ‘race to collect’. This allows the receiver to deploy the firm’s assets in a manner best designed to promote the bank’s interests... Enforcement in this fashion is likely to be better informed and quicker than if it were conducted by an outsider. By increasing the

¹²⁸ Webb (n 123) 144.

¹²⁹ Insolvency Service, *Productivity and Enterprise: Insolvency – A Second Chance* (HMSO 2001) 2.1.

¹³⁰ *ibid* 2.2.

¹³¹ *ibid* 2.5.

¹³² HL Deb 22 July 2002, vol 638, col 766.

¹³³ John Armour and Sandra Frisby, “Rethinking Receivership” (2001) 21 OJLS 73, 87-88.

expected returns following enforcement, it makes this a less costly strategy for the bank, hence enhancing the disciplinary function of debt.

Seen in this light, receivership is paradigmatic of Debt Collection Theory and certain contract- and market-based theories of insolvency law discussed in Chapter 1: it reflects the sort of bargain that creditors of unequal power would likely reach if they were to negotiate *ex ante* for an insolvency process. As such, receivership is open to many of the same criticisms levelled against Debt Collection Theory and contract-based accounts of insolvency law. In particular, we might argue that receivership merely reflects, and does not correct for, the arbitrary inequalities of stakeholders in insolvency. Insofar as such a model is unlikely to treat all stakeholders fairly, it lacks normative appeal.¹³⁴ At the same time, a model which focuses on maximising returns for a narrow group of creditors is less likely to maximise the value of insolvent enterprises on the whole, to the detriment of most stakeholders.¹³⁵

We can further develop the foregoing criticisms to see how, even if we grant that receiverships generate the kinds of efficiencies that Armour and Frisby suggest they can, they may also generate significant inefficiencies. The most obvious problem is that receiverships create perverse incentives for oversecured creditors to prefer fire sales. Specifically, where a creditor is oversecured, it has an incentive to seek to liquidate the distressed company's assets as quickly as possible, regardless of whether doing so maximises the value of the assets. Since the receiver is primarily responsible to the chargee, he would have no interest in maximising the value of the debtor's assets beyond what is required to ensure a full recovery for the chargee. In fact, the empirical evidence suggests that the holders of floating charges, typically banks, were oversecured in most cases.¹³⁶ In addition, there is reason to think that receivers and chargees will have perverse incentives to act in value-destructive ways even in cases where the chargee is undersecured. Banks lending to small and medium-sized companies will often obtain personal guarantees from those companies' shareholders and directors, in addition to a floating charge over the debtor's assets. Accordingly, when a debtor becomes insolvent, the bank and its receiver are not necessarily incentivised to seek to maximise the value of the insolvent enterprise. Rather, the receiver need only obtain net returns from the sale of the insolvent debtor's assets that are equal to what the bank

¹³⁴ Mokal (n 4) 41-43.

¹³⁵ Sarra (n 37) 52.

¹³⁶ Mokal (n 35) 364.

could recover in personal actions against the debtor's directors and shareholders.¹³⁷ In fact, this problem may be especially acute in cases where the chargee bank is undersecured, because in such cases it is more likely that the bank would have sought and obtained personal guarantees.¹³⁸

The above concerns provided much of the motivation behind the Enterprise Act reforms. Those reforms aimed, at least ostensibly, at encouraging company rescue in two ways: 1) by replacing administrative receivership with a stronger administration procedure, and 2) by shifting power from secured to unsecured creditors. It was thought that these reforms would help to maximise the value of insolvent enterprises for the benefit of all stakeholders, as well as increase transparency and accountability in the rescue process. Following these reforms, administration became the main rescue process. Although other processes such as CVAs and schemes of arrangement remain available, these are not commonly used for a number of reasons.¹³⁹ In a scheme, no moratorium is imposed on the debtor's creditors, and the court-driven process is more expensive than alternatives such as out-of-court administration.¹⁴⁰ CVAs, meanwhile, usually take longer and require more negotiation amongst creditors than administration.¹⁴¹

More recently, Armour, Audrey Hsu and Adrian Walters have presented data showing that while going concern sales yielded greater returns on the whole than receivership sales, the costs of administration were also higher. These results suggest that administration may be no better than administrative receivership:¹⁴²

Thus, whilst gross realizations in administration are higher, so too are costs, and it appears that the net effect on creditors therefore is equivocal. Moreover, administrations do not result in any significantly greater incidence of continued

¹³⁷ *ibid* 365.

¹³⁸ These scenarios are more likely to arise in cases where the debtor is a small or medium-sized, owner-operated business. In larger enterprises, it is less likely that the bank would obtain personal guarantees from the debtor's directors and shareholders. Nonetheless, empirical data from Chapter 11 cases in the U.S. suggest that there remain perverse incentives at least for oversecured creditors to prefer fire sales. See Kenneth M Ayotte and Edward R Morrison, "Creditor Control and Conflict in Chapter 11" (2009) 1 J Legal Analysis 511, 532: "The likelihood of traditional reorganization is higher among unsecured (44 percent) and undersecured firms (47 percent) than it is among moderately oversecured (21 percent) and highly oversecured firms (34 percent)."

¹³⁹ The relevant provisions for CVAs are found in Part I and Schedule A1 of the Insolvency Act 1986, while schemes of arrangement fall under section 895 of the Companies Act 2006.

¹⁴⁰ See Finch (n 45) 483-486.

¹⁴¹ *ibid* 514: "... it might be argued that the CVA is unlikely ever to offer the most popular or effective route to rescue because in most areas of corporate trouble the creditors tend to have such divergent interests and powers that rescue options are most likely to be arrived at by degrees of imposition rather than negotiation."

¹⁴² Armour and others (n 14) 132.

trading or going concern sales than did receiverships, indicating that the new procedure is not preserving any more employment.

But there are limitations to these findings. Firstly, the authors draw their data on administration sales from cases that commenced up to 31 December 2004. It is possible that administration costs were higher at that time because insolvency professionals were still familiarizing themselves with the new regime – a possibility which the authors acknowledge in an earlier paper:¹⁴³

As with any study of this nature there are limitations. Our statistical data give a snapshot of procedures that were commenced up to the 31st December 2004. The finding of increased direct costs, while statistically robust, might simply reflect the increased costs incurred as practitioners educate themselves about the way in which the new regime operates – if so, then we might expect costs to show a decline over time.

Secondly, the authors note the possibility of selection bias in their sample of post-Enterprise Act administration cases. Specifically, they note that secured creditors may be selecting the procedure (administration or receivership) based on which one they expect will maximise their recoveries. The authors dismiss the possibility of bias in this regard on the basis that most recoveries in administrations were in cases where the creditors were oversecured:¹⁴⁴

... one interpretation of the absence of a significant difference in realizations between post-Act receiverships and administrations in Table 8 is that secured lenders are selecting the procedure so as to maximize realizations. This consequently raises a suggestion of selection bias in the post-Act administration sample, which would bias the sample in favor of hypothesis 1 and 1A in the tests conducted in Table 5. Yet if this were the case, we would expect the bias—and consequent uplift in recoveries for post-Act administration as against pre-Act receivership—to be strongest in cases where the secured creditor is undersecured, as here they will have the strongest incentive to select a procedure which will maximize their recoveries. However, Table 5 reports that the increase in realizations is driven entirely by cases in which the lender is oversecured. In such cases the lender should be indifferent in selection as between administration and receivership.

But the expected recovery in a particular insolvency process is not the only relevant factor for a creditor in deciding which process to select. Speed, certainty and control may be even more important than the expected recovery in many cases. In this regard, the authors found that “cases conducted under the new administration procedure are much quicker than receiverships, taking on average *a little over half the*

¹⁴³ John Armour, Audrey Hsu and Adrian Walters, “Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002” (2008), 5 ECFR 148, 170-171.

¹⁴⁴ Armour and others (n 14) 130.

*time.*¹⁴⁵ Accordingly, even in cases where the senior secured creditor is oversecured, it will have strong reasons to favour administration over receivership. This gives rise to a different possibility: secured creditors may simply be using administration, and especially its abridged version, the pre-pack, as a speedy collection mechanism. All things being equal, oversecured creditors may prefer pre-packs even if the promised returns are lower than those of receiverships or standard administrations because the additional costs will be borne by undersecured and unsecured creditors. Interestingly, while the authors acknowledge the possibility that creditors may find ways of “contracting around” the legislation in the future, they do not suggest that this may have happened already.¹⁴⁶ Yet, as will be discussed further below, it is entirely possible that pre-packs represent this type of behaviour by creditors.¹⁴⁷

Without further empirical evidence, it is difficult to say for certain what is happening in administration sales. However, even if Armour et al. are correct that unsecured creditors are no better off under administration than receivership, this alone would not be sufficient reason to abolish the administration regime. Rather, there may be other benefits to administration that are not easily measured. I noted above the authors’ finding that administrations are typically completed much more quickly than receiverships. This in itself may make administrations preferable to receiverships in general because the longer a company remains in insolvency proceedings, the greater the indirect costs it is likely to incur as a result. For example, suppliers will be less likely to risk advancing goods or services to the insolvent company on credit, and may even extract “ransom” payments. Such additional costs might prove fatal to an insolvent enterprise that otherwise would have been viable. Although the U.K. government recently announced plans to expand the scope of Section 233 of the Insolvency Act, which restricts the ability of certain essential suppliers to vary their terms or withhold supply from insolvent companies, this expanded list will consist mainly of utilities and IT suppliers.¹⁴⁸ Conceivably, this leaves out many other suppliers that might be essential to the ongoing operation of an insolvent enterprise. Moreover, even the more robust “critical supplier” provisions found in

¹⁴⁵ *ibid* 131 (emphasis added).

¹⁴⁶ *ibid* 131.

¹⁴⁷ Note that while the authors’ study revealed that roughly 40% of administrations resulted in going concern sales, they did not distinguish between pre-packs and standard administrations. See 116 (Table 5).

¹⁴⁸ See <<https://www.gov.uk/government/consultations/continuity-of-supply-of-essential-services-to-insolvent-businesses>> accessed 21 July 2019.

the Canadian and U.S. restructuring regimes are not always effective.¹⁴⁹ Accordingly, companies that operate in insolvency may still incur the kinds of indirect costs discussed above. This suggests that there will still be strong reasons to prefer the quicker administration process over receivership even after the amendments to Section 233.

Given the foregoing, rather than serving as reasons to abolish administration, the authors' findings ought to encourage further investigation of the reasons why the policy goals of the Enterprise Act – namely, company rescue, transparency and accountability, and maximising value for all stakeholders of insolvent companies – are apparently not being met. Such an investigation may reveal that the administration regime can be improved through modest reforms instead of merely scrapping it in favour of the old receivership model.

2. Pre-Packs

The pre-pack is a process in which a distressed company and its creditors agree to a sale of the company's assets prior to initiating administration procedures.¹⁵⁰ As noted earlier, Schedule B1 of the Insolvency Act 1986 permits the appointment of an administrator both by court order and out-of-court. In a pre-pack, the administrator is appointed out-of-court and then implements the pre-arranged deal. In this way, the pre-pack is an alternative to full, formal administration proceedings – it is an abridged process.

For several reasons, pre-packs are widely regarded as giving secured creditors “a high level of control and certainty.”¹⁵¹ Firstly, secured creditors are typically the only parties involved in negotiating the pre-pack with the insolvent debtor and appointing the administrator. Secondly, secured creditors usually will possess more information about the debtor than other stakeholders. Thirdly, as noted already, the pre-pack is an abridged process and can be completed much more quickly than other processes. Consequently, most stakeholders will have limited opportunities to scrutinise and challenge the terms of

¹⁴⁹ For example, see *Re Northstar Aerospace Inc*, 2012 ONSC 4546, in which the Ontario Superior Court ordered that a critical supplier located in China be paid in full ahead of other creditors. The Court reasoned that doing so was necessary to ensure the continued supply of goods that were essential to the operations of the insolvent enterprise, even though the payment “reward[ed] improper conduct by a critical supplier who has ignored an order of this court” (para 14).

¹⁵⁰ Although other forms of pre-packs such as pre-packaged receiverships existed prior to the enactment of the Enterprise Act 2002, the focus here and in the scholarship is on pre-packaged administrations. See, for example, Finch (n 45) 453, fn 2.

¹⁵¹ *ibid* 455.

pre-packs. As such, most stakeholders will depend on the administrator to ensure that the pre-pack is fair and maximises value. Yet the administrator's hands are likely to be tied in most cases:¹⁵²

The danger is that when powerful creditors agree to a pre-pack such an agreement creates a momentum that is difficult for the administrator to upset. The proposals on the table will constitute something close to a *fait accompli* in so far as many administrators, when surveying possible options for the company, will have a strong bias towards the pre-pack. This may arise because all non-pre-pack options are likely to carry the prospect of greater uncertainties and more protracted negotiations... If this is the case, the pre-pack commits the administrator to a course of action that is agreed outside statutory procedures and it is extremely difficult for less powerful creditors to scrutinise the pre-pack and to renegotiate terms.

Indeed, we can go further and say that administrators will have strong incentives not to scrutinise or challenge the terms of pre-packs, for the same reasons that they would be strongly inclined to support senior secured creditors generally:¹⁵³

What is problematic here is that IPs would rightly expect most of their work (i.e. future appointments as administrators) to come from the banks. They would thus have strong incentives, in situations where the bank's interests diverge from those of other creditors, of developing a reputation for favouring the former.

In short, functionally pre-packs appear remarkably similar to administrative receiverships:¹⁵⁴

What is clear is that, notwithstanding the administrator's duty to perform his functions in the collective interests of creditors as a whole, secured creditors are able to use prepacks as a means of dictating the method and timing of asset realization, much in the same way that they previously used receivership. In other words, prepacks are little more than a functional substitute for receivership sales.

In this sense, pre-packs represent a shift in U.K. insolvency law away from reorganization, in which the insolvent debtor is rehabilitated and continues to operate, toward a realization model in which the debtor's assets are sold wholesale, after which the debtor ceases to exist.

Pre-packs may have made sense prior to the introduction of the Enterprise Act, but it is difficult to see the wisdom in judicial decisions permitting their continued use today. As noted earlier, the Cork Committee thought that there were significant benefits to giving control over the insolvency process to a

¹⁵² Finch (n 45) 471-472.

¹⁵³ Mokal (n 35) 387. Note that there are also significant obstacles to judicial scrutiny of pre-packs. See John Armour, "The Rise of the Pre-Pack: Corporate Restructuring in the UK and Proposals for Reform" in RP Austin and Fady JG Aoun (eds), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Sydney: Ross Parsons Centre 2012) 22: "In a case where the company has been well-marketed and is acquired by a third party, it will be very difficult to persuade a court to depart from the conclusion that the price obtained in the sale represents the best valuation of the assets."

¹⁵⁴ Walters (n 8).

single powerful secured creditor. On this reasoning, pre-packs could be seen merely as extending the “benefits” of receiverships to distressed companies that lacked a creditor with a floating charge and the means and incentives to appoint a receiver. But the Enterprise Act explicitly rejected the receivership model on the premise that it destroyed value, lacked transparency and accountability, and generally gave secured creditors too much power. For these reasons, the Enterprise Act sought to shift power from secured to unsecured creditors and to promote a *collective* administration process that differed fundamentally from administrative receivership.¹⁵⁵ Accordingly, pre-packs *prima facie* appear to undermine the stated goals of the Enterprise Act. Moreover, it is conceivable that the informational asymmetries between senior creditors and other stakeholders, coupled with the speed of the pre-pack process, may create incentives for rent-seeking through the undervaluing of businesses sold in pre-packs. If true, value that should be flowing to unsecured creditors would flow instead to purchasers, insolvency professionals, management or others. Meanwhile, fully secured creditors would be indifferent to this result so long as they were assured of a quick recovery.

Many of these concerns seem to be borne out in recent empirical studies of pre-packs. The U.K. government recently commissioned a report by Theresa Graham in response to widespread concerns about the propriety of pre-packs. The Graham Report made several key findings. Firstly, it found that pre-packs now comprise a significant proportion of administrations: roughly 600 out of 2,365 administrations in 2013.¹⁵⁶ At the same time, the number of administrations has increased dramatically since the Enterprise Act was introduced, rising nearly 300% between 2002 and 2007, while liquidations fell by 23% during the same period.¹⁵⁷ Secondly, around two-thirds of pre-packs in 2010 – 316 out of 499 – involved sales to connected parties within the meaning of the Insolvency Act 1986.¹⁵⁸ These findings are consistent with a recent study by the Insolvency Service which found that 79% of pre-packs in 2011 were to connected parties.¹⁵⁹ Thirdly, the Graham Report found that pre-packs very rarely resulted in distributions to unsecured creditors. When unsecured creditors recovered anything at all, median payments were 4.3% of total debt:¹⁶⁰

¹⁵⁵ Insolvency Service (n 129) 2.5.

¹⁵⁶ Graham Report (n 16) 3.1.

¹⁵⁷ *ibid* 5.14.

¹⁵⁸ *ibid* 7.50. The relevant provisions are found in s 249 of the Act.

¹⁵⁹ See Insolvency Service, *Report on the Operation of Statements of Insolvency Practice 16, 1 January to 31 December 2011* (HMSO 2011) 10-11.

¹⁶⁰ Graham Report (n 16) 7.4-7.6.

I was surprised at these low levels of payment for unsecured creditors, particularly in the pre-pack cases... This data shows that unsecured creditors in particular receive only a paltry benefit from a pre-pack administration. Secured and preferential creditors, as one would expect given the statutory order of priority, fare better than the unsecured creditors but if those classes of creditors are chiefly benefiting from the administration process, it is little different from the administrative receivership process that Enterprise Act 2002 style administration was supposed to supersede.

This finding is consistent with those of other studies that pre-packs tend to yield higher returns for secured creditors than other types of sales, at the expense of unsecured creditors.¹⁶¹ But the most striking finding is that returns to unsecured creditors are even lower in connected-party pre-packs, which now comprise the majority of pre-packs.¹⁶² Perhaps unsurprisingly, the Report also found that connected-party pre-packs also suffered from systemically poor marketing practices:

My researchers found the standard of reporting very variable and too often only limited marketing was carried out including:

- Limited enquiries made within the insolvency practitioner firm but no external marketing occurring;
- Insolvency practitioners accepting the word of the directors that there is no ready market for the business outside themselves or other connected parties, with no evidence that this assumption had been tested.

Furthermore, the valuation methods used were opaque at best: most valuations were desk-top only, and “there was rarely any explanation as to the valuation methods used by the valuers.”¹⁶³ Meanwhile, businesses sold in connected-party pre-packs were much more likely to fail within 3 years compared to those that were sold to third parties – a failure rate of 29% compared to 16%.¹⁶⁴ In short, the Graham Report found that most pre-packs involved sales to connected parties in which: 1) the administrator made negligible efforts to market the business, 2) the valuation and purchase price were hardly scrutinised, and 3) unsecured creditors recovered very little or nothing.

¹⁶¹ Frisby (n 14) 67, examining pre-packs carried out between 2001 and 2004. Note that while Frisby has found more recently that pre-packs provided marginally better returns for unsecured creditors than business sales, this study was less rigorous than the first and no tests were conducted in the latter study to confirm that the results were not statistical blips. See Sandra Frisby, “The pre-pack promise: signs of fulfilment?” [2010] *Recovery* 30.

¹⁶² Graham Report (n 16) 7.54.

¹⁶³ *ibid* 7.80-7.81.

¹⁶⁴ *ibid* 7.56.

3. Comparison with U.S. and Canadian Restructuring Regimes

In the U.S., the main restructuring mechanism is Chapter 11 of the Bankruptcy Code. Chapter 11 possesses several features that distinguish it from administration in the U.K. Firstly, it is only possible to enter Chapter 11 by filing a petition with the federal bankruptcy court. Filing triggers an automatic stay on the enforcement of any claims against the debtor that arose prior to the filing.¹⁶⁵ This stay remains in effect until the reorganization is complete or the court lifts the stay. Secondly, perhaps the key feature of Chapter 11 is that upon filing, the debtor becomes a “debtor in possession” (DIP). The debtor keeps ownership and control of its assets and operations for the duration of the reorganization.¹⁶⁶ Thirdly, the debtor must prepare and file a reorganization plan within 120 days of entering Chapter 11.¹⁶⁷ The court is empowered to reduce or extend this period within its discretion, but the period during which the debtor has the exclusive ability to file a plan cannot exceed 18 months – after that time, any creditor is permitted to file its own plan.¹⁶⁸ Once a plan is filed, the creditors vote on it. Typically, the debtor has 180 days after entering Chapter 11 to obtain its creditors’ acceptance of the plan.¹⁶⁹ In practice, the plan must establish different classes for all claimants, such as secured, preferred and general unsecured creditors, and equity claimants. In order for the plan to succeed, creditors holding at least two-thirds in value and more than one-half in number of the claims in each class must accept the plan.¹⁷⁰ Once the creditors accept the plan, it must be submitted to the court for its final approval.¹⁷¹

If a debtor has no intention of reorganizing, it can file instead under Chapter 7. Under Chapter 7, the debtor ceases operations and a trustee is appointed to sell the debtor’s assets and distribute the proceeds to its creditors. In this regard, the Code provides mechanisms for converting from Chapter 11 to Chapter 7 proceedings if a reorganization plan fails. But this is not the only way of liquidating an insolvent debtor’s assets. Chapter 11 also permits plans that “provide for a sale of all or substantially all” of the debtor’s assets and the distribution of the proceeds to claimants.¹⁷² Perhaps the most commonly used sale

¹⁶⁵ 11 USC § 362(a).

¹⁶⁶ Note that trustees can be appointed under Chapter 11, but this is rare. See § 1107(a). Similarly, though rare, an examiner may be appointed to investigate the debtor’s conduct and report to the court, see §1106.

¹⁶⁷ *ibid* § 1121(b).

¹⁶⁸ *ibid*.

¹⁶⁹ *ibid*. The court can extend this deadline, see § 1121(d).

¹⁷⁰ *ibid* §1126(c).

¹⁷¹ *ibid* §1129.

¹⁷² *ibid* §1123(b)(4).

process today is the so-called “363 sale”. Under section 363 of the Code, the debtor or its trustee may sell its assets outside the ordinary course of business.¹⁷³ While court approval of the sale is not strictly required, it is common practice to seek court approval for the purchaser’s benefit.¹⁷⁴ In this regard, section 363 is rather skeletal – it does not set out guidelines for courts to follow in deciding whether to approve a sale.¹⁷⁵ Consequently, courts have developed a large body of case law dealing with 363 sales.

There is significant controversy in the scholarship and the courts surrounding the appropriateness and efficacy of Chapter 11 as a reorganization mechanism. For example, Baird and Rasmussen have argued that the increasing use of insolvency contracting, as well as changes in the nature of companies, have rendered traditional reorganizations “largely unnecessary”.¹⁷⁶ Moreover, they assert that “the days when reorganization law promised substantial benefits are gone.”¹⁷⁷ One of their key claims is that the market now reflects the fact that traditional reorganizations are obsolete. That is, Chapter 11 is now used only to sell assets or obtain judicial approval of pre-existing deals:¹⁷⁸

Even when a large firm uses Chapter 11 as something other than a convenient auction block, its principal lenders are usually already in control and Chapter 11 merely puts in place a preexisting deal. Rarely is Chapter 11 a forum where the various stakeholders in a publicly held firm negotiate among each other over the firm’s destiny.

Setting aside the question of how accurate these claims are, there are good reasons to think that a private, contract-based insolvency system cannot and should not replace Chapter 11. Aside from the problems with Contract Theory discussed in Chapter 1, Warren and Jay Westbrook have found that Chapter 11 cases often include large numbers of maladjusting creditors such as tort claimants, utilities, tax authorities, employees, and voluntary creditors.¹⁷⁹ This suggests that a contract-based insolvency system would

¹⁷³ *ibid* § 363(b)(1). See also Charles J Tabb, *The Law of Bankruptcy* (4th edn, West Academic Publishing 2016) 452-459.

¹⁷⁴ Alan N Resnick and Henry J Sommer (eds), *Collier on Bankruptcy* (16th edn, LexisNexis 2013) 363.02[1].

¹⁷⁵ That said, section 363(f) sets out requirements to be met if the assets are to be sold “free and clear” of existing encumbrances. In particular, the secured creditor whose rights will be impaired must consent to the sale.

¹⁷⁶ Douglas G Baird and Robert K Rasmussen, “The End of Bankruptcy” (2002) 55 *Stan L Rev* 751, 755.

¹⁷⁷ *ibid* 789.

¹⁷⁸ *ibid* 752.

¹⁷⁹ Elizabeth Warren and Jay L Westbrook, “Contracting Out of Bankruptcy: An Empirical Intervention” (2005) 118 *HLR* 1197, 1236 (finding that in a sample of Chapter 11 cases representing about 40% of all filings in 1994, more than a quarter of the total dollar amount of all unsecured credit was owed to maladjusting creditors).

adversely impact a significant number of Chapter 11 creditors by shifting the risks and costs of insolvency onto them:¹⁸⁰

The claims of efficiency for contract bankruptcy are seriously undermined by the presence of significant numbers of maladjusting creditors. Each maladjusting creditor represents the possibility of substantial inefficiencies; as their numbers grow, the likelihood increases that these inefficiencies will overwhelm any purported efficiency gains from a contract bankruptcy system.

In addition, there are reasons to think that Baird and Rasmussen's claims about how Chapter 11 is used may not reflect the full picture. LoPucki has produced quantitative data showing that, at least in 2001 and 2002, most large companies still used Chapter 11 to attempt traditional reorganizations:¹⁸¹

Most firms that do liquidate in Chapter 11 did not file for that purpose. Only 20% of the 174 large public firms that filed for bankruptcy in 2001 and 2002 indicated at filing that their intent was to sell or liquidate their businesses. Only an additional 4% filed prepackaged cases intended "merely [to put] in place a preexisting deal." Nearly all of the remaining firms filed for the purpose of reorganization and for at least some period of time "negotiated over the firm's destiny." *Despite a variety of changes over the past two decades in the types of firms that use Chapter 11 and the ways in which they use it, Chapter 11 remains principally a vehicle for traditional reorganization of firms through the process of negotiation.*

Although LoPucki's study focused only on large companies, which do not represent most filers under Chapter 11, and which are more likely to attempt a reorganization than a liquidation, these results nonetheless rebut Baird and Rasmussen's claim that "[g]iant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure."¹⁸² Moreover, although large companies represent only a small percentage of Chapter 11 filers, Baird and Rasmussen themselves note that the aggregate value of the few large Chapter 11 companies far exceeds that of the smaller filers.¹⁸³ Consequently, if Baird and Rasmussen's argument is at all convincing, it can only be an argument for restricting the use of Chapter 11 to large companies, not for abolishing the regime entirely.

There are additional reasons for thinking that Chapter 11 remains an important tool for insolvency reorganization generally. Warren and Westbrook have presented data suggesting that Chapter 11 is reasonably successful in facilitating reorganizations for those companies that file with the intention of

¹⁸⁰ *ibid* 1235.

¹⁸¹ Lynn M LoPucki, "The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's *The End of Bankruptcy*" (2003) 56 *Stan L Rev* 645, 650-51 (emphasis added).

¹⁸² Baird and Rasmussen (n 176) 751. See also 788, in which the authors assert that "Chapter 11 cannot justify its continued existence on its ability to "save" such firms."

¹⁸³ *ibid* 756, especially fn 19.

actually reorganizing. Specifically, they argue that since Chapter 11 has a very low entry bar, it is often used by companies that have no realistic chances of reorganizing:¹⁸⁴

There is some evidence that Chapter 11 is used as both emergency room and morgue. Among larger companies, Chapter 11 is the nearly uniform choice of those filing for bankruptcy. It is highly unlikely that every one of these companies is a realistic candidate for reorganization, but they all take advantage of their right to try. Thus the challenge for a reorganization system is to identify those that do have a realistic chance to succeed.

This, in turn, leads to lower rates of reorganization plan confirmations when calculated as a proportion of all filings. So, for example, in slightly more than half of the cases that Warren and Westbrook examined between 1994 and 2002, the debtor never filed a plan. But for the balance of the cases, in which the debtor did file a plan, roughly 65% in 1994 and 71% in 2002 resulted in plan confirmations.¹⁸⁵ In other words, Chapter 11 actually serves a dual function: it filters hopeless debtors out of the system while also providing breathing room for debtors who might successfully reorganize. Viewed in this light, Chapter 11 is actually quite successful:¹⁸⁶

The data reveal that the cases – both those that exit the system and those that confirm plans of reorganization – moved at a lively pace. They also suggest that, at least between 1994 and 2002, the system showed signs of improvement. While the data cannot answer the normative question about whether the movement is as substantial as it should have been, they are adequate to dispel the notion that great numbers of debtors were hiding out in Chapter 11 for years, just mowing the lawn and waiting for the market to turn.

More recently, LoPucki and Joseph Doherty have presented further data showing that reorganizations of large public companies under Chapter 11 yielded more than twice the returns of sales during the period 2000 through 2004:¹⁸⁷

We found that companies sold for an average of 35% of book value and an average market capitalization value – based on post-reorganization stock trading – of 91% of book value. Even controlling for the difference in prefiling earnings of the two sets of companies, sale yielded less than half as much value as reorganization. These results suggest that creditors and shareholders can more than double their recoveries by reorganizing large public companies instead of selling them.

For a number of reasons, LoPucki and Doherty's arguments have not settled the reorganization vs. liquidation debate. Other scholars have taken issue with the claim that courts and insolvency professionals

¹⁸⁴ Elizabeth Warren and Jay L Westbrook, "The Success of Chapter 11: A Challenge to the Critics" (2009) 107 Mich L Rev 603, 617.

¹⁸⁵ *ibid* 618.

¹⁸⁶ *ibid* 619-620.

¹⁸⁷ Lynn M LoPucki and Joseph W Doherty, "Bankruptcy Fire Sales" (2007) 106 Mich L Rev 1.

favour sales because they have private agendas – there may be alternative and benign explanations for this phenomenon.¹⁸⁸ In addition, there is disagreement regarding how best to value companies in Chapter 11, with some claiming that LoPucki and Doherty's findings might be exaggerated.¹⁸⁹ That said, the data still show that pronouncements on the demise of Chapter 11 are premature at best.

In the absence of a definitive method for valuing companies pre- and post-Chapter 11, the reorganization vs. liquidation debate in the U.S. appears to be at a stalemate. In my view, however, the foregoing studies are still quite helpful in assessing some of the central claims of the major accounts of insolvency law discussed in Chapter 1. Recall from Chapter 1 that Debt Collection Theory's paradigm of insolvency reorganization was a value-maximising sale of the insolvent company's assets. On this account, one might think that the 363 sale process is preferable to traditional reorganization because it subjects the valuation of the assets of the insolvent company to a market test, which might not be possible in a traditional reorganization. Such a view would be buttressed if, as many Contract Theorists claim, most of the apparatus of formal insolvency regimes could be replaced by private contracting amongst stakeholders. If this were true, then formal court-driven processes could be dangerous impediments to maximising value in insolvency. Yet these concerns are not borne out by the data. Accordingly, calls for major reforms or the repeal of Chapter 11 are premature at best.

Rather, the data suggest that a more nuanced model is required for understanding and assessing modern insolvency procedures. Restructuring is complex and each case is different. This is why it is crucial that an insolvency regime focus on more than simply maximising returns to claimants. The regime must also investigate the causes of insolvency so as to determine the best response. It must provide a "forum where all the interests can be heard regarding the possible restructuring of the insolvent corporation", both to ensure the fair treatment of stakeholders and to increase the likelihood of formulating value-enhancing solutions.¹⁹⁰

Accordingly, and notwithstanding the current stalemate in the U.S. debate, the use of Chapter 11 to carry out quick sales of insolvent companies' assets warrants careful scrutiny. Where secured creditors

¹⁸⁸ James J White, "Bankruptcy Noir" (2008) 106 Mich L Rev 691, 704-710.

¹⁸⁹ See Jeremy Murphy, "Bankruptcy Avant-Garde" (2011) 19 Am Bankr Inst L Rev 113 (arguing that using an options-pricing valuation model, instead of LoPucki and Doherty's book asset valuation, renders the differences in returns between sales and reorganizations statistically insignificant).

¹⁹⁰ Sarra (n 37) 47.

are able to control the process, there is a risk that quick sales will not maximise value. In particular, fully secured creditors will prefer a quick sale even if a longer sales process or a reorganization would result in higher returns, as the costs and risks to the secured creditors rise the longer the process takes.¹⁹¹ In addition, the secured debt levels of U.S. companies are rising, and this appears to be correlated with significantly lower returns for unsecured creditors and equity holders in Chapter 11.¹⁹² In short, the concern is that senior secured creditors may have found ways to subvert the Chapter 11 process so as to enhance their own returns at other creditors' expense:¹⁹³

The Chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor-in-possession, expansion of creditor (particularly secured creditor) control, the increasing imposition of creditor designated chief restructuring officers ("CROs"), claims trading, more complex debt and organizational structures, short-term profit motivation and, of course, greed gratified by claims trading, acquisitions and litigation. Gordon Gekko is alive and well in the public and private markets, as well as in the benign environment of restructuring. As a consequence, the objective of a successful rehabilitation, the preservation of going concern value and the emergence of a rehabilitated stand-alone debtor has been eclipsed in most cases.

The rise of 363 sales increases the potential for abusive and value-destructive behaviour. Unlike in Chapter 7, there is no need to appoint a trustee for a 363 sale. Accordingly, the debtor often remains in possession, continuing to manage its own operations and conducting the sale process. In addition, there is no need to file a reorganization or liquidation plan in a 363 sale. Thus, while the court is usually still involved in approving the sale, the creditors do not vote on it. In effect, then, section 363 offers a quick realization tool for creditors by way of a sale made free and clear of all encumbrances, which takes advantage of the protections afforded by Chapter 11 while bypassing the requirement of a plan and a negotiation among creditors. In this regard, it is important to recognize the potential for abuse if, for example, a senior secured creditor is permitted to control the 363 sale process with the cooperation of the debtor in possession. In such cases, the debtor and the secured creditor will have various tools at their disposal to vary the

¹⁹¹ See Ayotte and Morrison (n 138) 532: "The likelihood of traditional reorganization is higher among unsecured (44 percent) and undersecured firms (47 percent) than it is among moderately oversecured (21 percent) and highly oversecured firms (34 percent)." See also Wood (n 8) 409.

¹⁹² See Andrew A Wood, "The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies" (2011) 85 Am Bankr LJ 429, 446: "Unsecured creditors and equity recovered significantly less in 2009-10 than they did in 1991-96... The explanation for this result is most likely the corresponding significant increase in secured debt between the two periods."

¹⁹³ Harvey R Miller, "Chapter 11 in Transition – From Boom to Bust and Into the Future" (2007) 81 Am Bankr LJ 375, 385.

distributional priorities in the Code, thereby maximising returns for the secured creditor at the expense of other claimants:¹⁹⁴

The Bankruptcy Code provides a specific set of distributional priorities in section 507, with priority claimants (according to their rankings, *inter se*) being awarded priority over general unsecured creditors. These can be varied only pursuant the Chapter 11 plan process. However, in secured creditor bankruptcies the debtor and secured party often seek to vary the priorities (as well as those among general unsecured creditors and equity interest holders) through gifting, carve-outs, or both. When successful, these private transfer schemes, unbled and unregulated by Congress, serve to undermine the absolute priority rule or to unfairly discriminate, thereby returning the process to the bad old days of pre-absolute priority rule federal equity receiverships. The secured creditor reaps benefits from selective application of the Bankruptcy Code, without lobbying for relevant changes in the Bankruptcy Code and without paying for the use of the bankruptcy courts. By utilizing the bankruptcy court for its individual gains, the secured creditor effects a private taking of a public good.

Some have argued that it is appropriate for a secured creditor to control the sale process when it is undersecured since, in such cases, no other claimants will receive any distribution, and the secured creditor will have an incentive to obtain the best possible price for the assets so as to maximise its own returns.¹⁹⁵ However, as noted earlier, the secured creditor's incentive to maximise its own recovery will only obtain in cases where it is truly undersecured – that is, where it does not also hold personal guarantees against persons or entities related to the debtor.¹⁹⁶ Furthermore, even in cases where the secured creditor is truly undersecured, it may well prefer the speed and certainty of a quick realization to the uncertainty, time and cost involved in a reorganization, even if the latter carries the potential for greater returns. Banks, in particular, may be more likely to exhibit this risk-averse bias.¹⁹⁷

More recent empirical studies suggest that 363 sales typically result in lower sale prices than other types of sales. In particular, a study comparing 363 sales with plan sales during the years 1996 to 2010

¹⁹⁴ Charles W Mooney, Jr, "The (II) Legitimacy of Bankruptcies for the Benefit of Secured Creditors" (2015) U III L Rev 735, 754. Note that the author is not expressing his own views, but merely stating key objections made to giving secured creditors control over insolvency processes.

¹⁹⁵ *ibid* 763: "If the secured creditor truly is under-secured, then absent collusion or self-dealing, the secured creditor would have incentives to seek the highest possible sales price. There would be no need, then, for the leverage of unsecured creditors in the plan process inasmuch as the secured creditor would already have an incentive to maximize its recovery." Again, the author is not necessarily expressing his own view here – he goes on to assert that courts "should be cautious about any substantial asset 363 sale early on in a case", see 764.

¹⁹⁶ Mokal (n 35) 365.

¹⁹⁷ This was certainly the case with respect to CVAs in the U.K., for example. See Finch (n 45) 497-498: "Banks tended to act cautiously in consideration of their own shareholders' interests and in fear of 'throwing good money after bad'."

found that 363 sales generated significantly lower prices, even correcting for companies in especially poor health or in distressed industries. Significantly, the authors found that the principal reason for the lower prices in 363 sales was the diminished leverage of junior creditors relative to plan sales:¹⁹⁸

Our primary finding is that 363 sales are associated with lower sale prices compared with plan sales, and this result holds even in sub-analysis that considers only 363 sale firms that are healthier or performing better than the median plan sale firm. These lower prices, however, are not due to the speed of the 363 sales which could reduce bidding activity or exacerbate fire sales, but appear to be associated with the diminished creditor negotiation leverage in 363 sales.

The authors also found that 363 sales are now the dominant method for selling substantially all of the assets of insolvent companies in the U.S.¹⁹⁹ For the purposes of comparing these results with pre-packs in the U.K., it should be noted that this study – the first of its kind – only focused on companies valued at more than \$50 million, whereas pre-packs tend to involve much smaller companies.²⁰⁰ It would be helpful if future studies on 363 sales were to focus on smaller companies, as these would be more comparable to the typical pre-pack. Nonetheless, the 363 and pre-pack processes are very similar in function. In addition, the fact that both processes appear to result in lower recoveries for unsecured creditors lends weight to the theoretical concerns raised here regarding secured creditor control, transparency and accountability.

4. Liquidating CCAAs

Insolvent corporations in Canada may attempt a reorganization through two principal mechanisms: commercial proposals under Part III of the Bankruptcy and Insolvency Act²⁰¹ (BIA), and the CCAA. In both cases, reorganization is a court-supervised process. Under the BIA, the debtor files a proposal²⁰² or a notice of intention to file a proposal with the court.²⁰³ This filing automatically triggers a stay of proceedings against the debtor by all secured and unsecured creditors, with some exceptions, prior to any court hearing.²⁰⁴ In practice, a debtor typically files a notice of intention first, as this gives it more time to prepare

¹⁹⁸ Anne M Anderson and Yung-Yu Ma, “Acquisitions in Bankruptcy: 363 Sales Versus Plan Sales and the Existence of Fire Sales” (2014) 22 Am Bankr Inst L Rev 1, 17.

¹⁹⁹ *ibid* 8.

²⁰⁰ *ibid* 7.

²⁰¹ RSC 1985 c B-3.

²⁰² BIA (n 94) s 50(1).

²⁰³ *ibid* s 50.4(1). Note that a liquidator, trustee, receiver or a bankrupt person can file a proposal, but only a debtor company can file a notice of intention.

²⁰⁴ *ibid* s 69. Some Crown claims may be exempt, see s 69.1. In addition, the stay does not apply to secured creditors who seized collateral prior to the filing, or who served a s 244 enforcement notice more than 10 days before the notice of intention was filed.

a proposal. Although the debtor remains in control of its assets and operations during this time, it must appoint a trustee to act as a monitor for the benefit of its creditors, and must file a cash flow statement with the trustee within 10 days.²⁰⁵ The debtor then has 30 days from the notice date to file its proposal, failing which the debtor is automatically assigned to bankruptcy,²⁰⁶ subject to any extensions granted by the court.²⁰⁷ Once the proposal is filed, the creditors vote on it. The proposal must be approved by a majority of creditors in each class present and voting at the creditors' meeting, and representing at least two-thirds in value of the claims in each class.²⁰⁸ If the creditors approve the proposal, the trustee must apply for a hearing within 5 days to obtain the court's approval.²⁰⁹ On the other hand, if the creditors reject the proposal, the debtor is automatically assigned to bankruptcy.²¹⁰

Compared to the CCAA, the BIA's commercial proposal regime is quite rule-driven and rigid. Accordingly, the BIA is used primarily by smaller businesses that benefit from the relative certainty and low costs of the regime. Meanwhile, the more flexible, court-driven CCAA has become the restructuring tool of choice for large corporations. Under the CCAA, an insolvent debtor with debts exceeding \$5 million,²¹¹ or its trustee in bankruptcy, liquidator or creditors, may file an initial application with the court for protection.²¹² The initial application must include a projected cash-flow statement and copies of financial statements prepared in the last year. The application can be filed without notice to the creditors, or with notice only to certain creditors, if it is impracticable to notify all of them. Upon filing, the court typically will grant an initial stay of proceedings effective against all creditors, not to exceed 30 days, and will schedule a "comeback hearing" during which the creditors can present any objections they may have. The initial order will also authorize the debtor to appoint a monitor to assist it in preparing a reorganization plan. The debtor can

²⁰⁵ *ibid* s 50.4(2)(b).

²⁰⁶ *ibid* s 50.4(8).

²⁰⁷ Note however that extensions can only be granted for 45 days at a time, and cannot in any event exceed 5 months in duration following the end of the 30 day period after which the notice of intention was filed. See s 50.4(9).

²⁰⁸ *ibid* s 54(2)(d).

²⁰⁹ *ibid* s 58(a).

²¹⁰ *ibid* s 61(2)(b). For a further discussion of the commercial proposal regime, see Stephanie Ben-Ishai and Thomas GW Telfer (eds), *Bankruptcy and Insolvency Law in Canada: Cases, Materials and Problems* (Irwin Law 2019), Chapter 16; and Jacob S Ziegel and Rajvinder S Sahni, "An Empirical Investigation of Corporate Division 1 Proposals in the Toronto Bankruptcy Region" (2003) 41 *Osgoode Hall LJ* 665, 676-682.

²¹¹ In determining whether this threshold has been met, the debts of the debtor's affiliates are included. See CCAA (n 1) ss 2(1), 3(1).

²¹² *ibid* ss 4 and 5.

apply for any number of extensions to the stay of proceedings, and the court usually will approve these provided that the creditors do not object and the debtor has demonstrated progress toward preparing and filing a plan.²¹³ Once a plan is filed, it must be approved by a majority in number of creditors representing two-thirds of the value of debt held by each class, calculated based on the number of creditors who actually vote.²¹⁴ If the creditors approve the plan, the debtor must then obtain final court approval before implementing it.²¹⁵ If the creditors vote against the plan, the debtor remains under CCAA protection and can attempt to negotiate a new plan, seeking additional court orders extending the stay of proceedings as necessary.

Canadian insolvency law also provides several different mechanisms for liquidating insolvent corporations on either a piecemeal or going concern basis. These mechanisms include receivership, pursuant either to a general security agreement or a court order under the BIA,²¹⁶ as well as liquidation by a trustee in bankruptcy. Given this range of liquidation tools, traditionally the CCAA has been reserved for reorganizations. This traditional use is reflected in recent statements by the Supreme Court of Canada on the purposes of the CCAA:²¹⁷

Unlike the *BIA*, the *CCAA* contains no provisions for liquidation of a debtor's assets if reorganization fails. There are three ways of exiting *CCAA* proceedings. The best outcome is achieved when the stay of proceedings provides the debtor with some breathing space during which solvency is restored and the *CCAA* process terminates without reorganization being needed. The second most desirable outcome occurs when the debtor's compromise or arrangement is accepted by its creditors and the reorganized company emerges from the *CCAA* proceedings as a going concern. Lastly, if the compromise or arrangement fails, either the company or its creditors usually seek to have the debtor's assets liquidated under the applicable provisions of the *BIA* or to place the debtor into receivership. As discussed in greater detail below, the key difference between the reorganization regimes under the *BIA* and the *CCAA* is that the latter offers a more flexible mechanism with greater judicial discretion, making it more responsive to complex reorganizations.

These statements, however, do not entirely reflect current practice. It is clear from the structure and history of the *CCAA* that it was designed to facilitate reorganization, not liquidation.²¹⁸ Today, however, insolvent

²¹³ *ibid* s 11.02.

²¹⁴ See *CCAA* (n 1) ss 4-6. The classification of creditors for voting purposes requires court approval, see s 22.

²¹⁵ *ibid* s 6.

²¹⁶ *ibid* s 243.

²¹⁷ *Century Services* (n 55) para 14.

²¹⁸ See, generally *Nocilla* (n 23), and *Wood* (n 8).

debtors often use the CCAA to conduct sales of substantially all of their assets, either piecemeal or on a going concern basis, and without presenting a plan to their creditors.²¹⁹ These “liquidating CCAAs” are increasingly used as an alternative to receivership or liquidation under the BIA. This trend appears to have accelerated following the introduction of section 36 of the CCAA in amendments to the Act made in 2009. Section 36 provides that an insolvent debtor under CCAA protection may sell its assets “outside the ordinary course of business” if it obtains court approval to do so. Many courts have interpreted these provisions to include liquidating CCAAs – that is, the sale of substantially all of the assets of an insolvent corporation, in the absence of a plan that is presented to the creditors.²²⁰ However, liquidating CCAAs are not universally accepted, and some courts have expressed scepticism:²²¹

I query whether the court should grant a stay under the CCAA to permit a sale, winding up or liquidation without requiring the matter to be voted upon by the creditors if the plan of arrangement intended to be made by the debtor company will simply propose that the net proceeds from the sale, winding up or liquidation be distributed to its creditors.

Although there are no data on returns to creditors from liquidating CCAAs, there are reasons to be concerned about these types of procedures.²²² Firstly, liquidating CCAAs may represent a very attractive collection mechanism for secured creditors because they are often quicker than bankruptcy or receivership sales.²²³ Secondly, liquidating CCAAs can eliminate troublesome liabilities that would survive in receiverships, such as successor employer liability, and courts have broad discretionary powers under the CCAA to eliminate other liabilities as well.²²⁴ Thirdly, as with a pre-pack, there is a sense in which the

²¹⁹ See Alfonso Nocilla, “Is ‘Corporate Rescue’ Working in Canada?” (2013) 53 CBLJ 382.

²²⁰ The court’s jurisdiction to authorize liquidating CCAAs was recognized as early as 1998 in *Canadian Red Cross Society* (1998) 5 CBR (4th) 299 (Ont Gen Div [Commercial List]), additional reasons (1998) 5 CBR (4th) 319, leave to appeal refused (1998) 32 CBR (4th) 21 (Ont CA). The fact that the sale approval process was only codified in the 2009 amendments to the Act reflects the strongly court-driven nature of CCAA law.

²²¹ *Cliffs Over Maple Bay Investments Ltd v Fisgard Capital Corp* 2008 BCCA 327 (BC CA) para 32. See also *Medical Intelligence Technologies inc, Re*, 2009 QCCS 2725 (Que SC) para 39.

²²² The Office of the Superintendent of Bankruptcy Canada only began tracking CCAA filings in September of 2009. Prior to that time, there were only infrequent attempts to collect data on CCAA proceedings. However, none of these examined recoveries in liquidating CCAAs. See, for example, Janis Sarra, *Development of a Model to Track Filings and Collect Data for Proceedings Under the CCAA: Final Report to the OSB* (March 2006) <[http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/vwapij/Sarra-2006-ENG.pdf/\\$FILE/Sarra-2006-ENG.pdf](http://strategis.ic.gc.ca/eic/site/bsf-osb.nsf/vwapij/Sarra-2006-ENG.pdf/$FILE/Sarra-2006-ENG.pdf)> accessed 24 August 2015 (examining data from CCAA filings between 2001 and 2005).

²²³ See Wood (n 8).

²²⁴ See, generally, Bill Kaplan, “Liquidating CCAAs: Discretion Gone Awry?” in Janis Sarra (ed), *Annual Review of Insolvency Law 2008* (Carswell 2009) 79; Robert Blair, “The CCAA Over 30 Years: From Chrysalis to Butterfly or Chrysalis to Gadfly? Some Thoughts from an Appellate Perspective” in Janis Sarra

liquidating CCAA may be presented to creditors as a *fait accompli*, thus precluding other options.²²⁵ In short, liquidating CCAs run counter to the basic objectives of the Act. One senior restructuring lawyer in Canada has observed that:²²⁶

The historic objectives of the CCAA, needless to say, had nothing to do with creditor realizations, and a purposive approach to statutory interpretation does not support the idea that the CCAA was intended to be a creditor's tool of choice for realizing on its security. The remedial nature of the CCAA was never intended to be employed to further creditors' remedies. Over the last decade, the CCAA has ceased to be a statute that operates for the benefit of debtors to permit them breathing room from their creditors while they seek to negotiate and effect a compromise and arrangement with their creditors. Rather, the statute has become a realization tool.

While I disagree with the author's premise that the CCAA was designed "for the benefit of debtors" – rather, the Act is better understood as a collective remedy that facilitates the preservation and maximisation of the value of insolvent enterprises for the benefit of all stakeholders – it is clear that the emergence of liquidating CCAs threatens to undermine these important goals. Although proponents of liquidating CCAs argue that they are more likely to enhance value than other procedures, such as receiverships, they have not yet presented any evidence to support this claim. Indeed, liquidating CCAs appear functionally equivalent to receiverships, suggesting that they are less about maximising value than appropriating it. At the same time, there is at least anecdotal evidence to suggest that liquidating CCAs benefit secured creditors at the expense of unsecured creditors, compared with reorganizations.²²⁷ Accordingly, while there is significant room in the scholarship for empirical studies of the outcomes of liquidating CCAs, there are good reasons to remain sceptical about these procedures.²²⁸

5. Conclusions Regarding Pre-packs, 363 Sales and Liquidating CCAs

Despite the overall differences among their respective insolvency regimes, pre-packs, 363 sales and liquidating CCAs are strikingly similar. Each of these procedures facilitates sales of substantially all

(ed), *Annual Review of Insolvency Law 2010* (Carswell 2011) 557. For a discussion of successor employer liability in receiverships and the CCAA, see Jeffrey C Carhart, "The Decision of the Supreme Court of Canada in *TCT Logistics* and the Future of Receiverships in Canada" (2007), 44 CBLJ 376.

²²⁵ See, for example: Shelley C Fitzpatrick, "Liquidating CCAs – Are We Praying to False Gods?" in Janis Sarra (ed), *Annual Review of Insolvency Law 2008* (Carswell 2009) 44-45; Richard B Jones, "The Evolution of Canadian Restructuring: Challenges for the Rule of Law" in Janis Sarra (ed), *Annual Review of Insolvency Law 2005* (Carswell 2006) 481.

²²⁶ David Bish, "The Plight of Receiverships in a CCAA World" (2013) 2 J Insol Inst Can 221, 232.

²²⁷ *ibid* 233.

²²⁸ For a further discussion of the scholarly and policy debates surrounding liquidating CCAs, see Nocilla (n 23); and Bish (n 226) 238-240.

of the assets of insolvent debtors under the auspices of restructuring legislation. In addition, there is little question that these procedures primarily benefit secured creditors, potentially at the expense of other stakeholders. Effectively, pre-packs, 363 sales and liquidating CCAs may simply be forms of “receivership lite”. If this analysis is correct, there is little question that pre-packs have the potential to undermine the aims of the Enterprise Act, a problem reinforced by the fact that, at least initially, many IPs were reluctant to let go of administrative receiverships and to fully adopt the changes to insolvency law and practice introduced by the Enterprise Act.²²⁹ This is especially concerning given that pre-packs are typically made to connected parties, yield very low returns to unsecured creditors, and often result in repeat business failures.

The analysis here suggests that a broader trend toward secured creditor-driven restructuring processes may be emerging on both sides of the Atlantic. While this trend may not be problematic in itself, its manifestations in the forms of pre-packs, 363 sales and liquidating CCAs appear to threaten the basic goals of insolvency law identified in Chapter 1. In particular, there are good reasons to think that wider stakeholder involvement is likely to be value-enhancing in most restructurings, and that “chances for successful reorganizations are enhanced where participants achieve common ground and all stakeholders are treated as advantageously and fairly as the circumstances permit.”²³⁰ Accordingly, to the extent that pre-packs, 363 sales and liquidating CCAs lack transparency²³¹ and limit the ability of weaker stakeholders to negotiate and scrutinise the deal, they may well interfere with insolvency law’s goals of maximising value and ensuring fair distributions to claimants.

At the same time, this chapter has highlighted some of the gaps in the existing scholarship on pre-packs, 363 sales and liquidating CCAs. In the U.S., for example, most studies have focused only on Chapter 11 cases involving very large public companies, to the exclusion of small and medium-sized

²²⁹ Mokal (n 35) 392: “There has been a paucity of understanding amongst the professionals, lawyers, and accountants, about the significance of the changes brought about by the Enterprise Act.”

²³⁰ *Century Services* (n 55) para 70.

²³¹ In response to this concern, Armour has suggested that related party bidders be required to disclose all of their information on the debtor to its independent directors, so as to enhance the transparency of pre-packs – see Armour (n 153) 30. However, this requirement may not go far enough in protecting the many dispersed unsecured creditors in a typical pre-pack, especially trade creditors. Even in cases where junior claimants have access to all of the relevant information on the debtor, they may still be unable to act, whether due to coordination problems or a lack of resources and negotiating leverage.

businesses.²³² Moreover, the existing empirical studies disagree as to the appropriate methods for collecting and comparing data – one example is the disagreement over the proper approach to valuing assets in 363 sales.²³³ Meanwhile, the data in the U.K. are limited, as pre-packs are a relatively new phenomenon, while in Canada empirical studies in general have been rare.

III. CONCLUSION

This chapter has argued that pre-packs have the potential to undermine the basic objectives of insolvency law. Specifically, pre-packs give too much control over the insolvency process to a debtor's incumbent managers, who will have various incentives to align their interests with those of the secured creditors. In the absence of adequate mechanisms to ensure transparency and accountability, the alignment of a debtor's managers and secured creditors will tend to lead to better recoveries for the secureds and worse recoveries for preferential and unsecured creditors. All of the foregoing appears to run directly counter to the stated goals of the Enterprise Act, and raises serious questions about the propriety of pre-packs given that most of them involve sales to connected parties. This chapter also compared pre-packs with 363 sales in the U.S. and liquidating CCAAs in Canada, identifying some broad similarities among these procedures, and buttressing some of the theoretical concerns raised regarding pre-packs. Based on the foregoing, I suggested that we should be sceptical of pre-packs, and that an empirically-informed comparison of pre-packs, 363 sales and liquidating CCAAs would be helpful both to better understand the role and effects of these procedures, as well as to formulate reform proposals.

²³² See Jay L Westbrook, "Secured Creditor Control and Bankruptcy Sales: An Empirical View" (2015) U III L Rev 831, 846.

²³³ *ibid* 845: "Another factor may be a trend toward legal empiricists being more interested in demonstrating statistical sophistication than in gathering otherwise unavailable data important to the things we study."

CHAPTER 3:
REORGANIZATION AND LIQUIDATION UNDER CHAPTER 11

I. INTRODUCTION

This chapter examines reorganizations and sales under Chapter 11 of the U.S. Bankruptcy Code,²³⁴ with emphasis on the debate surrounding the increasing use of Section 363 of the Code to carry out “quick sales” of the debtor’s assets, effectively bypassing the traditional Chapter 11 plan confirmation process. Chapter 2 of this thesis argued that there were strong functional similarities among 363 sales in the U.S., pre-packs in the U.K., and liquidating CCAAs in Canada. Chapters 4 and 5 will examine pre-packs in greater detail and propose reforms to their shortcomings, while Chapter 6 will do likewise for liquidating CCAAs. This chapter begins by examining the history and purposes of U.S. reorganization law, and in particular, the evolution of Chapter 11. It then discusses the rise of 363 sales and their implications, identifying the key problems with 363 sales in light of the history and purposes of Chapter 11 of the Code, the fundamental goals of insolvency law discussed in Chapters 1 and 2 of this thesis, and recent quantitative studies on 363 sales. It concludes by evaluating recent proposed reforms to the 363 sales process.

II. THE EVOLUTION OF INSOLVENCY REORGANIZATION IN THE U.S.

1. Overview

As discussed in Chapter 2, the U.S. Bankruptcy Code provides two main procedures for resolving corporate insolvency. Under Chapter 7, the court appoints a trustee over the debtor with the goal of gathering up the debtor’s assets, liquidating them, and distributing the proceeds to the creditors. Chapter 11, by contrast, provides debtors with the opportunity to reorganize and return to profitability.²³⁵ Whereas a Chapter 7 liquidation proceeding typically spells the death of the debtor company and its business, Chapter 11 represents a second chance for insolvent debtors. A further distinction can be found between Chapter 7’s manager-displacing model, in which the trustee takes over the business and begins selling off its assets, and Chapter 11’s debtor-in-possession (DIP) model, in which the debtor remains in control of its assets and operations, albeit subject to court’s supervision.

²³⁴ Code (n 2).

²³⁵ It should be noted that Chapter 11 does not require debtors to be insolvent in order to file.

In order to understand the role and implications of 363 sales, it is helpful to consider the background of Chapter 11 and its predecessor reorganization regimes. As discussed in further detail later, 363 sales are functionally similar in many ways to the equity receiverships that were widely used in the U.S. in the late nineteenth and early twentieth centuries. To some extent, then, the emergence of 363 sales harkens back to the early days of U.S. reorganization law and bears a certain “back-to-the-future quality”.²³⁶ This is significant because the development of U.S. reorganization laws over the past hundred years has been driven in large part by a reaction against secured-creditor driven processes such as equity receiverships. Beginning with Congress’ efforts to enact a federal reorganization regime in the 1930s, legislators sought to limit the influence of secured creditors in insolvency reorganizations.²³⁷ This trend culminated in the enactment of the Bankruptcy Code in 1978, which cemented the DIP model of reorganization in the U.S. This policy decision to leave debtors in full control of their assets and operations as well as the reorganization process marked the final stage of a major shift in U.S. reorganization law away from a largely pro- secured creditor regime to a pro-debtor regime. Yet over the past few decades, it is clear that Chapter 11 has changed again, and that the DIP model has been eroded in myriad ways; as Harvey Miller observed, the “Chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor-in-possession”.²³⁸ In other words, Chapter 11 is regressing, in some ways, back towards a model that places greater control over the reorganization in the hands of secured creditors. Perhaps the best example of this marginalization of the DIP model can be found in the emergence of 363 sales and the greater influence and control that they afford to secured creditors.

²³⁶ David A Skeel, Jr, *Debt’s Dominion: A History of Bankruptcy Law in America* (Princeton University Press, 2001) 220. Skeel uses this phrase in reference to the broader changes in modern U.S. bankruptcy practice, though it applies equally well to the emergence of 363 sales. In short, bankruptcy was a prominent practice area for large New York firms at the turn of the twentieth century, but the area lost much of its lustre when Congress enacted the first reorganization laws in the 1930s. Subsequently, with the enactment of Chapter 11 in 1978 and the growth in large corporate reorganizations, bankruptcy has regained much of its lost lustre and is once again an important practice area for large firms.

²³⁷ As noted in the ABI Report (n 12) 9, “[e]ach iteration of the law focused on strengthening business reorganizations and seeking an appropriate balance between the rights and obligations of the debtor and its stakeholders.”

²³⁸ Miller (n 193).

2. U.S. Reorganization Law Before Chapter 11

From an historical perspective, the focus on rehabilitating insolvent debtors is something of a revolutionary policy. For much of history, insolvency laws were aimed primarily at dismembering debtors – on some occasions, both literally as well as figuratively:²³⁹

One of the more eye-catching provisions of the Twelve Tables related to debtors. If, after performance of various legal rites and the passage of a certain amount of time – all very carefully defined – a debtor was still in default on his debts, his creditors could, literally, divide his body among them. Unfortunately for Portia, the Twelve Tables expressly stated that the creditors would be free from liability if they cut too much or too little.

In the U.S., modern insolvency reorganization laws evolved out of the equity receivership or “federal consent receivership” procedure developed in the nineteenth century.²⁴⁰ The quintessential case was the insolvent railroad company led by entrepreneurs who had hoped to build the first transcontinental line:²⁴¹

Unfortunately, similar to what occurred in the telecommunications industry at the end of the twentieth century, the entrepreneurs and their advisors miscalculated the physical difficulties of building a transcontinental railroad, failed to adequately consider the effects of competition (e.g., the Northern Pacific Railroad versus Central Pacific Railroad versus Southern Pacific Railroad) and overestimated revenues and underestimated expenses in the face of highly leveraged capital structures encompassing institutional debt, public bond debt, trade payables, and public stockholders. Thousands of miles of track were laid at great expense without considering a means for coordination between them... It was a recipe for disaster!

In the late nineteenth century, there was no federal insolvency reorganization regime for large, complex businesses. Although the Bankruptcy Act of 1867 included provisions dealing with corporations, the Act assumed that insolvent debtors would simply shut down their operations and liquidate their assets.²⁴² Furthermore, while Congress added provisions to the Act in 1874 permitting insolvent debtors to restructure their unsecured debts, these new “composition” provisions were geared to small businesses and were not at all suitable to railroads.²⁴³ Accordingly, the creditors of insolvent railroads typically were left with only their individual enforcement remedies. The consequence of each creditor enforcing individually would have

²³⁹ Andrew J Duncan, “From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law” (1995) 100 *Comm L J* 191. See also, generally: Emily Kadens, “The Last Bankrupt Hanged: Balancing Incentives in the Development of Bankruptcy Law” (2010) 59:7 *Duke L J* 1229; Louis Edward Levinthal, “The Early History of English Bankruptcy” (1919) 67:1 *Penn L R* 1.

²⁴⁰ Harvey R Miller and Shai Y Waisman, “Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?” (2004) 78 *Am Bankr L J* 153, 160.

²⁴¹ *ibid* 160-161.

²⁴² Skeel (n 236) 54.

²⁴³ *ibid*.

been the piecemeal dismemberment of the railroad, as each creditor foreclosed on the different portions of track against which their loans were secured, thereby terminating rail service on other parts of the line across many counties and states. The resulting loss of value for the creditors of the insolvent railroad, as well as the loss of jobs and the important services provided by the railroad to communities and the public, would be devastating. In short, the key stakeholders understood that the circumstances of the railroad industry at that time meant that individual enforcement actions typically would lead to the paradigmatic and destructive creditors' race later encapsulated by Thomas Jackson as follows:²⁴⁴

Bankruptcy, then, exists to constrain creditors (and others) from attempting to promote their individual interests when doing so would be detrimental to the group of claimants. A sole owner would not need bankruptcy because he could make a decision about what to do with his assets so as to maximize their value without concern that other claimants might thwart his plan. But diverse claimants (whose rights against assets make all of them species of "owners") have divergent interests and may use individual remedies in a fashion that reduces the value of the assets to the group as a whole. Bankruptcy is designed to assure that the asset "pie" is as large as possible, given a set of relative entitlements.

The equity receivership emerged as an alternative to the foreclosure and piecemeal liquidation of an insolvent debtor's assets. When the debtor defaulted on its bond payments, a creditor would file a "creditor's bill" asking the court to exercise its equitable powers to appoint a receiver. The receiver's appointment functioned as a sort of limited stay of proceedings – as the assets fell under the control of the receiver, the receiver could request injunctions from the court to block any enforcement or collection attempts by individual creditors. Next, a "foreclosure bill" would be filed asking the court to schedule a sale of the debtor's assets. Unlike a normal foreclosure sale, however, the sale date would be far into the future, sometimes months or even years away. In the meantime, the debtor's main underwriters would organize all of the creditors into different committees grouped by common interest, and together they would negotiate a plan to reorganize the debtor's capital structure. In order to incentivize lenders to finance the ongoing operations of the debtor during the reorganization period, the court would issue "receiver's certificates" giving those lenders priority over pre-existing claims. Then, once the plan was finalized, a reorganization supercommittee comprised of all of the creditors' committees would be formed and would "purchase" the insolvent debtor's assets at the foreclosure sale and transfer them into a shell corporation. Lastly, the new corporation would issue debt and equity to the original creditors and shareholders according to the terms

²⁴⁴ Thomas H Jackson, "Avoiding Powers in Bankruptcy" (1984) 36 Stan L R 725, 728.

of the reorganization plan.²⁴⁵ In effect, practitioners and the courts used the equity receivership remedy, a creature of foreclosure law, to create “the functional equivalent of a national reorganization statute”.²⁴⁶

Significantly, equity receiverships were a remedy for creditors, not insolvent debtors, as only a creditor could apply to the court for a receivership order as an alternative to enforcing on that creditor’s claims.²⁴⁷ In short, equity receiverships preserved the going concern value of the insolvent enterprise for the benefit of all of the stakeholders. Selling off individual sections of track or other assets, such as locomotives, would have realized proceeds for the creditors that were far below the total value of the reorganized entity. Consequently, a financial and operational restructuring of the insolvent railroad typically was the best choice for the creditors as a group. At the same time, reorganizing the business also meant saving jobs, preserving relationships with customers and suppliers, and ensuring continued service to various communities. This reality served to align the interests of bondholders with those of the employees, managers and shareholders of the insolvent railroad, as well as the communities in which the railroad operated.²⁴⁸ Accordingly, equity receiverships saw widespread use in the many railroad insolvencies of the late nineteenth and early twentieth centuries.

The stock market crash of 1929, and the Great Depression that followed, served as catalysts for major reforms of financial and insolvency laws in the U.S. Harvey Miller and Shai Waisman describe the dire economic circumstances as follows:²⁴⁹

On October 29, 1929, the stock market crashed, resulting in the loss of \$10 billion to \$15 billion in one day... Declining prices, falling production, and increased unemployment ensued at a drastic rate, and the United States fell deeper and deeper into the Great Depression, the worst and longest economic collapse in the history of the modern industrial world... In 1933, at the nadir of the depression, over fifteen million Americans – one quarter of the nation’s workforce – were unemployed.

In response to these conditions, Congress passed a series of emergency laws, including among other things, laws that formally empowered the federal courts to supervise insolvency reorganizations. As David Skeel notes, Wall Street and the corporate reorganization bar initially supported the codification of the

²⁴⁵ Skeel (n 236) 58-59.

²⁴⁶ Miller and Waisman (240) 162.

²⁴⁷ *ibid* 163.

²⁴⁸ *ibid* 164-165.

²⁴⁹ *ibid* 167. For reference, the Bureau of Economic Analysis estimates that the total U.S. Gross Domestic Product in 1929 was \$103.6 billion. Online: <https://apps.bea.gov/scb/pdf/2012/08%20August/0812%20gdp-other%20nipa_series.pdf>.

common law of equity receiverships, for several reasons. Firstly, the equity receivership procedure lacked an efficient method of dealing with dissenting creditors, who had to be paid in cash out of the reorganized debtor's already limited funds.²⁵⁰ Secondly, the reorganization of larger railroads often required initiating various "ancillary receiverships" in states where the railroad operated or owned property, as even the federal courts had limited jurisdiction to administer property across state lines. The new federal regime would eliminate the need for ancillary receiverships, thus streamlining the whole process. Thirdly, the standard justification for court orders granting equity receiverships over railroads, namely, that it was in the public interest to save the railroads, did not always translate easily to insolvent debtors in other industries. This complicated efforts to employ equity receiverships for the increasing number of non-railroad companies that began experiencing financial difficulties in the 1930s. In short, Congress' push to enact a federal statutory reorganization scheme presented an opportunity to centralize and streamline an otherwise expensive process, to extend its use more broadly across different industries, and ultimately, to codify the courts' jurisdiction to supervise reorganizations.²⁵¹ From the perspective of Wall Street and the professional reorganization bar, all of these were worthy goals.

Congress' initial reform efforts led, in 1933, to the addition of Section 77 to the Bankruptcy Act of 1898, which codified the reorganization procedure for insolvent railroads. This was followed by the enactment of Section 77B in 1934, which extended the reorganization procedure to non-railroad companies. Had Congress concluded its corporate insolvency law reform efforts with the enactment of Sections 77 and 77B, Wall Street and the reorganization bar would have been very pleased indeed.²⁵² However, Congress did not stop there:²⁵³

Buried in the Securities Exchange Act of 1934, which created the SEC and gave it rather than the FTC jurisdiction over the securities laws, was a provision instructing the SEC to investigate and report on the protective committees used in corporate and railroad receiverships. (Because the protective committees set up by Wall Street professionals lay at the heart of equity receivership practice, the charge to investigate protective committees was, in effect, an instruction to scrutinize every aspect of large-scale reorganization). Although the reorganization study would tie the reformers' hands for several years, it also offered several crucial benefits. Most obviously, the findings of the study could be used to buttress the case for subsequent reform.

²⁵⁰ Skeel (n 236) 104-105.

²⁵¹ *ibid.*

²⁵² *ibid* 107.

²⁵³ *ibid* 108.

The SEC's subsequent report, issued in 1937, attacked and outraged Wall Street and the reorganization bar. Among other things, the report accused the major law firms and banks involved in reorganizations of overlooking managerial incompetence and fraud in favour of gaining more control over the reorganization process and commanding ever higher fees from insolvent debtors.²⁵⁴ The report went on to recommend sweeping reforms to the reorganization laws for non-railroad companies.²⁵⁵ Against the backdrop of strong populist animus toward Wall Street during the Great Depression, along with the broader reforms of corporate and financial laws ushered in as part of the New Deal, the SEC's report had significant and lasting effects. In the years that followed, the SEC's report would lead to major reforms of the corporate reorganization regime that had remained largely unchanged since the late nineteenth century.

The SEC report's recommendations gradually culminated in the enactment of the Chandler Act of 1938.²⁵⁶ In particular, Chapter X of the Chandler Act provided a statutory mechanism for reorganizing large public companies wherein a mandatory court-appointed trustee would displace the senior managers of the insolvent debtor company, and the various stakeholders would negotiate and develop a formal reorganization plan, all under the supervision of the court. The insolvent debtor's underwriters and lawyers were barred from serving as the trustee and from negotiating with the bondholders while the trustee prepared a reorganization plan. In addition, the Chandler Act gave a prominent role to the SEC in regulating every large reorganization. Firstly, the Act provided that every reorganization plan involving more than \$3 million in debt had to be forwarded to the SEC "for investigation, examination, or report."²⁵⁷ Secondly, the Act defined the SEC as a party in interest in every reorganization, effectively granting the SEC general authority "to weigh in on any issue that arose in the course of the bankruptcy".²⁵⁸ In sum, the equity receivership process that previously had been typified by largely private negotiations among the stakeholders of the insolvent debtor, was now subject to "pervasive governmental oversight".²⁵⁹

²⁵⁴ *ibid* 111. *Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees* (1937).

²⁵⁵ It should be noted that the procedures for railroad company reorganizations under Section 77 remained in effect. Consequently, in railroad reorganizations, the company's existing managers remained in place and its underwriters and lawyers were permitted to participate in the reorganization process. For other reasons, however, railroad insolvencies declined significantly after World War II and the corporate reorganization bar "slowly faded away". See Skeel (n 236) 125.

²⁵⁶ Chandler Act of 1938, Pub L No 75-696, 52 Stat 840 (1938) (repealed 1978).

²⁵⁷ Skeel (n 236) 122.

²⁵⁸ *ibid*.

²⁵⁹ *ibid*.

Perhaps unsurprisingly, Chapter X was a rather cumbersome procedure. The requirement to appoint a trustee in every reorganization, and the restrictions on who could be appointed, strongly discouraged the managers of many struggling companies from filing for insolvency protection.²⁶⁰ Furthermore, many Chapter X cases would take as long as five or ten years to complete.²⁶¹ Consequently, whereas around 500 companies filed under Chapter X in 1938, Chapter X filings dwindled to 68 cases in 1944 and remained at around 100 cases per year through the 1960s.²⁶² As an alternative to the onerous Chapter X process, many companies began filing under Chapter XI of the Chandler Act instead. Chapter XI had been designed primarily for small businesses and did not mandate the appointment of a trustee, which permitted the managers of the insolvent debtor to remain in place. However, predictably, Chapter XI as drafted lacked many of the mechanisms necessary for carrying out large, complex reorganizations. Unlike Chapter X, for example, the rights of secured creditors could not be altered in Chapter XI proceedings. Consequently, much as they had done with equity receiverships in the late nineteenth century, practitioners and judges began crafting a variety of tools that “had the effect of transforming Chapter XI from a debtor-relief proceeding intended for small mom and pop businesses with small amounts of unsecured liabilities to a chapter used by Fortune 500 corporations.”²⁶³ Chapter XI of the Chandler Act remained the procedure of choice for large reorganizations until Congress enacted the Bankruptcy Code of 1978.

3. 1970s Reforms and the Code

The enactment of the U.S. Bankruptcy Code in 1978 followed several years of reform efforts, spurred on by the dramatic rise of consumer bankruptcies in the late 1960s. As Skeel notes, annual personal bankruptcy filings soared from around 10,000 per year in the 1940s to nearly 100,000 by 1960 – a tenfold increase in just 15 years.²⁶⁴ The resulting calls for changes to the federal consumer bankruptcy regime quickly evolved into comprehensive reform efforts in the 1970s, as various interest groups successfully lobbied Congress to undertake major overhauls of both the consumer and corporate

²⁶⁰ *ibid* 125.

²⁶¹ Miller and Waisman (n 240) 169.

²⁶² Skeel (n 236) 125.

²⁶³ Miller and Waisman (n 240) 171.

²⁶⁴ Skeel (n 236) 136-137. It remains an open question whether these massive increases in filings resulted from the growth of consumer credit in the new era of credit cards, the decline of the stigma associated with bankruptcy, or both.

regimes.²⁶⁵ The corporate reorganization bar, in particular, enthusiastically embraced the opportunity to lobby Congress to replace Chapter XI of the Chandler Act with a new and comprehensive reorganization mechanism.²⁶⁶ From the reorganization bar's perspective, despite the judicially driven changes that had transformed Chapter XI into a procedure suitable for large companies, Chapter XI remained a flawed tool. In particular, the Chapter XI procedure remained uncertain because the SEC continued to retain the authority to intervene in any Chapter XI reorganization and to order that the case be transferred to Chapter X.²⁶⁷ As noted earlier, the effects of transferring a case from Chapter XI to Chapter X would be the immediate displacement of the insolvent debtor's management by a trustee and the removal of the debtor's lawyers and underwriters from the reorganization process. These factors were strong motivators for the reorganization bar and the National Bankruptcy Conference (NBC)²⁶⁸ in lobbying for a more flexible DIP model for large corporate reorganizations.²⁶⁹

As a consequence of these wide-ranging reform efforts, not only did the resulting U.S. Bankruptcy Code of 1978 contain major changes to consumer bankruptcy laws, it also completely overhauled the corporate reorganization regime by replacing Section 77 and Chapters X and XI with the new Chapter 11 of the Code. Significantly, Chapter 11 permitted debtors' incumbent managers to remain in place during most reorganizations, as trustees could only be appointed for cause and receivers were prohibited. Other provisions "enhanced the comfort zone" of managers, such as the automatic stay of proceedings against debtors upon filing, as well as broader powers for debtors to obtain financing and to reject executory contracts.²⁷⁰ In addition, the SEC lost its authority to supervise large corporate reorganizations, and was

²⁶⁵ For a discussion of the various lobbies and competing reform proposals that emerged following Congress' establishment of the National Bankruptcy Review Commission in 1970, see Skeel (n 236) 138-141.

²⁶⁶ *ibid* 176: "The story of the 1978 Code's changes to corporate reorganization is, in a sense, a story of the reorganization bar achieving more than it could have dared to hope."

²⁶⁷ *ibid* 160-161.

²⁶⁸ The NBC is an invitation-only, non-profit and non-partisan organization of approximately 60 leading lawyers, law professors and bankruptcy judges. Online: <<http://nbconf.org/about-us/>>. The NBC gathered informally in 1932 to propose reforms to the Bankruptcy Act of 1898, later advised Congress on the Chandler Act of 1938, and was formalized in the 1940s. Today, it remains "the single most important voice in bankruptcy reform": see *ibid* 94-95.

²⁶⁹ In fact, the NBC's proposals went even further than those of the National Bankruptcy Review Commission by recommending, not only that trustees no longer be mandatory in large cases, but that the new legislation instruct courts to presume, at the outset of each case, that a trustee would not be appointed. See Skeel (n 236) 177-178.

²⁷⁰ Miller and Waisman (n 240) 176.

effectively replaced with a new entity known as the U.S. Trustee, which was given a much more limited role in appointing the members of creditors' committees and intervening on matters such as motions seeking court approval for the fees of debtors' counsel. The SEC retained standing as an intervener in corporate reorganizations.²⁷¹ In short, the "New Deal vision of bankruptcy was now dead".²⁷² Although the new DIP reorganization model operated under the supervision of federal bankruptcy courts, it was otherwise subject to light regulation.

Chapter 11's "manager-friendly" character has contributed to the rapid growth in corporate reorganizations since 1978. In the 1980s, for example, leveraged buyouts came to define much of the U.S. business and legal worlds. Chapter 11 encouraged these takeovers, to some extent, because the incumbent managers of both bidders and targets knew that they would likely remain in place if they were ever forced to file for Chapter 11 protection.²⁷³ In addition, other changes to the Code encouraged companies to use Chapter 11 to resolve new and unusual types of cases, such as mass tort actions. In particular, the Code broadened the definition of "claim" to include any legal or equitable right, including contingent and unliquidated rights.²⁷⁴ In these regards, modern U.S. reorganization law has been extended into new areas of "public interest" well beyond the original purpose of reorganization in the nineteenth century – namely, to preserve insolvent railroads. The broader and more flexible reorganization regime of Chapter 11 has continued to fuel the growth of reorganizations in the U.S. since 1978.²⁷⁵

4. The Evolution of Chapter 11 and the Rise of 363 Sales

More recently, U.S. reorganization law has changed again, as companies are increasingly using Chapter 11 to sell substantially all of their assets whether pursuant to a formal plan or through a 363 sale. There are many possible explanations for this trend away from longer, traditional reorganizations in which the debtor re-emerges as a profitable entity, toward a process in which the debtor's business is sold on a going concern basis to a third party and the debtor ceases to exist. Miller and Waisman point to several key factors influencing the changing nature of reorganization practice. Firstly, technological advances and globalization have altered the relationships among insolvent enterprises and their customers and suppliers.

²⁷¹ Skeel (n 236) 181.

²⁷² *ibid.*

²⁷³ *ibid* 214-215.

²⁷⁴ *ibid* 218.

²⁷⁵ *ibid* 219.

Sources of customers and suppliers have consolidated: one prominent example is the retail sector, which is now dominated by a few large national and multinational chains. Given their global reach, these multinationals are unconstrained by concerns surrounding local or regional economies and relationships. Consequently, whether these entities are customers or suppliers of an insolvent debtor, they can either refuse to deal with the debtor entirely, dissuade the debtor from filing for Chapter 11 protection, or otherwise exercise significant influence over the reorganization.²⁷⁶

Secondly, debt markets have changed significantly in the past two decades, with the market for distressed debt investing ballooning to over \$400 billion in 2013 in the U.S. alone.²⁷⁷ This has fundamentally changed the character of many Chapter 11 proceedings, with distressed debt investors such as hedge funds and private equity funds now dominating some of the largest cases, such that “it is difficult to overstate the impact distress investors have had on the chapter 11 process”.²⁷⁸ Specifically, the rise of distressed debt investing has eroded the “symbiotic relationship” that once existed between troubled companies and their creditors.²⁷⁹ Many lenders no longer have any interest other than monetizing their debt claims for a profit as soon as possible, without regard to other factors such as the survival of the debtor or its underlying business. As Douglas Baird and Robert Rasmussen note, traditional lenders such as banks typically have an interest in the long-term viability of their borrowers, or at least their underlying businesses, but the same is not necessarily true of distressed debt investors:²⁸⁰

Banks make their profit by lending and having it paid back. They do not seek to own and operate the business. Not so with hedge funds. A hedge fund may buy the loan with the view that in the event of default it would be left with the business, and given the amount at which it purchased the notes, it would not be a bad price at which to acquire it even if it were in financial distress. Banks want their money back; hedge funds loan to own. The same dynamic that plays out with respect to publicly traded unsecured debt now plays out with respect to traditional bank debt as well.

In short, the key players in modern Chapter 11 reorganizations can be very different from the key players in the equity receiverships of old. Compare, for example, early twentieth century Wall Street banks with

²⁷⁶ Miller and Waisman (n 240) 180-181.

²⁷⁷ Edward I Altman, “The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations” (2014) 22 Am Bankr Inst L R 75, 76.

²⁷⁸ Jonathan C Lipson, “Bargaining Bankrupt: A Relational Theory of Contract in Bankruptcy” (2016) 6 Harv Bus L Rev 239, 278.

²⁷⁹ Miller and Waisman (n 240) 181.

²⁸⁰ Douglas G Baird and Robert K Rasmussen, “Antibankruptcy” (2010) 119 Yale LJ 648, 670.

modern-day distressed debt funds: the former sought to rehabilitate insolvent businesses, while the latter typically try to break up and sell them piecemeal.

Thirdly, changes in lending practices have permitted secured creditors to exert increasingly greater influence over troubled borrowers both inside and outside of insolvency, effectively allowing the most powerful creditors to control the Chapter 11 process.²⁸¹ Creditors are able to exert control over debtors in a variety of ways. For example, when a debtor becomes distressed, it also typically encounters difficulties obtaining access to credit on the same terms as it enjoyed when it was financially healthy. Consequently, creditors lending to the distressed firm can demand, among other things, stronger positive and negative covenants in their lending agreements. This dynamic is further tilted in favour of lenders when the debtor is preparing to file for Chapter 11 protection and needs to secure financing for its restructuring. In such cases, debtors must often agree to DIP financing arrangements that impose various onerous conditions upon them, such as deadlines for filing a business plan, limitations on disbursements to parties that must be approved by the lender, and requirements for the debtor to retain financial advisors or a chief restructuring officer (CRO) approved by the DIP lender.²⁸² As Skeel has observed, DIP financing conditions can dramatically influence the course of the reorganization:²⁸³

The starkest strategy is to include one or more affirmative covenants with explicit drop dead dates. When FAO Schwarz filed for bankruptcy in 2002 (for what turned out to be the first of two filings), one of the covenants authorized the lenders to insist that the toy chain be liquidated unless it either sold all of its assets or confirmed a reorganization plan by April 4, 2002. In effect, the loan agreement served as a guillotine, giving the debtor's managers one limited chance to restructure the company.

In addition, senior lenders may exert control over a debtor's management by both direct and indirect means. In some cases, for instance, the senior lenders will insist that the debtor hire a CRO to replace the CEO, or that the debtor replace some or all of its directors.²⁸⁴ In other cases, the debtor may enter into key employee retention plans (KERPs) incentivizing its senior managers to remain in place during the reorganization. As George Kuney observes, the rationale for KERPs is not always clear because most of the "key" employees retained in KERPs are the debtor's upper management and directors, who may well have been complicit in

²⁸¹ Miller and Waisman (n 240) 183.

²⁸² *ibid.*

²⁸³ David A Skeel, Jr, "The Past, Present and Future of Debtor-in-Possession Financing" (2004) 25 *Cardozo L Rev* 1905, 1918.

²⁸⁴ Douglas G Baird, "The New Face of Chapter 11" (2004) 12 *Am Bankr Inst L Rev* 69, 81.

the debtor's failure.²⁸⁵ A better approach in many cases would be to replace upper management entirely, while implementing KERPs to retain the middle managers of the debtor, who are more likely to be intimately familiar with the debtor's actual day-to-day operations.²⁸⁶ An alternative view of KERPs, however, is that they serve to align the interests of upper management with those of the senior lenders. In many cases, the terms of the compensation packages provided by KERPs will be influenced by the senior lenders, whose continued support is required in order for the debtor to meet its obligations under the KERPs.²⁸⁷

Fourthly, the nature of companies has changed dramatically since the Code was enacted in 1978. The U.S. has shifted from a manufacturing-based to a service-based economy, with more than twice as many people working in services than in manufacturing today."²⁸⁸ Consequently, intangible assets now represent roughly half of the value of non-financial firms in the U.S., and even the hard assets of most firms are highly fungible. As Baird points out, the shift to a services-based economy has minimised the need for traditional reorganizations in many cases:²⁸⁹

Few businesses today center around specialized long-lived assets. In a service-oriented economy, the assets walk out the door at 5:00pm. Today the costs of starting a business are those involved in creating and implementing a business plan. Millions are spent training staff, building a client base, and cementing relationships with suppliers. But these investments are fundamentally different from those involved with building a railroad. The most salient characteristic of a railroad is low operating costs relative to the initial capital investment. Railroads of the 19th century generated at least enough revenue to cover their operating expenses. By contrast, a new business venture may be unable to cover its expenses if it is only just a little worse than a rival business. The hundreds of millions spent trying to establish WebVan were worthless once its business model failed.

Put another way, many firms' assets today consist of networks, knowledge and relationships, and therefore, these assets are not firm-specific.²⁹⁰ Accordingly, companies and businesses are more transitory today than they were in the past because many of their assets can be broken up and sold without sacrificing going-concern value.²⁹¹

²⁸⁵ George W Kuney, "Hijacking Chapter 11" (2004) 21 Emory Bankr Dev J 19, 89.

²⁸⁶ *ibid* 90.

²⁸⁷ Wood (n 8) 410.

²⁸⁸ Miller and Waisman (n 240) 183-184. See also Baird and Rasmussen (n 176).

²⁸⁹ Baird (n 284) 82. See also Elizabeth B Rose, "Chocolate, Flowers, and Sec. 363(B): The Opportunity For Sweetheart Deals Without Chapter 11 Protections" (2006) 23 Emory Bankr Dev J 249, 252.

²⁹⁰ Jassmine Girgis, "Corporate Reorganization and the Economic Theory of the Firm" in Janis Sarra (ed), *Annual Review of Insolvency Law 2010* (Carswell 2011) 467, 491.

²⁹¹ Baird (n 284) 82: "Most important, the going-concern surplus is less evident now than in the time of the great railroads." See also Miller and Waisman (n 240) 184.

All of the foregoing factors help to explain the changing nature of Chapter 11. The traditional reorganizations of the past have been replaced, in many cases, with quick sales of substantially all of the debtor's assets under Section 363(b). The highly fungible nature of assets and the liquidity of capital markets have made it much easier to simply sell troubled companies' underlying assets rather than attempt a lengthy, and possibly unsuccessful, reorganization. Moreover, falling trade barriers and an increasingly global marketplace mean that many companies can serve their customers from anywhere, such that a debtor's entire business might be sold and moved to another region or country with relative ease.

In light of the foregoing changes, several commentators have argued that traditional reorganizations have become obsolete. Baird and Rasmussen, for example, suggest that traditional reorganizations under Chapter 11 will gradually be replaced by out-of-court sales:²⁹²

Today, both small and large firms can be sold as going concerns, inside of bankruptcy and out. The ability to sell entire firms and divisions eliminates the need for a collective forum in which the different players must come to an agreement about what should happen to the assets. That decision can be left to the new owners.

As discussed in further detail in Chapter 2, a key premise of Baird and Rasmussen's argument is that private contracting can fill the gaps left behind by traditional, formal reorganization mechanisms. In fact, they seem to view this outcome as inevitable, stating that Chapter 11 is only necessary for firms whose owners "cannot collectively make coherent decisions outside the bankruptcy forum... there must be firms whose owners are unable to write effective investment contracts."²⁹³ Other scholars, such as Barry Adler, argue that Chapter 11 is a creature of "political compromises" and is therefore inherently inefficient – in the absence of Chapter 11, the creditors of insolvent debtors would be able to negotiate among themselves for optimal solutions.²⁹⁴

Although the foregoing contractarian views continue to capture the imaginations of many insolvency law scholars today,²⁹⁵ these views are deeply flawed for several reasons. Firstly, as Miller and Waisman

²⁹² Baird and Rasmussen (n 176) 756.

²⁹³ *ibid* 777.

²⁹⁴ Adler (n 76).

²⁹⁵ See, for example, Schwartz (n 78) and Schillig (n 78). A distinction should be made here between these views, which fall within the contractarian tradition of Thomas Hobbes, Richard Posner and David Gauthier, and the contractualist tradition of Jean-Jacques Rousseau, Jonathan Rawls and Ronald Dworkin – briefly, contractarian morality is based on self-interested agents cooperating for mutual advantage, whereas contractualist morality is based on the notion that individual persons have equal moral status, such that self-interested behaviour is limited by respect for the rational autonomous agency of others: see Mokal (n 4) 36-37; Elizabeth Ashford and Tim Mulgan, "Contractualism", in Edward N Zalta (ed) *The Stanford*

note, the mere fact that many companies today are services-based and possess highly fungible assets does not always mean that those companies lack going concern value. On the contrary, it is evident that many such companies do possess going concern value because they are using Chapter 11 to sell their underlying businesses, or individual business units, rather than selling their assets piecemeal. In these cases, the market supports higher sales prices for the debtor's assets if they are kept together within the business or within specific business units than if the assets were broken up and sold separately. These higher sales prices reflect the market's estimate of the going concern value of the underlying business or business units.²⁹⁶

Secondly, the prevalence of mergers and acquisitions, as well as the consolidation of businesses in many different industries, suggests that private contracting, alone, cannot provide benefits such as economies of scale.²⁹⁷ Likewise, the continued use of Chapter 11 illustrates that there are problems related to distressed businesses that cannot be resolved purely through private contracting. In contractarian terms, Chapter 11 "can be seen as a process whereby a reorganizing debtor chooses which transactions are valuable to continue to pursue within the firms and which are not."²⁹⁸ Presumably, if debtors could obtain the same results through private contracting and without incurring the additional costs of a Chapter 11 filing, they would do so. Indeed, some 20 years after Baird and Rasmussen declared that Chapter 11 had become obsolete, companies continue to use Chapter 11 at fairly predictable rates. If anything, the changes in Chapter 11 filings over the past few decades generally reflect the cycles of the U.S. economy: during the recession of the early 2000s, Chapter 11 filings increased to over 11,000 cases in 2002²⁹⁹ – the year that Baird and Rasmussen wrote "The End of Bankruptcy" – before declining to a low of 5,163 cases in 2006;³⁰⁰ then, at the height of the financial crisis in 2009, Chapter 11 filings rose again to over 15,000 cases, before gradually declining in subsequent years as the economy improved.³⁰¹ Over the past five years, there have

Encyclopedia of Philosophy (Summer 2018 Edition). Online: <https://plato.stanford.edu/archives/sum2018/entries/contractualism/> accessed 21 July 2019.

²⁹⁶ Miller and Waisman (n 240) 192.

²⁹⁷ *ibid* 192.

²⁹⁸ *ibid* 193.

²⁹⁹ Administrative Office of the U.S. Courts, Table F-2 – Bankruptcy Filings (December 31, 2002). Online: <https://www.uscourts.gov/statistics/table/f-2/bankruptcy-filings/2002/12/31> accessed 21 July 2019.

³⁰⁰ Administrative Office of the U.S. Courts, Table F-2 – Bankruptcy Filings (December 31, 2006). Online: <https://www.uscourts.gov/statistics/table/f-2/bankruptcy-filings/2006/12/31> accessed 21 July 2019.

³⁰¹ Administrative Office of the U.S. Courts, Table F-2 Bankruptcy Filings (December 31, 2009). Online: https://www.uscourts.gov/sites/default/files/statistics_import_dir/1209_f2.pdf accessed 21 July 2019.

been roughly 7,000 Chapter 11 filings per year.³⁰² In addition, filings remained steady for both large and small companies, and were similarly tied to business cycles in different industry sectors: whereas large company Chapter 11 filings in the early 2000s were concentrated in the health care, retail and telecommunications industries, large company filings following the 2007-2008 financial crisis were in the banking and automotive industries, and more recently, in the oil and gas sector.³⁰³ It is worth noting that in the past 5 years, the price per barrel of West Texas Intermediate Crude fell, quite dramatically, from a high of \$113.17 in 2014 to a low of \$36.34 in 2016, and has since hovered between \$50-\$70.³⁰⁴ In other words, the strongest determinants of Chapter 11 filings appear to be the prevailing conditions within specific industries and the economy as a whole in any given year. In short, predictions about the demise of Chapter 11 have been greatly exaggerated.

Thirdly, as explained in Chapters 1 and 2, there are both theoretical and practical problems with contract theories of insolvency law. The core normative problem with contract theories of insolvency is that they implicitly favour those stakeholders who possess greater relative resources, knowledge and bargaining power. In the absence of a system of background rules to supplement private contracting among unequal parties, the weaker parties will have limited means of deterring abusive and value-destructive behaviours by the stronger parties in many cases. This is particularly concerning given the large number of involuntary and maladjusting creditors often implicated in corporate insolvency, such as tort claimants, employees, and the wider community.³⁰⁵ In effect, a contract-based insolvency system would shift the risks and costs of insolvency onto those stakeholders who are least able to bear them.³⁰⁶ The key practical problem with contract theories of insolvency, meanwhile, is that real-world businesses and markets are both dynamic

³⁰² Filings for each of the last 5 years were as follows: 7,095 in 2018 (<https://www.uscourts.gov/sites/default/files/data_tables/bf_f2_1231.2018.pdf>); 7,442 in 2017 (<https://www.uscourts.gov/sites/default/files/data_tables/bf_f2_1231.2017.pdf>); 7,292 in 2016 (<https://www.uscourts.gov/sites/default/files/data_tables/bf_f2_1231.2016.pdf>); 7,241 in 2015 (<https://www.uscourts.gov/sites/default/files/table_f-2_yearly_dec_2015_0.pdf>); and 7,234 in 2014 (<https://www.uscourts.gov/sites/default/files/statistics_import_dir/1214_f2.pdf>) accessed 21 July 2019.

³⁰³ Samuel L Gerdano and Ed Flynn, “ABI 2017 Chapter 11 Review: Large Company Filings Down, Retail & Oil Still Show Distress”, January/February 2018, *ABF Journal*. Online: <<https://www.abfjournal.com/articles/abi-2017-chapter-11-review-large-company-filings-down-retail-oil-still-show-distress/>> accessed 21 July 2019.

³⁰⁴ “Crude Oil Prices – 70 Year Historical Chart”. Online: <<https://www.macrotrends.net/1369/crude-oil-price-history-chart>> accessed 21 July 2019.

³⁰⁵ Community interests might include, for example, the payment of unremitted taxes by the insolvent debtor, or the remediation of environmental damage caused by the debtor’s business activities.

³⁰⁶ Warren and Westbrook (n 179).

and imperfect. Governments already regulate virtually every sphere of economic activity, such that a system of purely private ordering in insolvency alone would be incongruent. Moreover, even if markets were far freer than many contract theorists suppose, the purported benefits of private contracting as a replacement for formal insolvency reorganization are often overstated. Parties' circumstances can change over time, and they can be mistaken about the benefits of contractual terms for which they negotiate. Consequently, parties might find themselves locked into agreements or bound to perform certain obligations that later turn out to be detrimental to their interests. Contract theories of insolvency provide no obvious, seamless corrective mechanisms for the foregoing problems – on the contrary, private contracting practices might even exacerbate these problems and impose additional uncertainties and transactional costs upon the parties.³⁰⁷ Indeed, as Adler observes in a recent article, the predicted “end of bankruptcy” has not come to pass, and the collective forum provided by Chapter 11 clearly continues to serve some important goals:³⁰⁸

That bankruptcy has evolved, and is not truly at an end, is significant for the purposes of this Article because the changes that Baird and Rasmussen describe do not include an elimination of a collective proceeding. In the new world of corporate bankruptcy, there is perhaps little traditional reorganization, but assets are held together away from individual creditor collection until the court can decide what to do with them. The assets may eventually be sold in piecemeal liquidation, as in the examples given by Baird and Rasmussen, but they may instead be sold as a going concern if that brings the best price. Alternatively, assets are held together until the court can determine that the firm belongs to and can be run, or disposed of, by what Baird and Rasmussen describe as the “principal creditors.”

Although it is unlikely that Chapter 11 will be replaced with a system of private contracting in the near future, if ever, it is nonetheless clear that Chapter 11 is changing. In 2012, the American Bankruptcy Institute (ABI) established the Commission to Study the Reform of Chapter 11. The Commission was comprised of some of the most prominent insolvency and restructuring practitioners in the U.S., including the two principal draftsmen of the Bankruptcy Code of 1978 and the chairs and former chairs of leading organizations such as the NACI, the American College of Bankruptcy, the New York City Bar Committee on Bankruptcy and Reorganization, and the Turnaround Management Association, among others.³⁰⁹ The ABI

³⁰⁷ Armour (n 84).

³⁰⁸ Barry E Adler, “The Creditors’ Bargain Revisited” (2018) 166 U Pa L Rev 1853, 1862-1863.

³⁰⁹ ABI Report (n 12) 2.

charged the Commission with conducting a 3-year study and proposing comprehensive reforms to Chapter 11 in accordance with the following mission statement:³¹⁰

In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the Commission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors — with the attendant preservation and expansion of jobs — and the maximization and realization of asset values for all creditors and stakeholders.

The end result of the Commission's work was its Final Report, which was unanimously adopted by the Commissioners on December 1, 2014.³¹¹ Certain of the Commission's key recommendations are discussed later. Of particular note here, however, are the Commission's findings with respect to the changing nature of Chapter 11 reorganizations. Following over 16 public hearings across the U.S., the Commission identified several common themes with respect to the evolution of Chapter 11 since it was enacted in 1978. In particular, the Commission noted that quick sales under Section 363 had grown in importance, while traditional reorganizations seemed to be fading:³¹²

First, many witnesses acknowledged that chapter 11 cases have changed over time. These changes include: (1) a perceived increase in the number and speed of asset sales under section 363 of the Bankruptcy Code; (2) a perceived decrease in stand-alone reorganizations; (3) a perceived decrease in recoveries to unsecured creditors; and (4) a perceived increase in the costs associated with chapter 11.

With respect to points (1) and (2) above, despite some annual fluctuations, 363 sales generally have increased as a percentage of all large public company Chapter 11 filings over the past twenty years, as seen in the below table:³¹³

³¹⁰ *ibid* 3. It should be noted that the Commission was charged with focusing exclusively on the resolution of financially distressed business under Chapter 11.

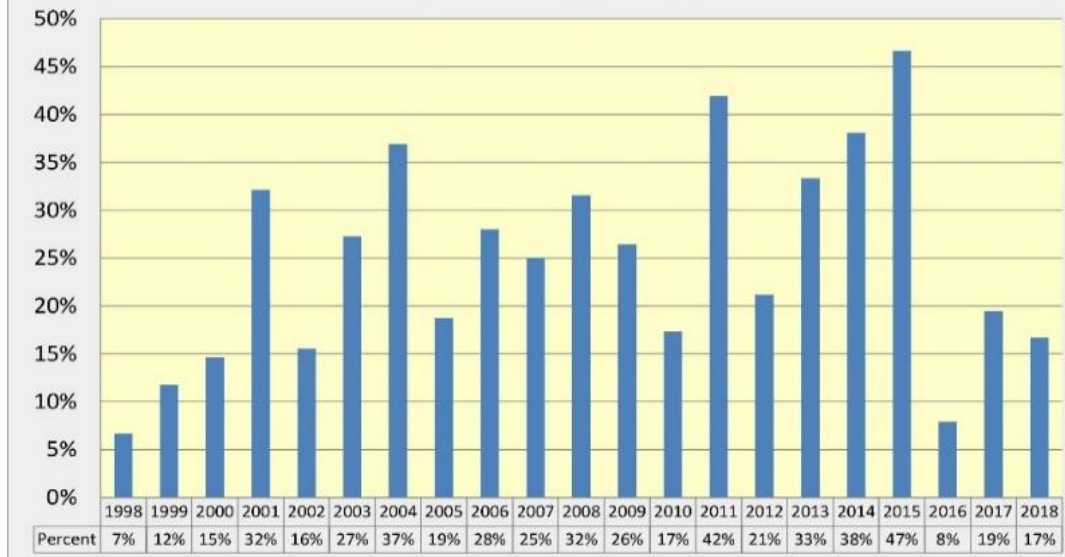
³¹¹ *ibid*.

³¹² *ibid* 15.

³¹³ UCLA-LoPucki Bankruptcy Research Database. Reproduced by permission. Online: <http://lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf> accessed 21 July 2019. See also ABI Report (n 12) 203, acknowledging the "positive linear trend... in the number of 363 sales in chapter 11 cases" albeit limited to large public companies.

**363 Sales of All or Substantially All Assets in Large,
Public Company Bankruptcies, as a Percentage of all
Cases Disposed, by Year of Case Disposition**

Source: UCLA-LoPucki Bankruptcy Research Database



Many scholars have also acknowledged the trend towards the use of 363 sales as an alternative to traditional reorganizations or sales pursuant to plans. In a 2011 article, Kimon Korres predicted that the trend toward 363 sales was “likely to grow” as creditors continued to gain greater control over the Chapter 11 process and insolvent debtors encountered greater difficulties in obtaining financing for reorganizations.³¹⁴ More recently, Charles Tabb has observed that “it is a secured creditor’s world now... secured lenders effectively have captured and now control the reorganization process”.³¹⁵ Consequently, the traditional Chapter 11 reorganization process “has gone the way of the rotary phone”, and 363 sales

³¹⁴ Kimon 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, 960-61. See also Bryant P Lee, “Chapter 18? Imagining Future Uses of 11 U.S.C. § 363 to Accomplish Chapter 7 Liquidation Goals in Chapter 11 Reorganizations” 2009 Colum Bus L Rev 520, 530.

³¹⁵ Charles Tabb, “What’s Wrong With Chapter 11?” (March 13, 2019) University of Illinois College of Law Legal Studies Research Paper No 19-15, 9. Online: <<https://ssrn.com/abstract=3352137>> accessed 21 July 2019.

have become the norm.³¹⁶ While Tabb may be overstating the point, it is clear that 363 sales have grown in importance and that they are here to stay.

To some extent, the trend toward 363 sales has validated Baird and Rasmussen's predictions that sales would gradually replace traditional reorganizations,³¹⁷ but they are mistaken about the primary reasons for this shift in Chapter 11 practices. It is the underlying reasons for the 363 sales, and not the phenomenon of their increasing use, that matters for the purposes of insolvency policymaking. From a descriptive perspective, Baird and Rasmussen are wrong to suggest that the increasing use of 363 sales can be explained purely, or even primarily, by changes in the nature of modern firms, financial markets, and the broader economy.³¹⁸ As discussed earlier, all of the foregoing changes, of course, are contributing factors in the rise of 363 sales. However, while these changes may be necessary causes of the trend toward 363 sales, they are not sufficient causes. After all, if such broad economic changes were the primary drivers of the shift toward sales, the result would not be more 363 sales per se, but out-of-court sales. In order for debtors to pursue 363 sales – or, for that matter, other types of sales process under Chapters 7 or 11 of the Code – there must be some value in those processes that goes beyond what could be obtained through an out-of-court sales process. That added value is to be found in certain technical aspects of the Chapter 11 regime, and in particular, of the 363 sales process.

Howard Berman identifies several specific features of 363 sales that typically make them faster and more certain than traditional reorganizations.³¹⁹ Firstly, 363 sales can be completed without a formal plan. Therefore, they need not comply with the requirements of Section 1129 of the Code. These requirements include, for example, court approval of a disclosure statement by the debtor, a creditor vote on the plan,

³¹⁶ *ibid* 10-11.

³¹⁷ Baird (n 280).

³¹⁸ *ibid*.

³¹⁹ Howard J Berman, "363 Asset Sales: The Latest Restructuring Tool" (2010) 6 *Pratt's J Bankr L* 291, 292-293.

and court approval of the final plan.³²⁰ By contrast, in a 363 sale, there is no formal plan or creditor vote, and it is up to the court to decide whether to approve the proposed sale:³²¹

In a § 363 sale process, creditors do not vote at all; instead, they are represented en masse by an official creditors' committee, which speaks for the collective interest of general unsecured creditors. The court, having heard the committee's pitch, is then free to make its decision, and although the court typically takes the wishes of major stakeholder groups into account, it is formally unconstrained by their views.

It is also worth noting that because there is no creditor vote in a 363 sale, any creditor who wishes to stop the sale must prove to the court that the sale will cause harm. This can be a difficult hurdle to overcome because a 363 sale typically proceeds quickly and the information available to creditors is more limited than in a Chapter 11 plan confirmation process.³²²

Secondly, in a 363 sale, the debtor can transfer title to its assets free and clear of all liens, claims and other encumbrances, and in some cases even successor liability for tort claims can also be extinguished. Thirdly, leases and executory contracts can be transferred more easily because anti-assignment clauses are unenforceable in Chapter 11, while Section 365 of the Code permits the debtor to terminate unprofitable contracts. Fourthly, sales under the Code are immune from fraudulent conveyances challenges that could otherwise be brought by creditors under state law, while the court's approval of the sale terms provides the purchaser with further protections against any attempts to undo the deal ex post. It is difficult to overstate the significance of these protections; pursuant to Section 363(m), an appeal from the sale is moot unless the objector obtains a stay pending the hearing of the appeal or the purchaser failed to act in good faith.³²³ Moreover, all things being equal, selling debtors and potential purchasers will tend to prefer a 363 sale over an out-of-court sale because a 363 sale can transfer all of the debtor's assets free and clear and immunize the transfer from challenges under state fraudulent conveyances laws.

³²⁰ As Elizabeth Rose notes, the lower disclosure requirements for 363 sales compared to Chapter 11 plan confirmations means that parties objecting to 363 sales have less information available to them even though the onus is on them to prepare a detailed objection within twenty days prior to the sale approval hearing. The costs associated with conducting research in order to formulate an objection within the twenty-day period can be significant. See Rose (n 289) 260-262.

³²¹ Ralph E Brubaker and Charles J Tabb, "Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM" (2010), U Ill L Rev 1375, 1386.

³²² Anderson and Ma (n 198).

³²³ See Rose (n 289) 262; *Karbo Assocs v Colony Hill Assocs* (In re *Colony Hill Assoc*), Ill F 3d 269, 272-74 (2d Cir 1997).

More generally, as Tabb explains, 363 sales can be particularly attractive to secured creditors because the process gives them more control and tends to be faster than a reorganization. As noted earlier, debtors will need to borrow new money in order to finance a Chapter 11 filing, lenders can often use their enhanced leverage at the pre-filing stage to impose terms that are most favourable to them, and offering only enough DIP financing to complete a quick sale.³²⁴ Furthermore, in most cases the pre-filing senior lender will become the DIP lender because that lender will already have blanket liens over all of the debtor's assets. This makes it impractical for any other potential lenders to offer DIP financing as the debtor will not have any unencumbered assets to serve as collateral for the loans. In addition, intercreditor and subordination agreements will commonly prohibit junior lenders from providing DIP financing without first obtaining the senior lender's consent, thus further limiting the field of potential DIP lenders.³²⁵ The pre-filing senior lender's control is further enhanced by the fact that other potential DIP lenders will need to invest time and resources to conduct due diligence on the debtor before deciding whether to offer financing.³²⁶

As a result of all of the foregoing factors, the pre-filing secured lender often "call[s] all the shots and capture[s] all of the reorganization value up to the amount needed to pay themselves off". In short, "almost everything goes to [them]".³²⁷ In economic terms, the pre-filing lender has an effective monopoly over the debtor's working capital which then permits the lender to extract monopolistic rents when setting the terms of the DIP financing arrangement. For example, the DIP lender can initiate a "roll-up" or cross-collateralization so as to convert pre-filing debts that were undersecured into secured debts in Chapter 11. In essence, this allows the DIP lender to elevate its unsecured claims above all others, priming the other unsecured creditors.³²⁸ The DIP lender may also be able to obtain concessions regarding the validity of the pre-filing liens of other creditors, effectively eliminating any challenges to the DIP lender's secured position.³²⁹ Lastly, in most cases the DIP financing will be conditional on the debtor's satisfaction of various

³²⁴ Tabb (n 315) 11-12.

³²⁵ *ibid* 14. See also: ABI Report (n 12) 75; and generally, Mark N Berman and David Lee, "The Enforceability in Bankruptcy Proceedings of Waiver and Assignment of Rights Clauses Within Intercreditor or Subordination Agreements" (2011) 20 Norton J Bankr L & Prac, Art 1.

³²⁶ *ibid*.

³²⁷ *ibid* 13.

³²⁸ *ibid* 15. See also Donald A Jordan, "Cross-Collateralization in Chapter 11: Protecting the Small Business" (1993) 40 Wayne L Rev 219, arguing that cross-collateralization advances Chapter 11's rehabilitation purpose by allowing high-risk debtors to access credit and continue in business.

³²⁹ *ibid* 16.

conditions according to strict deadlines, such as filing a disclosure statement, conducting an auction to sell its assets, or closing the sale transactions.³³⁰

The speed of the 363 sales process can also be a very attractive feature from the perspective of secured creditors. Even the largest debtor companies can dispose of their assets through a 363 sale at breakneck speeds, providing secured lenders with a quick return on their investment.³³¹ For example, Chrysler completed the sale of \$2 billion in assets within 41 days, while GM sold \$45 billion in assets in only 39 days.³³² As noted in the ABI Report, the average time between the filing date of a 363 proceeding and the closing date of the sale has also gradually declined over the past two decades.³³³ The faster speed of 363 sales compared to traditional reorganizations may have various potential benefits:³³⁴

The Commissioners discussed the potential benefits to a quick sale — e.g., potentially less time in chapter 11; potentially less expensive reorganization strategy; typically preferred by postpetition lenders and prepetition secured creditors because of faster payoff; and typically preferred by stalkinghorse bidders because a quick sale disfavors outside bidders. The Commission also recognized that if a debtor’s business assets are of a perishable nature or otherwise subject to a rapid decline in value, then a quick sale may be the best and perhaps only option for maximizing value for the estate and its stakeholders.

As will be discussed later, there are also significant potential downsides to 363 sales. However, from the perspective of secured creditors and especially DIP lenders, the foregoing are all very attractive features of the 363 process. Even if a speedier sales process might result in a lower overall purchase price for the debtor’s assets, all things being equal, secured creditors will still naturally favour the process so long as they can expect a full return.³³⁵ This may well explain why companies with greater unsecured and undersecured debts are more likely to pursue a traditional reorganization than debtors with moderately or highly oversecured debts.³³⁶ Although Jay Westbrook argues that the relationship between secured creditor control and the likelihood of 363 sales has been exaggerated,³³⁷ he nonetheless acknowledges that “secured credit is a highly important part of the Chapter 11 system”, even if secured creditor control may

³³⁰ *ibid* 16.

³³¹ *ibid* 11.

³³² Brubaker and Tabb (n 321) 1377.

³³³ ABI Report (n 12) 85.

³³⁴ *ibid* 87.

³³⁵ For further discussion, see Alfonso Nocilla, “Asset Sales and Secured Creditor Control in Restructuring: A Comparison of the U.K., U.S. and Canadian Models” (2017) 26:1 *International Insolvency Review* 60.

³³⁶ Ayotte and Morrison (n 138).

³³⁷ Westbrook (n 232).

not be as pervasive as is commonly believed.³³⁸ In addition, Westbrook's study was based on a sample of only 424 Chapter 11 proceedings that commenced in 2006.³³⁹ It may be that a longitudinal study, particularly one covering several years following the financial crash in 2007, would reveal a different story about secured creditor control. For example, it is clear that debtor companies across the economy have become more highly leveraged since the time of Westbrook's study, as the leveraged loan market "has grown dramatically in the last 10 to 15 years" and secured debt now comprises 50% of the leveraged finance market as a whole.³⁴⁰ Moreover, the financial crash and the recession that followed "accelerated or contributed to firms' financial distress."³⁴¹ These factors reduce the equity available for distressed debtors to support their reorganization efforts. Necessarily, this dynamic strengthens the position of lenders generally and DIP lenders, in particular, vis-à-vis distressed debtors. In short, it is apparent that secured creditors and especially DIP lenders are stronger today than they were 10 to 15 years ago, and that all things being equal, they should favour 363 sales over traditional reorganizations.

5. Conclusions Regarding the Evolution of U.S. Reorganization Law and Problems with 363 Sales

As noted earlier, 363 sales are functionally similar in many ways to the equity receiverships of the late nineteenth and early twentieth centuries. Both procedures share some key features. Firstly, both would typically involve a going concern sale of the insolvent debtor's business under the court's supervision, on terms negotiated by the debtor's incumbent managers and senior creditors. Somewhat ironically, equity receiverships would be carried out under the auspices of foreclosure laws – in effect, they were going concern sales couched in terms of piecemeal liquidations – whereas 363 sales are typically going concern sales couched in terms of traditional reorganizations. Secondly, the senior creditors would usually drive both processes. In a 363 sale, the secured creditors may have security interests over most, if not all of the debtor's key assets, such that their cooperation is required to close the sale, or the debtor may need them to provide DIP loans before the going concern sale is completed. In an equity receivership, secured lenders would typically advance funds so that the insolvent debtor could pay key suppliers during the reorganization, and in exchange, the lenders would be issued receiver's certificates. Thirdly, the pool of potential

³³⁸ *ibid* 842.

³³⁹ *ibid* 838.

³⁴⁰ ABI Report (n 12) 214, fn 780.

³⁴¹ *ibid* 171.

purchasers would usually be small in both cases, because in equity receiverships, the distressed business would be worth more to the existing investors than to anyone else, while in 363 sales, the debtor may have canvassed potential purchasers and identified the likely purchaser already prior to filing for Chapter 11 protection. The end result under both procedures would be the same: a secured-creditor driven going concern sale, blessed by the court so as to reassure the purchaser and minimise post-closing issues.³⁴² All of these similarities give the 363 process a kind of “back-to-the-future quality”.³⁴³

Although equity receiverships were a remedy for creditors, not for insolvent debtors, it is important to note that the procedure was more than simply a collection mechanism for creditors. On the contrary, by facilitating a sale of the distressed debtor’s underlying business, the equity receivership aimed to preserve the going concern value of the railroad, save jobs along with customer and supplier relationships, and serve the public interest by ensuring that the rehabilitated business would continue serving the communities in which it operated. In short, the main stakeholders in the typical equity receivership all had a common interest in rehabilitating the debtor’s business. In this sense, the mere fact that the secured creditors generally controlled the process was not, in and of itself, problematic. It is perhaps trite to point out that when the interests of all stakeholders are identical in a given case, then it does not matter who controls the insolvency process. In such cases, all things being equal, each party will be happy to cede its decision-making power to any of the others, knowing that its interests would be protected. It is only in situations where the interests of the different stakeholders diverge, and if one or a few stakeholders are able to exert greater control over the process than others, will opportunities for rent-seeking and other value-destructive behaviours arise. Specifically, in such cases, the parties in control of the insolvency process may be able to divert value away from the common pool of assets to themselves, with the result that the actions of the powerful few may result in suboptimal outcomes for the group as a whole.³⁴⁴

³⁴² Although Section 363 does not strictly require court approval for the sale, approval is often sought for the purchaser’s benefit. In particular, if the assets are to be sold free and clear, Section 363(f) sets out various requirements that must be met. Resnick and Sommer (n 174) 363.02[1].

³⁴³ Skeel (n 236) 220. See also: Mooney (n 194) 754; Roe and Skeel (n 8) (suggesting that the Chrysler 363 sale was really a reorganization structured as a sale “in a way eerily resembling” a nineteenth century equity receivership).

³⁴⁴ For further discussion, see Nocilla (n 335) 75-76.

Certainly, the equity receivership model was susceptible to various forms of abuse. As Roe and Skeel explain, insiders could often leverage their positions in order to maximise their own returns at the expense of weaker creditors.³⁴⁵

The nineteenth century receivership process was a creature of necessity, and it facilitated reorganization of the nation's railroads and other large corporations at a time when the nation lacked a statutory framework to do so. But early equity receiverships created opportunities for abuse. In the receiverships of the late nineteenth and early twentieth century, insiders would set up a dummy corporation to buy the failed company's assets. Some old creditors—the insiders—would come over to the new entity. Other, outsider creditors would be left behind, to claim against something less valuable, often an empty shell. Often these frozen-out creditors were the company's trade creditors.

Having said this, there may have been unique historical factors that curbed the potential for abuses by powerful secured creditors in at least some of the early U.S. railroad reorganizations. Firstly, the news for trade creditors in equity receiverships was not always bad. As Skeel himself points out in *Debt's Dominion*, many railroad reorganizations would take months or years to unfold, and during that time the railroad would need to maintain its relationships with suppliers in order to continue operating. The railroad “could only keep running if its suppliers continued to supply coal for power and steel for track and the numerous other things the railroad needed.”³⁴⁶ The solution to this problem, as noted earlier, was for the court to issue receiver's certificates giving priority to lenders who provided funding to pay suppliers and other operating costs of the railroad. In such cases, the suppliers could be expected to be paid in full in cash upon delivery.³⁴⁷

Secondly, and more generally, despite the influence of certain senior secured creditors who were repeat players and “insiders” in many reorganizations, the nature of railroad financing in the late nineteenth and early twentieth centuries was such that no group of bondholders could ever afford to buy out all of the others. In effect, this meant that any disaffected bondholder could foreclose on its individual section of track and thereby shut down parts of the railroad, significantly diminishing the going concern value of the business and all of the debtor's other assets.³⁴⁸ Accordingly, even where a few powerful bondholders could control the process, their opportunities to engage in value-destructive behaviour – e.g. structuring the

³⁴⁵ Roe and Skeel (n 8) 767-768.

³⁴⁶ Skeel (n 236) 59.

³⁴⁷ *ibid* 59-60.

³⁴⁸ *ibid* 164-165.

reorganization in such a way as to appropriate for themselves the entitlements of weaker creditors, or sacrificing overall returns in order to complete the process more quickly so that the senior creditors could collect faster – may have been limited due to the leverage of the other bondholders. Put another way, the parties, or at least the bondholders, may have found themselves in a sort of Nash equilibrium in many cases, as none of them could act unilaterally to improve their own position. The key point here is simply that the success of railroad equity receiverships in the late nineteenth and early twentieth centuries may well have been the result of an historical accident, namely, the nature of railroad companies and how they were financed during that time. In these regards, it is interesting to note that the SEC’s report in 1937 only recommended reforms to Section 77B of the Bankruptcy Act of 1898 – the reorganization regime for non-railroad companies – while Section 77, dealing with railroad companies, remained unchanged despite the SEC report’s scathing criticisms of the equity receivership model generally.³⁴⁹ At all events, it is clear that in many cases, the senior secured creditors controlling the reorganization still needed the cooperation of other, weaker creditors such as junior bondholders and suppliers. Consequently, those other creditors had to be included in the reorganization process and to have their entitlements protected. This is an important point, because the historical circumstances that may have made railroad equity receiverships successful in the late nineteenth and early twentieth centuries are unlikely to obtain in other industries and at other times. Accordingly, modern secured-creditor drive processes such as 363 sales may be more susceptible to abuse.

Tabb suggests that two distinct types of concerns arise with respect to 363 sales.³⁵⁰ From a procedural perspective, there is a concern that due to the abridged nature of the 363 sale itself, unlike in a plan confirmation process, a detailed disclosure statement and a formal plan are not required, and the ability of all stakeholders to meaningfully participate in the process is limited. Furthermore, there is no creditor vote because there is no formal plan in a 363 sale:³⁵¹

In a § 363 sale process, creditors do not vote at all; instead, they are represented en masse by an official creditors’ committee, which speaks for the collective interest of

³⁴⁹ It should be noted that the procedures for railroad company reorganizations under Section 77 remained in effect. Consequently, in railroad reorganizations, the company’s existing managers remained in place and its underwriters and lawyers were permitted to participate in the reorganization process. For other reasons, however, railroad insolvencies declined significantly after World War II and the corporate reorganization bar “slowly faded away”. See Skeel (n 236) at 125.

³⁵⁰ Tabb (n 315).

³⁵¹ Brubaker and Tabb (n 321) 1386.

general unsecured creditors. The court, having heard the committee's pitch, is then free to make its decision, and although the court typically takes the wishes of major stakeholder groups into account, it is formally unconstrained by their views.

Consequently, some debtors may decide to pursue a 363 sale in order to circumvent the procedural requirements of a traditional Chapter 11 reorganization, leaving some stakeholders without much of a say in the process. From a substantive perspective, meanwhile, there are the questions of whether a sale is the best way of maximising the value of the debtor's assets, as well as whether the sale will respect the distributional entitlements of all stakeholders.³⁵² In Brubaker and Tabb's view, so long as stakeholders' distributional entitlements are respected in the process, it makes little difference whether the debtor undertakes a traditional Chapter 11 reorganization or a sale.³⁵³

The heart of the matter is this: whether reorganization value is captured by "sale" or by "plan" is not the critical question, as long as the method chosen preserves and upholds chapter 11's distributional norms. Given that any particular "plan" can be structured as a "sale," and any "sale" can be effectuated through a "plan" structure, it may simply be impossible to meaningfully distinguish between the two-through some sort of "true sale" versus "true reorganization" construct-in a manner that can preserve those distributional norms. We submit, therefore, that courts confronting these issues must keep their primary focus on the core need to protect the normative distributional entitlements of stakeholders, whether the reorganization proceeds by sale or plan. If the mechanism used impairs or obstructs the court's ability to fulfill that central protective role, then and only then should the court reject the reorganization vehicle.

This is generally correct, but it is important to note the crucial connections here between the above-mentioned procedural and substantive concerns with 363 sales. For example, Jessica Uziel observes that the expedited process and the lower disclosure requirements of a 363 sale make it more difficult for stakeholders to investigate all aspects of the proposed transactions. This lack of transparency, in turn, can make it difficult to thoroughly evaluate the terms of the proposed deal, whether they maximise the value of the debtor's assets, and whether all stakeholders' interests are protected.³⁵⁴ All of these issues are exacerbated by the fact that there is no creditor vote in a 363 sale, nor any prolonged period of negotiation towards developing a plan as in traditional Chapter 11 reorganizations. As a result, stakeholder participation is more limited in 363 sales. The foregoing concerns reflect the fundamental goals of insolvency law discussed in Chapter 1 of this thesis, namely: (1) to preserve and maximise the value of

³⁵² Tabb (n 315) 12.

³⁵³ Brubaker and Tabb (n 321) 1379-1380.

³⁵⁴ Jessica Uziel, "Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law" (2011) 159 U Pa L Rev 1189, 1214. See also ABI Report (n 12) 86.

insolvent enterprises; (2) to establish a fair system of ranking and compromising claims, and of distributing assets among all stakeholders; and (3) to investigate the causes of insolvency so as to prevent future harm and abuse. Transparency and stakeholder participation in the insolvency process, whether it be a sale or a traditional reorganization, are critical to ensuring that all of the foregoing goals are met. As Elizabeth Rose puts it, “[w]ithout comprehensive information available to the court and the committee the sale is vulnerable to sweetheart deals or unfair dealing.”³⁵⁵ Such unfair deals would undermine all three of the foregoing fundamental goals of insolvency law.

More generally, transparency and stakeholder participation are important elements of any insolvency process because they facilitate the investigation of the causes of the debtor’s insolvency as well as the selection of the correct resolution tool. As discussed in Chapter 1, debtors that are merely financially distressed are likely to be good candidates for traditional reorganizations or, at the very least, going concern sales. This is because a financially distressed debtor’s business is fundamentally profitable, but the debtor is overleveraged or has encountered difficulties accessing financing on favourable terms. By contrast, economically distressed businesses are fundamentally unviable and unprofitable; they will continue to lose money no matter how the business or capital structure is organized. Allowing economically distressed businesses to continue operating through a lengthy formal reorganization process merely throws good money after bad and delays the inevitable redeployment of the debtor’s assets to more productive uses in the economy.³⁵⁶ In these regards, Chapter 11 plays an important sorting function by identifying debtors that will be able to reorganize successfully and those that have no realistic chances of so doing.³⁵⁷ The latter are then filtered out into Chapter 7 liquidation.

To the extent that the 363 sales process limits the flow of information and the ability of all stakeholders to participate fully, it undermines Chapter 11’s sorting function and reduces opportunities to scrutinize the terms of the proposed deal. Accordingly, if a single creditor or group of creditors is powerful enough to take control of the sale process, the combination of speed, opacity, lack of participation and divergence of interests among the “insiders” and “outsiders”, could result in suboptimal outcomes for the stakeholders as a whole. This is an acute version of a problem that exists generally in Chapter 11. As

³⁵⁵ Rose (n 289) 272.

³⁵⁶ Mokal (n 4) 195.

³⁵⁷ Warren and Westbrook (n 184) 617.

Oscar Couwenberg and Stephen Lubben note, parties who can exert influence over, or take control directly or indirectly of a Chapter 11 proceeding, will be able to extract private benefits for themselves at the expense of other stakeholders:³⁵⁸

...controlling positions in chapter 11 allow those having such positions to help or set details of a control deal. But in bankruptcy, private benefits might also be extracted by those without direct control over the debtor, if they nonetheless have control over approval of the debtor's reorganization plan.

For example, while creditors might not have an ability to control the debtor's board or its actions, they might have a blocking position in the capital structure that gives them a veto over the debtor's plan. With such veto power comes the position to extract private benefits.

Once in control, a party can insist that the debtor relocate certain assets, grant specific rights to different securities or issue new securities under the reorganization plan, or pay certain fees.³⁵⁹ It follows from this that the more control a party has over the process, and the fewer tools that are available to other stakeholders to scrutinise and challenge the debtor's behaviour, the more susceptible the process will be to rent-seeking and other abuses.³⁶⁰ Couwenberg and Lubben correctly point out that this is a general problem with insolvency processes: where the pool of assets is insufficient to satisfy all claims, parties will seek whatever leverage is available to them in order to enhance their own returns even at the expense of the group. Given the foregoing, and in the absence of any safeguards, rent-seeking will abound. For these reasons, it was argued earlier that a purely contract-based insolvency regime would undermine the fundamental goals of insolvency law, as rent-seeking is more likely to occur where every aspect of the insolvency procedure is negotiated among parties with unequal knowledge, resources and bargaining power. Likewise, this problem is exacerbated in 363 sales by the speed and opacity of the process as well as the limited opportunities for stakeholder participation, all of which make it costlier and more difficult to scrutinise and challenge the terms of the deal. From the perspective of secured creditors, however, these

³⁵⁸ Oscar Couwenberg and Stephen J Lubben, "Private Benefits without Control: Modern Chapter 11 and the Market for Corporate Control" (2018) 13 Brook J Corp Fin & Com L 145, 153.

³⁵⁹ *ibid.*

³⁶⁰ This assumes, as noted earlier, that the interests of the controlling parties or insiders diverge from those of the non-controlling parties or outsiders.

are all features, rather than flaws, of the process. One practitioner expressed the approach of most secured creditors as follows:³⁶¹

In modern chapter 11 practice what really motivates secured lenders to use § 363 is that they're paying me, they're paying a financial advisor, they're paying the debtor, they're paying the debtor's financial advisors, they're paying Kay, they're paying Kay's financial advisors. And the burn rate in a modern chapter 11 is extremely, extremely high.

Jonathan Lipson relates the comments of another practitioner to the effect that in the past, lenders wanted distressed businesses to survive, but “[t]oday people only want one thing: to get paid.”³⁶² The speed of the 363 sales process, therefore, is very attractive to secured creditors. The promises of a quick return on investment, lower costs for the secureds, and greater certainty of a 363 sale make it preferable to a longer, traditional reorganization. Significantly, however, these benefits do not necessarily accrue to the unsecured creditors and other stakeholders of the debtor, who may prefer a longer process that provides more time to scrutinise the deal and ensure a better result for all stakeholders, such as a better price for the assets or a reorganization that preserves jobs and ensures a continued supply of important goods or services.

Recent quantitative studies suggest that many of the foregoing concerns regarding 363 sales are warranted. As discussed in Chapter 2, a study by Anderson and Ma comparing 363 sales to Chapter 11 plan sales found that 363 sales resulted in significantly lower prices.³⁶³ The lower prices appeared to result from the diminished ability of many creditors to negotiate and challenge the terms of the sales. These results lend weight to the theoretical concerns outlined above regarding the lack of transparency and stakeholder participation in 363 sales.³⁶⁴ In particular, creditors had diminished leverage in 363 sales because of the speed of the process and the limited information about the deal, compared with traditional Chapter 11 reorganizations. Of course, the main losers when the debtor's assets are sold at a lower price will be the undersecured and especially the unsecured creditors. In these regards, there is also some evidence that returns to unsecured creditors are declining in Chapter 11 cases more broadly. For example,

³⁶¹ Comments of Alan Pope, Partner, Moore & Van Allen. Kay Kress and others, “A Debate Among the Players in a Modern Chapter 11 Drama: Who Needs Chapter 11 When You Have §363?” (2014) 30 Emory Bankr Dev J 321, 328.

³⁶² Lipson (n 278) 289. See also Jonathan C Lipson, “The Shadow Bankruptcy System”, (2009) 89 B U L Rev 1609.

³⁶³ Anderson and Ma (n 198) 17. The study examined sales that were completed between 1996 and 2010 and corrected for the financial health of the companies as well as of the industries in which they operated.

³⁶⁴ The authors specifically refer to Rose (n 289), stating that their findings confirm her theory that junior creditors' reduced negotiating leverage result in lower returns.

in a study of Chapter 11 companies that had plans of reorganization confirmed in 2009-2010, Andrew Wood found that unsecured returns were significantly lower than in the period 1991-1996.³⁶⁵ Although Wood acknowledged that the recession may have depressed asset values during 2009-2010, he found that the most likely cause was the much higher secured debt loads and second-lien financing of companies compared with twenty years earlier.³⁶⁶ While these findings should be viewed with caution because Wood's sample of cases was relatively small and there have been periods in recent decades when unsecured returns have actually increased,³⁶⁷ if Anderson and Ma are correct that 363 sales yield lower prices than plan sales, unsecured creditors likely will have the most to lose as 363 sales become more common.³⁶⁸

Part of the difficulty in drawing firm conclusions from the quantitative studies to date is that it is not immediately clear which method is the most appropriate for valuing a debtor's assets in Chapter 11. In the past, discounted cash flow and comparables were the most common valuation methods, but these have gradually given way to market-based valuations.³⁶⁹ In 363 sales, the common method of obtaining a market valuation is to conduct an auction of the debtor's assets under the court's supervision.³⁷⁰ Arguably, the final purchase price can be viewed as the true "market" price of the assets – at a basic level, something is worth whatever a purchaser is willing to pay for it. However, care should be taken in relying on the price obtained in a 363 auction as definitive of the assets' valuation, for several reasons. Firstly, as a general matter, valuations of distressed businesses are "notoriously subjective and the mere definition of *overvalued* versus *undervalued* is not straightforward."³⁷¹ Secondly, the manner in which a sale process is structured and conducted typically has a significant impact on the final price. Consequently, the mere fact that an auction, or some other sale process, resulted in a sale does not establish that the price paid was the market price

³⁶⁵ Wood (n 192).

³⁶⁶ *ibid* 430.

³⁶⁷ Altman (n 277) 109.

³⁶⁸ It should be noted that Wood's study included only three 363 sales, which was an insufficient number to establish a correlation with lower unsecured returns: see Wood (n 192) 430. But if Anderson and Ma are correct that 363 sales tend to depress sale prices compared with plan sales, it follows that unsecured returns in 363 sales ought to be lower, as well.

³⁶⁹ Michael Simkovic, "The Evolution of Valuation in Bankruptcy" (2017) 91 Am Bankr L J 299, 302-304.

³⁷⁰ *ibid* 304.

³⁷¹ Konstantin Danilov, "Debating the Question of Undervaluation in Chapter 11" (December 1, 2016), online: <<https://ssrn.com/abstract=2939844>> accessed 21 July 2019.

or the best price that could have been obtained in the circumstances. The ABI Commission recognized this reality when considering the issue of asset valuations in 363 sales:³⁷²

A section 363x sale transforms the estate from illiquid assets with fluctuating value to a fixed sum of money or securities. Consequently, it potentially alters the value of the estate in a positive or negative direction, depending on factors such as the timing of the sale, the marketing of the assets, the competitive nature of the auction, and the sale and restructuring alternatives explored by the debtor in possession leading up to the section 363x sale. Anecdotal evidence suggests that section 363x sales can facilitate quicker sales that create value for the estate. Such evidence also suggests, however, that a bidder may pursue certain strategies such as a “loan-to-own” strategy or streamlined sale process that may chill bidding and depress the value of the assets.

As discussed earlier, a DIP lender typically has various tools at its disposal to influence the course of the Chapter 11 proceedings. This may include insisting that the debtor structure the auction process in a specific manner that could ultimately result in a lower price for the assets than if the process had been structured differently. For example, if the DIP lender would like to encourage a quick sale of the assets, a stalking-horse auction would provide some assurance of a smooth and quick closing, as the existence of the stalking horse typically discourages outside bidders. At the same time, the lower price obtained in the auction would result in lower returns to the undersecured and unsecured creditors of the debtor.

6. Comments on Section 363 Reform Proposals

Following the conclusion of its 3-year study, the ABI Commission proposed comprehensive amendments to Chapter 11. While many of these reform recommendations are beyond the scope of this thesis, the ABI Commission also proposed several important changes to Section 363 that warrant careful examination. Certain of these key recommendations are discussed immediately below.

(1) Timing of 363 sales

The Commission recommended imposing a 60-day moratorium on court approval of proposed sales of substantially all of a debtor’s assets from the date of commencement of proceedings. The court would only be permitted to shorten this moratorium where: (i) the trustee or another party demonstrates that there is a high likelihood the debtor’s assets will decrease significantly in value during that time; and (ii) the proposed sale satisfies the standards set forth in the principles for 363 sales.³⁷³ In making this recommendation, the Commission recognized that in the past, 363 sales could take an average of 3 months

³⁷² ABI Report (n 15) 202 (emphasis added).

³⁷³ ABI Report (n 12) 83.

or longer to conclude. Beginning in the early 2000s, however, 363 sales typically have been completed much more quickly, with mean and median durations of 82 and 74 days, respectively, in 2013.³⁷⁴ The purpose of the moratorium is to ensure that sales are not completed so quickly that the auction process is cut short, the debtor lack sufficient time to explore alternatives such as reorganization, or without leaving a reasonable amount of time for stakeholders to assess whether the market will rebound during the Chapter 11 proceedings. Although the Commission acknowledged that there were various potential benefits of a quick sale, such as a shorter process leading to a faster payoff for secured creditors, these benefits were “significantly outweigh[ed]” by the potential harm to the value of the debtor’s assets from a sale that is completed too quickly.³⁷⁵

The foregoing concerns and recommendations are well-founded. As a general matter, the speed of an insolvency procedure is not necessarily linked to lower costs. As will be explained in Chapter 4, the speed of pre-packs in the U.K. tends to yield only modest cost savings compared with other types of procedures, after correcting for professional fees and other expenses incurred in setting up the deal prior to filing for protection. Likewise, as will be discussed in Chapter 6, the data on liquidating CCAAs in Canada are mixed: liquidating CCAAs are completed quickly, but the debtor continues to remain in CCAA proceedings for at least as long as it would have in a full reorganization, while the creditors negotiate over the distribution of the sale proceeds. The primary benefit of speed, in all three procedures, is the certainty and faster payoff that it offers to the secured creditors of the debtor. It is noteworthy that this benefit does not square with any of the fundamental goals of insolvency law, namely, to maximise the value of the debtor’s assets, to ensure that fair distributions are made to stakeholders, or to investigate the causes of insolvency. Indeed, for the reasons discussed earlier, speed may well undermine all of these fundamental goals. In those cases where a party can demonstrate that the debtor’s assets must be sold before the 60-day moratorium has ended because the assets are “melting ice cubes” that will rapidly decline in value due to their nature, the courts can grant an exceptions to the moratorium in those rare cases.³⁷⁶ The Commission’s recommendations with respect to the 60-day moratorium are, therefore, appropriate in light of the concerns already raised regarding 363 sales.

³⁷⁴ *ibid* 84-86.

³⁷⁵ *ibid* 87.

³⁷⁶ *ibid* 86.

(2) Finality of court orders approving sales

The Commission recommended codifying the standards surrounding the court's power to reopen an auction or to set aside a previous order approving a sale, except where there are "extraordinary circumstances or material procedural impediments (such as the lack of adequate notice or an improperly conducted sale process)".³⁷⁷ In the Commission's view, permitting courts to reopen auctions or other sales after the fact, simply on the basis that a better offer has been made, would undermine the certainty and predictability of the process. Uncertainty regarding the finality of the auction or sale process would, in turn, discourage prospective purchasers from participating in the first place, and would prevent gamesmanship. Protecting the integrity of the process in this way was worth more, in the Commission's view, than leaving open the potential for higher bids being made after the auction or sale has ended.³⁷⁸

This recommendation raises some difficult questions. To the extent that potential purchasers in an auction or other sale of an insolvent debtor's assets require certainty as to the rules and integrity of the process – otherwise, they may choose not to participate in the process at all – then it should not be an easy matter to reopen an auction or undo a sale simply because a late bidder has submitted a better offer. On the other hand, maximising the value of the debtor's assets is a fundamental goal of insolvency law. While it may be that restricting the ability of parties to reopen auctions ex post is the best policy from a macro perspective, so as not to discourage potential bidders in 363 sales generally, in specific cases the stakeholders of insolvent debtors would stand to lose when a better offer is submitted after the bidding process ends and cannot be accepted.

A related issue is whether the courts are properly placed to evaluate the intricacies of proposed 363 sales at all. Arguably, it is very difficult, if not impossible, for courts to meaningfully assess whether all of the specific terms of a complex process such as a stalking horse auction, and its specific terms, are appropriate in any given case – that is, to assess whether the process is likely to yield the best price for the debtor's assets or the best results overall for all stakeholders. Ideally, the auction or other sales process could be structured at the outset of 363 proceedings so that it yields the best possible price, without any need to alter the terms during proceedings or reopen the auction or sale ex post. Realistically, however,

³⁷⁷ *ibid* 139.

³⁷⁸ *ibid* 139-142.

this is rarely the case and the question ought to be whether all stakeholders, other than those who are driving the 363 process, will be able to meaningfully scrutinise and challenge the terms of the auction or other sale. Rather than placing the onus on disaffected stakeholders to ask the court to undo the deal ex post in order to accept a better offer, a better approach would be to require greater disclosure by the debtor and input from all stakeholders, both initially when the debtor asks the court to review and approve the auction procedures, and later if the debtor seeks to vary the terms of the auction. In short, enhanced transparency and stakeholder participation ex ante would reduce the burden on the court when deciding whether the proposed auction or sales process, or any changes thereto, are likely to result in a better outcome. Greater scrutiny of the debtor's proposed auction or sale process ex ante may also lead to a more optimal structure from the outset of proceedings, minimizing the need to alter the process once it has begun or to reopen it after it has concluded. In this sense, restricting the court's authority to reopen an auction or sale after the fact may encourage stakeholders to participate more fully by scrutinising the debtor's proposed plans before the sale process is initiated. However, whether stakeholder participation can be enhanced in this way will depend on improving the transparency of 363 sales and reducing the ex ante obstacles to participation for those stakeholders who are not part of the group of "insiders" that initially crafted the proposed deal with the debtor.

(3) Approval of 363 sales generally

The Commission's key recommendation with respect to the approval process for 363 sales was that the 363 process should provide creditors with the same protections that they would have in a Chapter 11 plan confirmation. In particular, courts use different standards of review when approving 363 sales and formal plans. A court's analysis of a proposed 363 sale may simply turn on the question of whether the debtor has a "good reason" for the sale in the circumstances.³⁷⁹ This is a lower standard than the test applied in a Chapter 11 sale plan confirmation, which requires the debtor to satisfy the court that all of the requirements of Section 1129 of the Code have been met. Specifically, the plan must be in good faith and in the best interests of the creditors, must not discriminate unfairly, and must be fair and equitable with respect to each dissenting impaired class.³⁸⁰ The Commission noted that in quick sales, "many creditors do

³⁷⁹ *ibid* 205.

³⁸⁰ *ibid* 206.

not receive notice of the sale or sufficient information to evaluate the sale” and yet the sale may significantly reduce returns for unsecured creditors or impose other obligations on the creditors, such as subjecting them to third-party releases.³⁸¹

The Commission’s recommendation to use the same standard in evaluating 363 sales and plan sales is appropriate. There is no principled reason why the protections available to creditors in the Chapter 11 plan confirmation process should not also be available in 363 sales. If anything, it is especially important to extend these protections in 363 sales because of the speed and opacity of 363 sales and the reduced ability of most stakeholders to participate in the process, all of which demand greater scrutiny by the courts in order to permit asymmetrical outcomes for stakeholders in 363 and plan sales.

III. CONCLUSION

This chapter has considered the rise of quick sales under Section 363 in light of the history and purposes of U.S. reorganization law, the fundamental goals of insolvency law, and recent empirical studies. Although the quantitative data on 363 sales remain limited and mixed,³⁸² the available data suggest that many of the theoretical concerns about quick sales are warranted. As with pre-packs in the U.K. and liquidating CCAAs in Canada, in 363 sales there is a risk that the abridged process will shut out weaker stakeholders from the negotiations leading up to the proposed sale or auction, as well as limit their ability to scrutinise the sale or auction terms once the process is underway. These problems are compounded by the speed of the process and the costs associated with gathering information about the debtor and the deal so as to effectively scrutinise it. The ABI Report’s recommendations encourage greater transparency and stakeholder participation in 363 sales. The 60-day moratorium addresses one of the major problems with quick sale processes not only the U.S., but in Canada and the U.K. as well. That is, once initiated, a quick sale process tends to gain momentum very quickly until it cannot be reversed – effectively, it may well be a *fait accompli* from the time of filing.³⁸³ The moratorium provides more time for stakeholders and the court to scrutinise the debtor’s proposed course of action, and to gather additional information so as to determine whether the terms of the sale represent the best deal for the stakeholders as a group. In these ways, rules that foster greater transparency and provide opportunities for stakeholder participation will help to further

³⁸¹ *ibid.*

³⁸² *ibid* 203.

³⁸³ Finch (n 45) 471-472.

the fundamental goals of insolvency law, namely: to maximise the value of the insolvent enterprise or the assets, ensure fair distributions to key stakeholders, and facilitate the investigation of the causes of insolvency. The Commission's recommendations are a step in the right direction to reforming the 363 sales regime so that opportunities for abuse and rent-seeking by more powerful stakeholders will be minimised and optimal outcomes for stakeholders as a group will be more likely to result.

CHAPTER 4:
QUANTITATIVE OUTCOMES OF U.K. INSOLVENCY PROCEEDINGS³⁸⁴

I. INTRODUCTION

This chapter compares the quantitative outcomes of different types of formal insolvency proceedings in the U.K., based upon data originally collected by the author on over 2,500 administration and administrative receivership cases. As further described below in Part II, this study is the largest and most detailed quantitative analysis of U.K. insolvency proceedings carried out to date, dwarfing the numbers of cases and variables tracked in previous attempts. It is also the first such project to examine the outcomes of formal insolvency proceedings in all three U.K. jurisdictions, namely, England and Wales, Scotland and Northern Ireland.

Specifically, this chapter examines the outcomes of U.K. insolvency proceedings with a view to answering the following fundamental questions that are specific to U.K. insolvency law:

- i. Is the new administration regime introduced by the Enterprise Act 2002 (amending the Insolvency Act 1986) related to better outcomes for creditors as a whole, compared to the now-abolished administrative receivership regime?
- ii. Are pre-packs related to better outcomes for creditors than standard administrations?

Intrinsic to insolvency practice is the fact that one cannot unscramble the egg. Once a given process is completed, “all other possible outcomes are consigned to the realm of the hypothetical”.³⁸⁵ Moreover, different stakeholders tend to have different and often competing interests. As such, different stakeholders may disagree about whether a given insolvency process was “successful” or whether some other, alternative process would have served them better. It is therefore challenging, if not impossible, to identify any single determinant of “success” when evaluating different insolvency processes. That said, as explained later in Part II, it is certainly possible to identify various proxies for success across different types

³⁸⁴ This chapter refers throughout to Rizwaan Mokal, Nigel J Balmer and Alfonso Nocilla, “Contractualised Distress Resolution in the Shadow of the Law: United Kingdom National Findings”, Draft of 14 May 2018. Online: <<http://www.codire.eu/wp-content/uploads/2018/07/National-Findings-UK-formatted-clean.pdf>> accessed 21 July 2019. In addition, parts of this chapter have been reproduced in Alfonso Nocilla and Vern W DaRe, “The Trouble with Pre-Packs”, forthcoming in Janis P Sarra and others (eds), *Annual Review of Insolvency Law 2018* (Thomson Reuters, 2019) 621. The commentary and analysis herein are the author’s alone, except where otherwise indicated. All statistical analyses were conducted by Balmer. See Appendix A for further discussion of the differences between Mokal and others and the project discussed in this chapter and Appendix B for a summary of journal articles and conference papers based on this thesis.

³⁸⁵ Jones (n 225) 481.

of insolvency processes, such as returns to different classes of creditors, professional fees and other expenses, and survival rates of businesses post-exit. Other data points, such as the duration of each insolvency process, can also serve as indicia of success. As explained in Chapter 2, an insolvent debtor will typically incur greater indirect costs, such as higher financing costs, the longer that it remains insolvent. All things being equal, then, a shorter process is better than a longer one.

Comparing proxies for success across different types of proceedings provides a basis for assessing the relative advantages and disadvantages of each type of proceeding. In addition, such comparisons are helpful in evaluating whether the Enterprise Act is fulfilling its stated goals of improving outcomes for creditors in insolvency, particularly unsecured creditors.

II. METHODOLOGY

1. Dataset, Data Collection and Significance of Study

The initial dataset consisted of 3,128 formal insolvency proceedings, identified by reviewing notices published in the *London Gazette*,³⁸⁶ and comprised as follows:

- i. 2,120 administration proceedings under the Insolvency Act 1986 (as amended by the Enterprise Act 2002), representing the total number of administrations that commenced between January 1 and December 31, 2012; and
- ii. A comparator group of 1,008 administrative receivership proceedings that commenced between January 1 and December 31, 2002.

The year 2002 was chosen for the receivership cases because it was the last full year before the Enterprise Act effectively abolished administrative receiverships. Accordingly, the 2002 receivership cases contain the most recent available data from proceedings completed under the old regime. With respect to the administration cases, the year 2012 was chosen for three reasons. Firstly, there was a lower likelihood that cases initiated in 2012 would still be ongoing by the time of the U.K. data collection, as compared with cases initiated in more recent years. Secondly, 2012 marked roughly 10 years from the time that the Enterprise Act took effect, and as such, there is little question that insolvency practitioners (“IPs”) had fully adopted the new regime and were highly familiar with it by that time. This is important because the costs of administration, for example, may have been relatively higher in earlier administration cases as IPs were

³⁸⁶ Online: <<https://www.thegazette.co.uk/>> accessed 21 July 2019.

still familiarizing themselves with the new regime, which would have complicated comparisons with receiverships.³⁸⁷ Thirdly, examining cases from 2012 permitted comparisons of the survival of distressed businesses after 12, 24 and 36 months following the conclusions of the proceedings, providing a sufficient period of time in which to evaluate the long term outcomes of different types of procedures.

The database was populated using information from reports filed by IPs with Companies House. Most records were available through Companies House's public online database;³⁸⁸ however, some records, however, were unavailable, particularly for receiverships which concluded over 10 years prior to the time of data collection. These cases comprised most of the receiverships examined in this project. The relevant records for these receiverships were obtained by ordering scanned copies of the originals from Companies House's archives.

As data collection progressed, the dates of the *London Gazette* notices were compared to the actual dates of initiation of insolvency proceedings recorded in the reports filed with Companies House. These comparisons revealed that a number of insolvency proceedings in the initial dataset were initiated outside of the desired timeframes. In general, these were cases in which proceedings were initiated in late December of 2001 (for receiverships) or 2011 (for administrations), such that notices were published in the *London Gazette* the following January, causing the cases to be misidentified initially as cases that commenced in 2002 and 2012, respectively. Accordingly, such cases were removed from the dataset, reducing the total number of cases to 3,037.

Part II.4 below sets out the different variables tracked across each case and procedure. Where practicable, data collection and entry were automated using Companies House's online database. For example, as shown below in Screenshot 1, data such as the name and number of each company, the dates of incorporation and dissolution (where applicable), SIC code and head office address generally are available on the information page of each company on Companies House's website, thereby permitting automated collection and entry for many of these data:

³⁸⁷ See, for example, Armour and others (n 143) 170-171.

³⁸⁸ Online: <<https://beta.companieshouse.gov.uk/>> accessed 21 July 2019.

SCREENSHOT 1

The screenshot shows the Companies House profile for WINTER, BROWNE & COMPANY LIMITED. At the top, there is a navigation bar with the Companies House logo and name. Below this is a 'BETA' notice and a search bar. The company name is prominently displayed in large, bold letters, followed by its company number 00141940. There are two green buttons: 'Follow this company' and 'File for this company'. A horizontal menu contains tabs for 'Overview', 'Filing history', 'People', 'Charges', and 'Insolvency', with 'Overview' selected. The 'Registered office address' is listed as Highfield Court, Tollgate, Chandlers Ford Eastleigh, Hampshire, SO53 3TZ. The company status is 'Liquidation'. The company type is 'Private limited Company' and it was incorporated on 22 October 1915. Three red warning icons indicate overdue accounts, confirmation statements, and annual returns. The 'Nature of business (SIC)' is 16290 - Manufacture of other products of wood; manufacture of articles of cork, straw and plaiting materials. At the bottom, there are links for Policies, Cookies, Contact us, and Developers.

Companies House

BETA This is a trial service — your [feedback](#) will help us to improve it.

[Sign in / Register](#)

Search for a company or officer

WINTER, BROWNE & COMPANY LIMITED

Company number **00141940**

[Follow this company](#) [File for this company](#)

[Overview](#) [Filing history](#) [People](#) [Charges](#) [Insolvency](#)

Registered office address
Highfield Court, Tollgate, Chandlers Ford Eastleigh, Hampshire, SO53 3TZ

Company status
Liquidation

Company type
Private limited Company

Incorporated on
22 October 1915

! **Accounts overdue**
Next accounts made up to **31 December 2011**
due by **30 September 2012**
Last accounts made up to **31 December 2010**

! **Confirmation statement overdue**
First statement date **4 August 2016**
due by **18 August 2016**

! **Annual return overdue**
Last annual return made up to **4 August 2012**

Nature of business (SIC)
16290 - Manufacture of other products of wood; manufacture of articles of cork, straw and plaiting materials
[Is there anything wrong with this page?](#)

[Policies](#) [Cookies](#) [Contact us](#) [Developers](#)

Automated entries were verified manually so as to confirm that the entries based on the Companies House information page were consistent with the reports filed by the IPs in each case. Manual verification was necessary because there were various discrepancies between the automatically entered data and the information contained in the IPs' reports. For example, the head office address of the company was sometimes changed during or after insolvency proceedings were initiated – often to the address of the IP's firm – such that the automated entry from Companies House's information page did not provide the correct

address at the time that insolvency proceedings began. This is illustrated in the Companies House information page in Screenshot 1 above, which lists a registered office address in Eastleigh, Hampshire; however, a review of the Filing History tab in the below Screenshot 2 shows that the company's address was changed on 18 October 2012:

SCREENSHOT 2

WINTHER, BROWNE & COMPANY LIMITED

Company number **00141940**

Follow this company
File for this company

Overview

Filing history

People

Charges

Insolvency

Filter by category

Show filing type

Accounts

Confirmation statements / Annual returns

Capital

Incorporation

Charges

Officers

Date	Description	View / Download
20 Jul 2018	Appointment of a voluntary liquidator	View PDF (2 pages)
27 Jun 2018	Removal of liquidator by court order	View PDF (10 pages)
01 Dec 2017	Liquidators' statement of receipts and payments to 23 September 2017	View PDF (28 pages)
01 Dec 2017	Notice of move from Administration case to Creditors Voluntary Liquidation <small>This document is currently unavailable, a copy can be ordered from the Contact Centre. Telephone +44 (0)303 1234 500. There is a £3.00 charge per document.</small>	
21 Dec 2016	Liquidators' statement of receipts and payments to 23 September 2015	View PDF (20 pages)
30 Nov 2016	Liquidators' statement of receipts and payments to 23 March 2016	View PDF (15 pages)
07 Dec 2015	INSOLVENCY:progress report	View PDF (19 pages)
04 Dec 2014	Liquidators' statement of receipts and payments to 23 September 2014	View PDF (16 pages)
16 Oct 2013	Administrator's progress report to 24 September 2013	View PDF (23 pages)
11 Oct 2013	Appointment of a voluntary liquidator	View PDF (1 page)
24 Sep 2013	Notice of move from Administration case to Creditors Voluntary Liquidation	View PDF (1 page)
20 May 2013	Administrator's progress report to 8 April 2013	View PDF (21 pages)
10 Jan 2013	Statement of affairs with form 2.14B	View PDF (10 pages)
28 Dec 2012	Result of meeting of creditors	View PDF (2 pages)
04 Dec 2012	Statement of administrator's proposal	View PDF (45 pages)
18 Oct 2012	Registered office address changed from 75 Bilton Way Enfield EN3 7ER on 18 October 2012	View PDF (2 pages)
17 Oct 2012	Appointment of an administrator	View PDF (1 page)

As also shown on the Filing History Tab, the IP was appointed on the day before the company's address was changed. Predictably, a review of the Insolvency tab in Screenshot 3 below confirms that the Eastleigh address was the IP's office:

SCREENSHOT 3

WINTHER, BROWNE & COMPANY LIMITED

Company number 00141940

Follow this company

File for this company

Overview

Filing history

People

Charges

Insolvency

2 Insolvency cases

Case number 2 — Creditors voluntary liquidation

Commencement of winding up

24 September 2013

Practitioner

Richard Patrick Brewer

Highfield Court Tollgate, Chandler'S Ford, Eastleigh, Hampshire, SO53 3TY

Appointed on

18 May 2018

Practitioner

David James Green

Highfield Court Tollgate, Chandlers Ford, Eastleigh, Hampshire, SO53 3TZ

Appointed on

24 September 2013

Ceased to act

18 May 2018

Practitioner

Alexander Kinninmonth

Highfield Court Tollgate, Chandlers Ford, Eastleigh, Hampshire, SO53 3TZ

Appointed on

24 September 2013

Case number 1 — In administration

Administration started

9 October 2012

Administration ended

24 September 2013

Practitioner

David James Green

Highfield Court Tollgate, Chandlers Ford, Eastleigh, Hampshire, SO53 3TZ

Ceased to act

24 September 2013

Practitioner

Alexander Kinninmonth

Highfield Court Tollgate, Chandlers Ford, Eastleigh, Hampshire, SO53 3TZ

Ceased to act

24 September 2013

A further review of the company's annual report dated 4 August 2012 (Screenshot 4), posted under the Filing History tab with an electronic filing date of 12 September 2012, just a few months prior to the insolvency filing, confirms that the company's head office prior to the insolvency filing was located in Enfield:

SCREENSHOT 4



AR01 (ef)

Annual Return



Received for filing in Electronic Format on the: 12/09/2012

X1HBH91L

Company Name: **Winther Browne & Company Limited**

Company Number: **00141940**

Date of this return: **04/08/2012**

SIC codes: **16290**

Company Type: **Private company limited by shares**

Situation of Registered Office: **75 BILTON WAY
ENFIELD
LONDON
ENGLAND
EN3 7ER**

In addition, in some cases one or more IPs ceased to act and new IPs were appointed, but the automated entries only reflected the most recently appointed IPs and firms. Accordingly, automated entries from the information page were revised in those cases to include the names of the IPs and firms at the time insolvency proceedings were initiated, as set out in the documents filed at the initiation of proceedings. In the above Screenshot 3, the Insolvency tab discloses that Alexander Kinninmonth and David James Green were the responsible IPs for the administration; Richard Patrick Brewer was later appointed after Green ceased to act.

The balance of the data, comprising the vast majority of the database, were manually collected and entered. This process involved detailed reviews of the reports filed with Companies House by IPs over the course of each insolvency proceeding. Specifically, the following reports were reviewed in each administration and administrative receivership case, where available:

- i. Administration: (a) Statement of Affairs, filed upon or shortly after commencement of administration proceedings; (b) Statement of Administrator's Proposal, filed shortly after commencement; and (c) Administrator's Progress Report(s), filed at different stages of proceedings.
- ii. Administrative Receivership: (a) Statement of Affairs; (b) Receiver's Abstract(s) of Receipts and Payments; and (c) Administrative Receiver's Report(s), typically filed shortly after commencement of proceedings.

The final dataset comprised all 2,120 administration cases, along with data on a subset of 500 receiverships. For comparison, the quantitative study forming the basis of the Graham Report³⁸⁹ collected data on roughly 500 pre-packs and 100 other administrations.³⁹⁰ Accordingly, the final database is the largest of its kind to date on formal insolvency proceedings in the U.K. The data collected also permit analyses with greater granularity than previous studies, both because of the number of variables identified and the size of the dataset; as such, the database is an important resource enabling quantitative analyses of different types of U.K. insolvency proceedings, as well as meaningful comparisons to similar procedures in other countries.

2. Notes on Quality and Completeness of Data Sources

Despite the regulatory obligations imposed on IPs and insolvent companies to provide various prescribed data in a clear and uniform manner, significant variations in the quality and presentation of the relevant data were found in the IPs' reports across all cases. In particular, several obstacles were encountered as data collection progressed and many documents were found to be incomplete, excessively lengthy, poorly organised, internally inconsistent, or otherwise erroneous, missing or unavailable. The nature and extent of the discrepancies and omissions varied by report and case, but inconsistent or incomplete reports frequently complicated the data collection process for various key data such as levels

³⁸⁹ Graham Report (n 16).

³⁹⁰ Wolverhampton Report (n 13).

of debt, returns to creditors, and costs of the insolvency proceeding. For example, often the directors' or IPs' initial valuations of the insolvent debtor's assets and liabilities would be revised in subsequent reports, necessitating careful review of all reports in a given proceeding so as to ensure that complete and accurate data were entered. One example is the Statement of Affairs dated 10 October 2012 for The Meynell Pub Company, company number 06388438, which failed to disclose secured debts in the amount of £1,045,000, as well as various other liabilities of the insolvent debtor. As a result, the figures entered into the database from the Statement of Affairs were revised using the corrections set out in the Statement of Administrator's Proposals dated 30 November 2012; the relevant pages of the Statement of Administrator's Proposals are shown below in Screenshot 5:

SCREENSHOT 5

5. STATEMENT OF AFFAIRS

The directors have prepared a statement of affairs of the Company as at 10 October 2012 which is attached at Appendix 2. It makes no provision for amounts due to the secured creditor or the costs of the administration.

The administrators' comments on the statement of affairs are as follows:

1. Assets subject to fixed charge

This relates to the freehold property known as the Meynell Ingram Arms and any goodwill associated with that business.

The directors' statement of affairs does not make any provision for the sums due to the fixed charge creditor, Santander UK Plc who are owed £1,045m and consequently there will be no equity available for any other class of creditor.

- 4 -

2. Assets subject to floating charge

This category of assets includes furniture & equipment and stock held at the Meynell Ingram Arms for which no values are listed by the directors.

3. Estimated total assets available for preferential creditors

The estimated to realise figure is incorrect as stated above. When taking into consideration the amount due to the secured creditor, it is clear there will be no surplus available for any other class of creditor.

4. Debts secured by floating charges

The brought forward figure is incorrect for the reasons stated above in respect of the fixed charge.

5. Estimated deficiency/surplus as regards non-preferential creditors

The brought forward figure has been entered incorrectly in this category. The brought forward figure of £86,190 is the directors' estimate of unsecured creditor claims.

The listing of creditors attached to the directors' statement is incomplete in as much as it does not contain addresses. A schedule of unsecured creditors is therefore attached as Appendix 3.

While time consuming, the process of collecting full and accurate data on each case was necessary in order to permit meaningful analyses. Although researchers in past studies undoubtedly encountered similar difficulties with data collection, such studies examined comparatively much smaller samples of cases. By comparison, data cleaning and quality control for the number of cases in this project necessarily imposed significant demands upon the author's time and resources. It is also worth noting here that since the availability of individual data points such as procedure, outcome, debt levels etc. varied in each case, the number of cases with full data – permitting reliable statistical analyses – also varied depending on the variables modelled.

Missing documents were a particular problem for the receivership cases, as many companies which underwent receivership proceedings in 2002 were dissolved over a decade ago and their documents were archived. Accordingly, unlike for most of the administration cases, the data on receiverships were rarely available in Companies' House's online archive. Instead, the relevant data could only be obtained by identifying specific IP reports and ordering scanned copies of them from Companies House's physical archives.

For all of the foregoing reasons, data collection was a time- and resource-intensive process. Although the time spent accessing the relevant documents and entering the data into the database varied in each case, the average time per case was roughly 32 minutes.³⁹¹ This estimate relates to manual data collection and entry only, and excludes automated data entry (where such was possible), research design, and all forms of analysis and discussion.

3. Coding Procedure and Outcome

Procedure and outcome were hand-coded by the author in each case. In coding procedure and outcome for each administration case, a distinction was made between two aspects of the administrator's reports:

³⁹¹ This estimate is based upon roughly 1,400 hours spent reviewing 2,620 cases. In this regard, it is important to emphasize that the data collection process involved far more than mere rote data entry. In many cases, for the reasons already noted, careful thought was often required in order to accurately identify and record relevant and accurate data.

- i. the statement of the goals of the administration, which is based on the language of Paragraph 3(1) of Schedule B1 of the Insolvency Act 1986, and which each administrator is required to provide in its initial report; and
- ii. the administrator's actions over the course of the proceedings, as set out in each progress report.

Whereas the former is a mostly formal statement and is subject to change later in the administration, the descriptions of the administrator's actions in each progress report more accurately reflect the type of procedure that was implemented. Accordingly, procedure and outcome were coded by reviewing the most recent administrator's progress reports in each case, with reference to the formal statement of the administration's goals only where no other information was available. The same approach was taken when coding procedure and outcome in administrative receiverships.

Procedures were categorized as follows:

- a. Pre-pack: The administrator carried out a going concern sale of the business and assets of the insolvent company based upon a pre-arranged deal, thereby preserving some or all of the business as a going concern. In accordance with the Statement of Insolvency Practice 16, the administrator identified the sale as a pre-packaged sale in its report. The sale was successfully completed.
- b. Standard Administration: The administrator carried out a reorganization of the insolvent company with a view to saving the company and its business as a going concern. The company returned to solvency and exited administration. As part of this process, some parts of the assets or business may have been sold on either a piecemeal or going concern basis.
- c. Going Concern Sale Administration: The administrator carried out a going concern sale of at least some part of the business and assets of the insolvent company, thereby preserving some or all of the business. The sale was successfully completed. Parts of the business and assets may have been sold piecemeal.
- d. Piecemeal Sale Administration: The administrator sold the business and assets of the insolvent company on a piecemeal, a.k.a. "break-up" basis. The business did not survive. In some cases, the administrator pursued this sale from the outset of proceedings. In other cases, the administrator

carried out a piecemeal sale after a failed attempt at a pre-pack, standard or going concern sale administration.

- e. Piecemeal Sale Receivership: The administrative receiver sold the insolvent company's business and assets on a piecemeal basis. The receiver may have set out to complete such a sale from the outset of proceedings, or may have decided to do so following a failed attempt at a going concern sale.
- f. Going Concern Sale Receivership: The administrative receiver carried out a going concern sale of at least some part of the business and assets of the insolvent company. The sale was successfully completed, although other parts of the business and assets may have been sold piecemeal.

4. Variables and Models

The following variables were tracked in each case, where the data were available:

- a. ID Number: A unique number was assigned to each case for ease of identification. IDs were randomized prior to data collection so as to ensure a random sample regardless of the final size of the database.
- b. Name of company: The name of the corporate entity or entities identified in the IPs' reports.
- c. Registered number: The company's number, as recorded by Companies House.
- d. Head office location: Postcode of head office, as recorded in the IPs' reports.
- e. Date of incorporation: As recorded by Companies House.
- f. Procedure: Coded by the author as described earlier in Part II.3.
- g. Start date: The date upon which the proceeding was initiated, as recorded in the IPs' reports.
- h. End date: The date upon which the proceeding concluded, as recorded in the IPs' reports.
- i. Duration of proceeding: Calculated using the start date and end date, recorded in months.
- j. Group: Coded by the author where the company was part of a corporate group.
- k. Outcome: Coded by the author as described earlier in Part II.3.
- l. SIC Code: Standard Industrial Classification (SIC) code recorded by Companies House.
- m. Business activity: Description of the company's business activity based upon the SIC code.
- n. Court location: The city or county in which the proceeding was initiated, as recorded in the IPs' reports.

- o. Age at commencement: Calculated using the incorporation of the company and the start date of the proceeding.
- p. Turnover at commencement: Turnover in GBP,³⁹² as recorded in the IPs' reports.
- q. Appointer: The identity of the party which appointed the IP, e.g. the board of directors of the company or the name of the secured creditor.
- r. IP Name: The name of the individual IP(s) appointed, as recorded in the IP(s)' initial report.
- s. IP Firm: The name of the IP firm as recorded in the IP(s)' initial report.
- t. Book value at commencement: The book value of the company, as recorded in the Statement of Affairs (including any revised figures provided in subsequent IP reports).
- u. Market value: The market value of the company's assets as estimated by the IP.
- v. Accounts receivable (book debts): As recorded in the Statement of Affairs (including any revised figures provided in subsequent IP reports).
- w. Total debt: The sum of all of the company's debts, namely secured, unsecured and preferential debts.
- x. Secured debt: Debts held by secured creditors, in GBP, as recorded in the Statement of Affairs (including any revised figures provided in subsequent IP reports).
- y. Preferential debt: Debts held by preferential creditors, in GBP, as recorded in the Statement of Affairs (including any revised figures provided in subsequent IP reports).
- z. Unsecured debt: Debts held by unsecured creditors, in GBP, as recorded in the Statement of Affairs (including any revised figures provided in subsequent IP reports).
- aa. Total realised: Sum of proceeds, in GBP from sale of assets and surplus from trading (if any), as recorded in IPs' reports.
- bb. Secured returns: Total recoveries, in GBP, of secured creditors.

³⁹² Comparing the nominal monetary figures for receiverships commenced in 2002 with administrations commenced in 2012 would have ignored the effects of inflation and skewed the comparisons. Accordingly, after the nominal figures were recorded, all figures for receiverships were adjusted to their 2012 equivalents based upon the Retail Price Index, as reported by the Office for National Statistics. Online: <<https://www.ons.gov.uk/economy/inflationandpriceindices>> accessed 21 July 2019. Specifically, the monetary figures for all receiverships were multiplied by a factor of 1.38 in order to convert them from 2002 to 2012 purchasing power values. All comparisons of receiverships and administrations that include monetary amounts are, therefore, based upon 2012 inflation-adjusted GBP.

- cc. Preferential returns: Total recoveries, in GBP, of preferential creditors.
- dd. Unsecured returns: Total recoveries, in GBP, of unsecured creditors.
- ee. Secured percentage returns: Secured recoveries as a percentage of total secured debt.
- ff. Preferential percentage returns: Preferential recoveries as a percentage of total preferential debt.
- gg. Unsecured percentage returns: Unsecured recoveries as a percentage of total unsecured debt.
- hh. Employees at commencement: Number of employees of the company, if and as recorded in IPs' reports.
- ii. Employees transferred to purchaser (if company was sold): If and as recorded in IPs' reports.
- jj. Trading revenues: Total revenues from trading in GBP, if any, during the insolvency proceeding.
- kk. Trading expenses: Total expenses from trading in GBP, if any, during the insolvency proceeding.
- ll. Total costs: Sum of all expenses of the proceeding, in GBP.
- mm. Total IP fees: Sum of all pre- and post-appointment fees charged by the IP(s).
- nn. IP pre-appointment fees: Fees charged by the IPs for pre-appointment work done to prepare for the insolvency proceeding.
- oo. Still operating: Whether or not the company was still operating at the time of data collection.
- pp. Date ceased to operate: The date upon which the company ceased to operate. For surviving companies, the date used was the date of data collection.
- qq. Survival after exit: Total time, in months, that the company continued to operate following the conclusion of insolvency proceedings. For surviving companies, the date used was the date of data collection.
- rr. Purchaser name: Name of the purchaser of the business and/or assets of the insolvent company, if any, as recorded by the IP.
- ss. Purchaser connected: Whether or not the purchaser, if any, was related to the insolvent company.
- tt. Deferred consideration: If the business and/or assets of the insolvent company were sold, the amount of any consideration that was deferred on closing.
- uu. Purchaser still operating: Whether or not the purchaser was still operating at the time of data collection.
- vv. Date purchaser ceased to operate: As recorded by Companies House.

- ww. Purchaser survival: The length of time, in months, that the purchaser continued to operate following the conclusion of proceedings.
- xx. Jurisdiction: The jurisdiction in the U.K. in which the proceedings were initiated, namely, England and Wales, Scotland, or Northern Ireland.

The foregoing variables were selected for several reasons. Obviously, tracking data on procedures and outcomes was necessary in order to enable basic comparisons. The data on returns to creditors, jobs preserved, survival post-exit, and duration and costs of proceedings, served as proxies for the relative success of different procedures. Data on jurisdiction, court, head office location, incorporation date, industry sector, and IP names and fees, permitted more detailed analyses of different types of procedures. Data on debt levels, turnover and number of employees served as indicia as company size, which permitted analyses of the correlations between company size, type of procedure and outcome.

In general, the variables used in this study tracked those in previous similar studies,³⁹³ with some additional variables such as IP names, court location, industry sector and number of employees, which permitted analyses using additional derived variables and models compared with previous studies. In particular, the following sets of derived variables and models were generated based on the foregoing data points, among others:

- a. Average durations of each type of procedure;
- b. Total debt by type of procedure;
- c. Total costs (including pre- and post-appointment IP fees and other expenses) by type of procedure;
- d. Survival of purchaser (where applicable) by procedure, debtor size, percentage of secured debt, region, industry sector, IP firm, whether the purchaser was connected, whether creditors were over or under-secured, duration, and whether consideration was deferred;
- e. Total realisations by procedure, total debt, percentage of secured debt, industry sector, region, IP firm, and the presence of a purchaser and whether the purchaser was connected;
- f. IP fees by procedure, debtor size, total debt, whether creditors were secured or over-secured and the percentage of secured debt, industry sector, region, IP firm, and the presence of a purchaser and whether the purchaser was connected;

³⁹³ See, for example, Graham Report (n 16); Armour and others (n 14); Frisby (n 14).

- g. Total returns to all creditors by procedure, total debt, percentage of secured debt, industry sector, region, and the presence of a purchaser and whether the purchaser was connected; and
- h. Total returns to secured creditors by procedure, debtor size, total debt, percentage of secured debt, industry sector, region, IP firm, and the presence of a purchaser and whether the purchaser was connected.

For the purposes of this chapter, only the key findings from the foregoing models are discussed in Part III.

5. Notes on Statistical Analyses of Dataset

Quantitative analyses of the data in Mokal et al. were conducted by Balmer using a range of statistical methods and “took the form of descriptive statistics... describing the dataset and introducing key variables and more detailed statistical modelling”.³⁹⁴ Each modelling section was accompanied by text “describ[ing] and interpret[ing] the statistical model in lay terms” as well as a separate statistical appendix setting out the specific model and outputs.³⁹⁵ Based on the foregoing, Mokal supplied the summary of key takeaways, namely with respect to the key determinants of procedure and outcome, creditor returns, purchaser survival, effects of IP firms and connected purchasers, and differences between pre-packs, standard administrations and receiverships that appear in Mokal et al.³⁹⁶

Central to the analysis in this chapter is the question of whether pre-packs are correlated with better outcomes for creditors than standard administrations, or whether the theoretical concerns raised in Chapter 2 are borne out by the data. To the extent that pre-packs are correlated with worse outcomes for creditors than standard administrations, there is at least prima facie evidence that the concerns raised in Chapter 2 extend beyond the realm of insolvency law theory.

III. RESULTS AND ANALYSIS

Choice of Procedure

The size of debtor companies, proxied by total debt, had significant correlations with choice of procedure and outcomes, as shown below in Figure 1.³⁹⁷ Although piecemeal sale administrations were the most common procedure across all sizes of companies, pre-packs were the second most common for

³⁹⁴ Mokal and others (n 385) 9.

³⁹⁵ *ibid.*

³⁹⁶ *ibid* 1-7.

³⁹⁷ Mokal and others (n 385) 19-20, Figure 6.

companies with less than £3,000,000 in debt.³⁹⁸ Pre-packs were most prominent for companies in the less than £500,000 and £500,000 to £1,000,000 debt groups.³⁹⁹

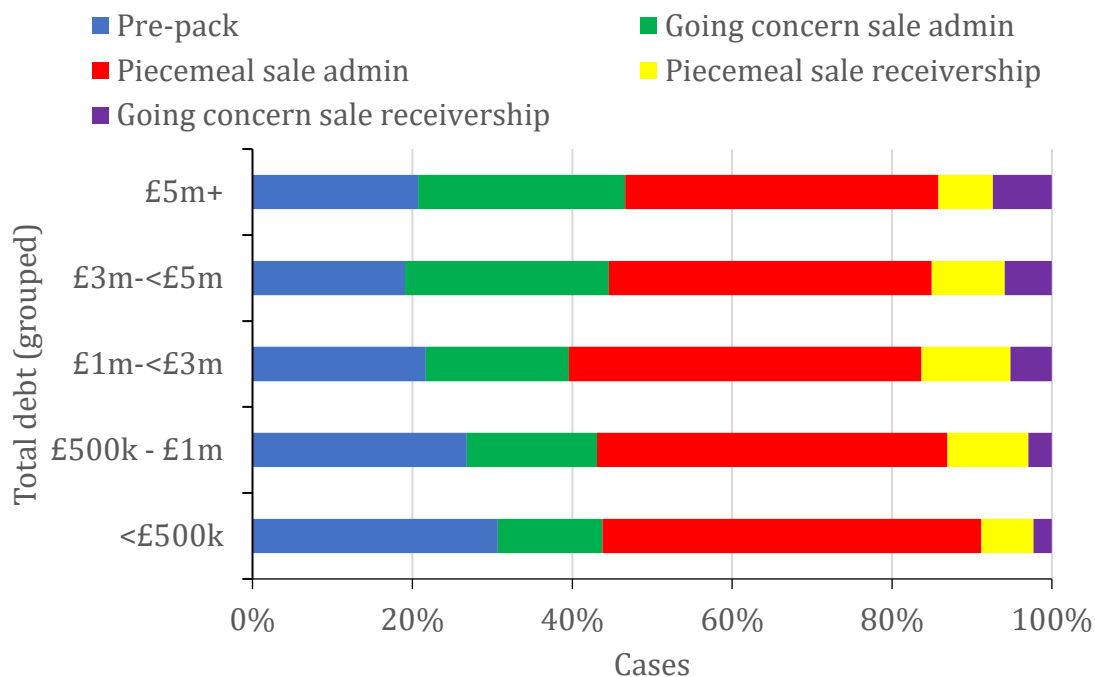


Figure 1. The relationship between procedure and debtor size (total debt), derived from the multinomial logistic regression model and controlling for a range of other variables

Similarly, when defining debtor size by turnover, pre-packs were most prominent among micro and small companies, while going concern sale administrations were more common for medium and large companies.⁴⁰⁰

The foregoing results were consistent with the findings of previous studies of pre-packs. The Wolverhampton Report, which supplied the quantitative analysis for the Graham Report, examined a sample of 500 pre-packs from 2010 and found that the majority of pre-pack companies fell into the micro and small categories.⁴⁰¹ Likewise, Frisby's 2007 study, examining a sample of 227 pre-packs, found that over 60% of the pre-pack companies had secured debt of less than £500,000, and two-fifths had secured

³⁹⁸ *ibid.*

³⁹⁹ *ibid.*

⁴⁰⁰ *ibid* 21, Figure 7. Micro companies were defined as having turnover of less than £2,000,000, while small companies had turnover of £2,000,000 to £8,000,000, *ibid* 18.

Wolverhampton Report (n 13) 12. Micro companies were defined as having 9 or fewer employees and turnover of £632,000 or less, while Small companies had 10 to 49 employees and turnover of £632,000 to £6,500,000.

debts under £250,000.⁴⁰² It seems fair to say, then, that the typical pre-pack company is a micro to small company, broadly defined.

There were also statistically significant correlations between the choice of procedure and whether the creditors were oversecured or undersecured. Going concern sale administrations were far more common where the creditors were oversecured (20.6% of oversecured cases) compared with undersecured (13.5% of undersecured cases). Pre-packs were also marginally more common in oversecured cases. Piecemeal sale receiverships, meanwhile, were significantly less common where creditors were oversecured (8.2%) compared with undersecured cases (12.7%).⁴⁰³ Lastly, the percentage of secured creditors in each case had a significant relationship with the choice of procedure. For example, where the secured creditors held 75% to 100% of the company's total debts, pre-packs and going concern sale administrations were far less common than in cases where secured creditors held 25% or less of total debts.⁴⁰⁴ These results are interesting for several reasons. Firstly, as discussed later, going concern sale administrations tended to generate better overall returns than pre-packs and piecemeal sale administrations, but they were also costlier. Necessarily, pursuing a going concern sale also means that the debtor would need to obtain additional financing in order to remain in operation during the administration. To the extent that secured creditors are able to influence the debtor's choice of procedure, it makes sense that secured creditors would be more willing to support going concern sale administrations, and perhaps to extend additional financing for the duration of the administration, when they are oversecured. Secondly, and by contrast, secured creditors would be less willing to support the costlier approach of a going concern sale administration when they are undersecured and when they already hold most of the debt of the insolvent debtor company. In such cases, it may well be that the prospects for continuing the business as a going concern are slim.

Returns to Creditors

As a function of total debt, overall returns were marginally higher in going concern sale and piecemeal sale administrations than in pre-packs, as shown below in Figure 2.⁴⁰⁵ Specifically, going

⁴⁰² Graham Report (n 16) 24.

⁴⁰³ Mokal and others (n 385) 21, Figure 8.

⁴⁰⁴ *ibid* 23, Figure 9.

⁴⁰⁵ *ibid* 112, Figure 70.

concern sale administrations yielded returns of 15.5% of total debt compared to 15.4% for piecemeal sale administrations and 14.8% for pre-packs. Average returns in all types of administrations were significantly higher than in piecemeal sale and going concern sale receiverships, which yielded returns of 7.2% and 10.2%, respectively.⁴⁰⁶

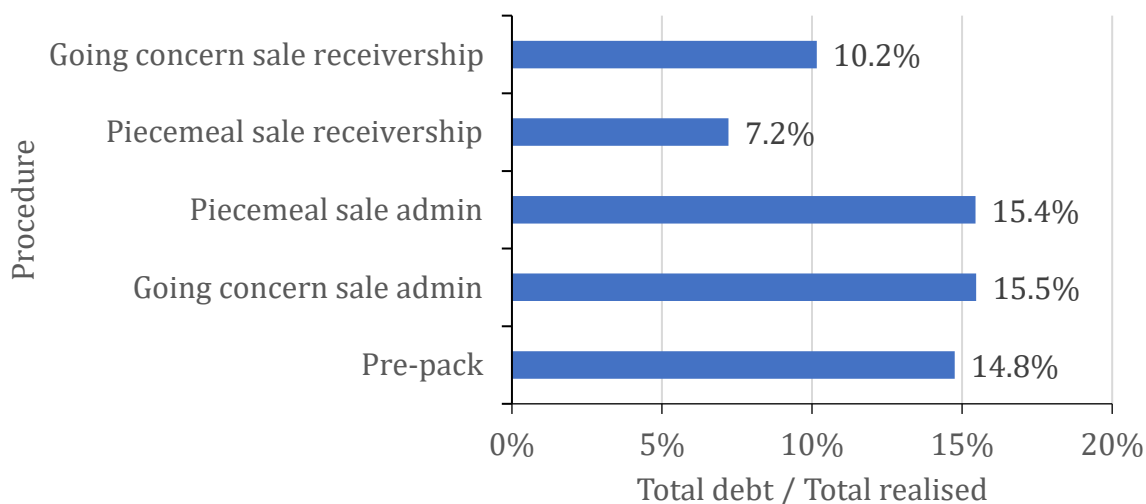


Figure 2. The relationship between total returns as a proportion of total debt and procedure, derived from the zero one inflated beta model and controlling for a range of other variables

These broadly similar results in total returns across different types of administrations belied differences in returns to different classes of creditors from each type of procedure. While secured creditors did relatively well across all types of administrations, their returns were better in pre-packs (39.7%) than in going concern sale administrations (38.1%) and piecemeal sale administrations (35.8%).⁴⁰⁷ All types of administrations yielded significantly higher returns than either piecemeal sale receiverships (19.1%) or going concern sale receiverships (23.9%).⁴⁰⁸ Replacing procedure in the same model with three categories – pre-packs, all other administrations, and receiverships – showed that pre-packs clearly generated the best returns for secured creditors (39.7%) compared to other administrations (36.1%) and receiverships (23.3%).⁴⁰⁹

Given that pre-packs generated marginally lower average returns for creditors as a whole than each of going concern sale and piecemeal sale administrations, these results suggest that compared to

⁴⁰⁶ *ibid.*

⁴⁰⁷ *ibid* 128-129, Figure 80.

⁴⁰⁸ *ibid.*

⁴⁰⁹ *ibid* 129, Figure 81.

other procedures, any benefits generated by pre-packs for the creditors as a group flowed largely to secured creditors. This finding is consistent with past studies of pre-packs. Frisby found that compared with other types of sales, pre-packs tended to generate better returns for secured creditors than other creditors, and they generally yielded lower returns for unsecured creditors.⁴¹⁰ In addition, the Wolverhampton Report found that pre-packs rarely yielded any returns to unsecured creditors, with average unsecured returns amounting to only 7.22%.⁴¹¹

The problem of lower returns to unsecured creditors in pre-packs is brought more sharply into focus when considering the average total realisations that were generated by each type of procedure. Specifically, controlling for other factors, pre-packs typically realised significantly less from the debtor's assets than going concern sale administrations, for almost all sizes of debtor companies (using total debt to determine debtor size). For example, for companies with total debts of less than £500,000, pre-packs realised £549,678 on average compared with £1,071,650 for going concern sale administrations. For companies with total debts between £3,000,000 and £4,999,999, pre-packs realised £3,025,728 compared with £3,411,900 for going concern sale administrations. The only debt group in which pre-packs fared better was the £1,000,000 to £2,999,999 range, in which pre-packs realised £1,014,577 compared with £871,559 for going concern sale administrations.⁴¹² Notably, however, pre-packs were most common for companies with less than £500,000 in total debt, and far less common for larger companies.⁴¹³

While unsecured creditors often will be out of the money, it is important to recall that the Enterprise Act reforms were intended, in part, to strengthen the position of unsecured creditors and improve outcomes for them. The quantitative results discussed here suggest that in general, unsecured creditors have fared better under the new, post-Enterprise Act administration regime than they did under administrative receivership. Pre-packs, however, appear to be the exception to this rule because they tended to yield higher returns for secured creditors and lower returns for unsecureds compared with other types of administrations. At the same time, pre-packs are less transparent than other types of administrations and

⁴¹⁰ Frisby (n 14) 67.

⁴¹¹ Wolverhampton Report (n 13) 32.

⁴¹² Mokal and others (n 385) 52, Figure 27.

⁴¹³ *ibid* 20-21, Figure 7.

rarely afford unsecured creditors a chance to participate. In short, pre-packs may be undermining key objectives of the Enterprise Act reforms.

The industry sector and region of the debtor company were also correlated with total returns. Total returns as a percentage of total debt were 6.7% for debtors in the “financial and insurance services” sector, compared with 9.7% for “information and communications” and 13.5% for “manufacturing”.⁴¹⁴ Returns were highest for debtors in the “real estate activities” (25%) and “accommodation and food services” (16.6%) sectors. This was likely the result of debtor companies in the real estate and accommodation sectors having more hard assets that could be sold upon insolvency compared with financial and communications firms. In addition, it is generally more difficult to value intangible assets compared with tangible assets.⁴¹⁵ Similarly, returns varied significantly in different regions of the U.K. Debtors yielded the highest returns in the West Midlands (18.9%), North West (18.4%), Northern Ireland (16.8%) and Scotland (16.25%). Debtors in the South West (12.8%), London (12.4%) and the East (11.3%) had the lowest returns.⁴¹⁶ The explanation for these results is less clear, but may be related to the industries and asset mixes of the debtors in each region. For example, if a higher proportion of debtors in the West Midlands held hard assets such as real estate and heavy equipment, then we might expect to see better overall returns there than in a region with a higher proportion of debtors holding intangible assets.⁴¹⁷

Total returns also varied significantly for different sizes of companies. Measuring size by total debt, companies in the “£500,000 to less than £1,000,000”, “£1,000,000 to less than £3,000,000”, “£3,000,000 to less than £5,000,000” and “£5,000,000 or more” debt categories were much more likely to yield positive returns to creditors compared to companies in the “less than £500,000” category.⁴¹⁸ Perhaps surprisingly, total returns as a proportion of total debt were lowest for companies in the “£5,000,000 or more” debt

⁴¹⁴ Mokal and others (n 385) 116-117, Figure 75.

⁴¹⁵ Girgis (n 102) 51. Although firm-specific assets still exist today, generally speaking “the hard assets in firms are now designed to be utilized in any kind of operation and not necessarily dedicated to one firm” such that they can be sold upon insolvency: see Girgis 47.

⁴¹⁶ Mokal and others (n 385) 118, Figure 76.

⁴¹⁷ Although further analysis would be required in order to confirm this explanation, it seems prima facie plausible. Manufacturing firms contributed 15% of the West Midlands’ annual GVA in 2016 and employed a higher percentage of the population than the national average (10% compared with 8%), see <<https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/base-profile/west-midlands>> accessed 21 July 2019. By contrast, the East of England, where average total returns were lowest, is “heavily reliant on services, with a strong financial services sector”, see <<https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/base-profile/east-england>> accessed 21 July 2019.

⁴¹⁸ Mokal and others (n 385) 112.

category; similarly, measuring company size by turnover, large companies had lower returns as a proportion of total debt (12%) compared to medium (15.4%), small (16%) and micro (14.7%) companies.⁴¹⁹

Costs of Proceedings

The total costs of each proceeding, including pre- and post-appointment professional fees and any trading costs, were calculated as a proportion of total realisations and compared across each type of procedure. As a proportion of total realisations, pre-packs had total costs of 61.5% on average, compared with 62.5% for piecemeal sale administrations and 64.6% for going concern sale administrations.⁴²⁰ For companies with less than £500,000 in total debt, which were the most likely debt group for pre-packs, pre-packs had average total costs of 69.6% of realisations, compared with 70.9% for piecemeal sale administrations and 72.2% for going concern sale administrations.⁴²¹ Notably, excluding pre-appointment professional fees would have skewed these results, as pre-packs unsurprisingly had disproportionately much higher pre-appointment fees than all other types of procedures.⁴²² At all events, these findings are significant because previous studies, such as the Wolverhampton Report, seemed to suggest that pre-packs may be more costly, on average, than other types of procedures.⁴²³ On the contrary, Mokal et al. found that, controlling for other variables, costs for pre-packs were broadly comparable to other types of procedures.⁴²⁴ In other words, while the Wolverhampton Report was correct in pointing out that the costs of pre-packs consumed most of the realisations, the same was true for other types of procedures, when comparing similar debtors.

Ultimately, although these differences in costs across different procedures were statistically significant, they were “fairly modest”.⁴²⁵ If pre-packs were significantly more efficient than other types of administrations, one might have expected to see greater differences in the costs of each procedure. It may

⁴¹⁹ *ibid* 112-113, Figure 71. Debtor size by turnover was defined as follows: less than £2,000,000 – micro; £2,000,000 to £8,000,000 – small; £8,000,000 to £40,000,000 – medium; £40,000,000 or more – large; see *ibid* 18.

⁴²⁰ *ibid* 68, Figure 34.

⁴²¹ *ibid* 72, Figure 38.

⁴²² *ibid* 17, Table 4.

⁴²³ Wolverhampton Report (n 13) 84. It is also important to note, however, that the Wolverhampton Report did not collect statistical data regarding costs, and that their comments regarding the costs of pre-packs were “impressionistic observations made through the data collection process that were not recorded”; *ibid* 82.

⁴²⁴ Mokal and others (n 385) 68.

⁴²⁵ *ibid* 67.

be that at least some of the perceived savings from the shorter pre-pack process are being consumed at the pre-appointment stage, when the debtor first retains the administrator and other professionals to prepare for the filing and sale.

Interestingly, costs were significantly higher in cases where the creditors were oversecured, compared with cases where they were undersecured. In particular, average total costs, as a percentage of total realisations, were 67.1% in cases where the creditors were oversecured, compared with 57.8% in undersecured cases.⁴²⁶ There are a number of possible explanations for these results. As a general matter, oversecured creditors may be less zealous in disciplining the debtor and the IP than undersecured creditors, for obvious reasons. More specifically, and as discussed earlier, going concern sale administrations tended to cost more than other procedures and occurred more frequently when the creditors were oversecured.

The choice of IP firm was significantly correlated with both total costs and total realisations. Cases handled by IP firms classified as “top 4” had significantly lower average total costs, as a percentage of total realisations, than cases handled by “second tier” or “other” firms.⁴²⁷ Specifically, top 4 firms had average total costs of 53% of realisations, compared with 63.6% for each of the second tier and other firms.⁴²⁸ Further modelling of costs by IP firm and procedure showed that top 4 firms still had significantly lower costs than second tier and other firms across all types of procedures other than going concern sale receiverships.⁴²⁹ These results are likely tied to the fact that top 4 firms had significantly higher total realisations than second tier and other firms. Specifically, and controlling for other factors, top 4 firms had average total realisations that were 3.2 times higher than second tier firms and 3.6 times higher than other firms.⁴³⁰ Accordingly, a case that would realise £1,000,000 for other firms would realise £1,107,000 for second tier firms and £3,577,000 for top 4 firms.

Debtor size was also correlated significantly with the total costs of each procedure. In particular, for companies in the £5,000,000 or more total debt category, going concern sale administrations had

⁴²⁶ *ibid* 73-74, figure 40.

⁴²⁷ Firms were categorized as either “top 4”, “second tier” (5-13) or “other firms”, based upon the 2016 Accountancy Age rankings. Online: <<https://www.accountancyage.com/rankings/top-5050-accountancy-firms-2016/>> accessed 21 July 2019. Mokal and others (n 385) 18.

⁴²⁸ *ibid* 80, figure 46.

⁴²⁹ *ibid* 81, Figure 47.

⁴³⁰ *ibid* 58-59, Figure 31.

average total costs of 53.1% of total realisations, compared with 59.3% for pre-packs.⁴³¹ Pre-packs, meanwhile, appeared more cost-effective for companies in the £1,000,000 to under £3,000,000 total debt category, with total costs of 55.1% of realisations compared with 66.2% for going concern sale administrations.⁴³² There is no obvious explanation for these differences in costs. As noted earlier, after piecemeal sale administrations, pre-packs were the most common type of procedure for companies with less than £3,000,000 in debt. Going concern sale administrations, meanwhile, were the second most common procedure after piecemeal sale administrations for companies with more than £3,000,000 in debt. One might think that smaller companies were simply more suitable candidates for pre-packs than going concern sale administrations, with correspondingly lower overall costs for pre-packs in such cases; however, this supposition is difficult to reconcile with the finding that IP fees as a percentage of total realisations were significantly higher in pre-packs than in going concern sale administrations among the smallest companies (less than £500,000 and £500,000 to £1,000,000 debt groups) whereas going concern sale administrations had higher IP fees for companies in every other debt group.⁴³³ On the other hand, these particular results may simply be statistical artefacts resulting from smaller sample sizes as the larger dataset was split into smaller categories in order to examine the various interactions between total debt, costs, and procedures.

Duration of Proceedings

The mean duration of all proceedings was 22.4 months. Pre-packs had mean and median durations of 13.4 and 11.8 months, respectively, compared with 17.4 and 12 months respectively for going concern sale administrations, and 17.3 and 12 months respectively for piecemeal sale administrations.⁴³⁴ The sample size for standard administrations was small, but disclosed mean and median durations of 20.5 and 12 months, respectively. By comparison, piecemeal sale receiverships had mean and median durations of 39.1 and 32 months, respectively, and going concern sale receiverships had mean and median durations of 44.6 and 34.9 months, respectively.⁴³⁵ Roughly 45% of all pre-packs were completed within 9

⁴³¹ *ibid* 70-71, Figure 37.

⁴³² *ibid*.

⁴³³ *ibid* 93, Figure 56.

⁴³⁴ *ibid* 13-14, Figure 4.

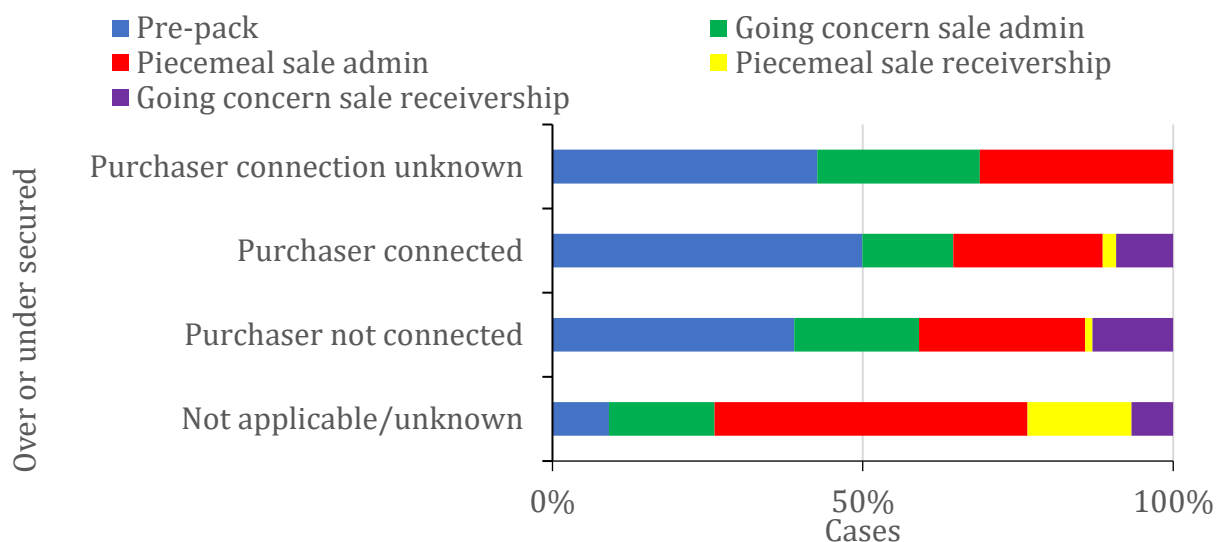
⁴³⁵ The results for standard administrations and both types of receiverships should be interpreted with care owing to their smaller sample sizes.

to 12 months, compared with less than 40% for each of going concern sale and piecemeal sale administrations.

Proponents of pre-packs have long argued that pre-packs typically can be completed more quickly than other types of administrations, and these results vindicate such claims. Duration is an important measure of the success of an insolvency procedure, not only because the direct costs of the procedure are tied to its duration – e.g. professional fees, administrative expenses, etc. – but also because of the indirect costs borne by the debtor. For example, insolvent debtors are likely to face higher financing costs and more stringent conditions from suppliers, problems which tend to become more acute the longer the insolvency process takes. However, as noted earlier, the shorter average duration of pre-packs did not result in appreciably lower direct costs for pre-packs compared with other types of administrations.

Sales to Connected Parties

There was a strong correlation between choice of procedure and whether or not the debtor sold its assets or business to a connected party, as shown below in Figure 3.⁴³⁶ There was a higher percentage of pre-packs in cases where the purchaser was connected to the debtor (49.9%) than where they were not connected (38.9%). By comparison, only 14.6% of connected sales were completed through a going concern sale administration, compared to 20.1% for non-connected sales.⁴³⁷



⁴³⁶ Mokal and others (n 385) 27, Figure 13.

⁴³⁷ *ibid.*

Figure 3. The relationship between procedure and whether a purchaser could be identified (and whether or not they were connected), derived from the multinomial logistic regression model and controlling for a range of other variables

Frisby similarly found that a higher percentage of pre-packs involved sales to connected parties (59%) than other types of going concern sales (52%).⁴³⁸ The Wolverhampton Report, meanwhile, found an even higher proportion of connected party pre-packs, 63.3%, in its sample of 2010 cases.⁴³⁹ These results, therefore, seem to confirm that pre-packs generally are correlated with sales to connected purchasers.

Connected purchasers had lower survival chances than non-connected purchasers. This risk of failure for connected purchasers rose more sharply over time, with a 65% survival chance after 60 months compared to 75% for non-connected purchasers. Survival after 120 months was 50% for connected purchasers compared with roughly 62% for non-connected purchasers.⁴⁴⁰

In addition, the presence of a connected purchaser significantly impacted total realisations as well as the costs of the procedure as a proportion of realisations. Specifically, average total realisations were 2 times higher in cases where the purchaser was not connected.⁴⁴¹ Total costs of the procedure as a proportion of total realisations were also lower for non-connected purchaser cases (56.8%) compared with connected purchaser cases (61.9%).⁴⁴² That said, there was no statistically significant difference in IP fees between connected and non-connected purchaser cases.⁴⁴³

Similarly, total returns to creditors were significantly higher where the purchaser was not connected. Where the purchaser was connected, average returns to creditors as a percentage of total debts were 14.1%, compared with 18.4% where the purchaser was not connected.⁴⁴⁴ Returns for secured creditors, in particular, were higher where the purchaser was not connected (45.1%) compared with cases where the purchaser was connected (36%).⁴⁴⁵

⁴³⁸ Frisby (n 14) 41-43.

⁴³⁹ Wolverhampton Report (n 13) 19.

⁴⁴⁰ *ibid* 45, Figure 21.

⁴⁴¹ *ibid* 59-60, Figure 32.

⁴⁴² *ibid* 82, Figure 49.

⁴⁴³ *ibid* 101-102, Figure 68.

⁴⁴⁴ *ibid* 119-120, Figure 78.

⁴⁴⁵ *ibid* 138-139, Figure 91.

Purchaser Survival Post-Exit

Of the 658 cases in the database for which data on purchaser survival were available, the purchaser ceased to operate in 170 cases (25.8%).⁴⁴⁶ The average survival rate after 60 months was roughly 73% in pre-packs, compared with 74% in piecemeal sale administrations, 68% in going concern sale administrations, and 62% in receiverships. Survival rates after 120 months were 61% in pre-packs, compared with 63% in piecemeal sale administrations, 56% in going concern sale administrations, and 47% in receiverships. Although survival rates for all types of receiverships were lower than for administrations, the differences were not statistically significant.⁴⁴⁷ There were no significant differences in survival rates depending on the duration of the procedure,⁴⁴⁸ or across companies of different sizes (as a function of total debt) or companies with a higher proportion of secured debts.⁴⁴⁹

Meaningful comparisons of purchaser survival rates should likely be limited only to those procedures in which the debtor's business was sold on a going concern basis, because it is only in such cases that the success of the procedure in restoring the viability of the distressed business can be evaluated. Where the insolvent debtor's assets were sold piecemeal, namely in piecemeal sale administrations and receiverships, it goes without saying that the distressed business could not be saved as a going concern and as such, the purchaser's survival is of little interest vis-à-vis the insolvency procedure that the debtor chose. At all events, there were no statistically significant differences in purchaser survival across different procedures.⁴⁵⁰

Survival rates differed significantly across different regions of the U.K. Average survival rates after 60 months were 65% in the North East, North West, Yorkshire and Humberside, compared with 80% in London; these rates fell to 53% and 69%, respectively, after 120 months.⁴⁵¹ Similarly, there were significant differences in survival rates depending on the IP firm, whether creditors were over or undersecured, and whether any consideration was deferred in the case of a sale of the debtor's business. Where the IP was from a "top 4" firm, survival rates averaged 83% after 60 months and 75% after 120 months, compared with

⁴⁴⁶ *ibid* 38.

⁴⁴⁷ *ibid* 38-39, Figure 15.

⁴⁴⁸ *ibid* 46-47, Figure 23.

⁴⁴⁹ *ibid* 39-40, Figures 16 and 17.

⁴⁵⁰ *ibid* 38.

⁴⁵¹ *ibid* 41-42, Figure 18.

68% and 55%, respectively, for “second tier firms”.⁴⁵² Where the creditors were undersecured, survival rates were significantly lower, averaging 65% after 60 months and 50% after 120 months, compared with 76% and 64%, respectively, where creditors were oversecured.⁴⁵³ As shown below in Figure 4, the risk of failure was also significantly higher where consideration was deferred – cases of deferred consideration had survival rates of 66% after 60 months and 52% after 120 months, compared with 76% and 65%, respectively, in cases where the purchase price was paid in full on closing.⁴⁵⁴

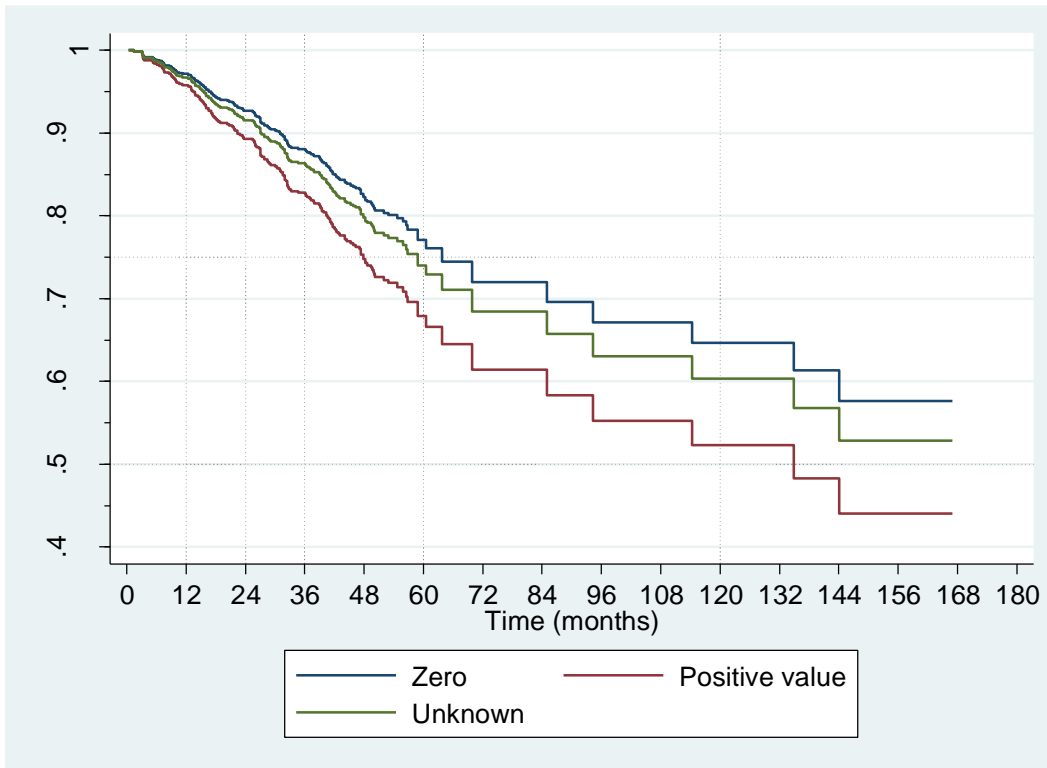


Figure 4. Survivor functions for different deferred consideration groups, derived from the Cox regression model and controlling for other variables.

The Wolverhampton Report found that consideration was deferred in 52.9% of pre-packs; in most cases, payment of the deferred sum was payable within 12 months.⁴⁵⁵ In addition, of the 121 purchasers in the Wolverhampton Report’s sample that had failed 36 months following the sale, 101 were involved in sales where consideration was deferred.⁴⁵⁶ Interestingly, the Wolverhampton Report found that the

⁴⁵² *ibid* 43-44, Figure 19.

⁴⁵³ *ibid* 45-46, Figure 22.

⁴⁵⁴ *ibid* 47-48, Figure 24.

⁴⁵⁵ Wolverhampton Report (n 13) 20.

⁴⁵⁶ *ibid* 38.

combined impact of a connected party sale and deferred consideration increased failure rates significantly:⁴⁵⁷

It has been seen that the incidence of both a sale to a connected party and deferred consideration individually appear to increase the rate of failure of the purchaser in a pre-pack administration. The combined effect of these two factors on the subsequent failure of the purchaser provides interesting data. As can be seen from the table below, the failure rate of a connected party sale increases from 15% of all cases without deferred consideration to 37.0% when deferred consideration is introduced. Generally, when deferred consideration is present, whether or not a connected sale is also present, the failure rate rises considerably.

Frisby, likewise, found that sales to connected parties in both pre-packs and other types of business sales had an average survival rate of 58%, compared with 71.9% in unconnected sales. For pre-packs specifically, connected sales had a survival rate of 51.4%, compared with 71.5% for unconnected sales.⁴⁵⁸

In general, then, key indicia of failure seemed to be whether the creditors were undersecured, the sale was to a connected party, and consideration was deferred. Pre-packs as such, however, did not appear to have lower survival rates than other types of procedures, except when these other factors (connected sales and deferred consideration) were present.

IV. CONCLUSIONS REGARDING PRE-PACKS, ADMINISTRATIONS AND RECEIVERSHIPS IN THE U.K.

Part I of this chapter suggested that the quantitative data examined here permit us to answer two fundamental questions, namely:

- i. Is the new administration regime introduced by the Enterprise Act 2002 correlated with better outcomes for creditors as a whole?
- ii. Are pre-packs correlated with better outcomes for creditors compared to standard administrations?

The data permit us to answer the first question unambiguously in the affirmative. All types of administrations yielded significantly better returns for creditors than administrative receiverships. Although this thesis has focused on criticisms of pre-packs, it is important to recognize that the post-Enterprise Act administration regime appears to be a major improvement over the old receivership regime. This particular finding may help to resolve any lingering objections to the Enterprise Act reforms. At the time the Enterprise

⁴⁵⁷ *ibid* 39.

⁴⁵⁸ Graham Report (n 16) 79.

Act was enacted, some commentators questioned whether it was wise to move away from the receivership model, in which a senior secured creditor controlled the process, to the current administration model in which creditor control is at least nominally more diffuse:⁴⁵⁹

We suggest that the law relating to administrative receivership acts to extend the benefits of creditor concentration to the reduction of the costs of enforcement. The structure of the law functions to stay the claims of junior creditors when the debenture-holder does decide to enforce... Giving control over enforcement to the concentrated creditor allows it to make use of the information it has gathered in the course of its decision whether or not to continue to support the debtor, and may therefore allow for cheaper and quicker enforcement than would a collective insolvency procedure in which an outside appointee took over the firm.

While it seems undeniable that secured creditors can significantly reduce costs for other types of creditors by relieving them of the burden of performing various monitoring and enforcement functions, and indeed enhancing the chances for successful turnarounds,⁴⁶⁰ nonetheless, creditors generally appear to be doing significantly better under the new administration regime than they did under receivership. As detailed earlier, creditors enjoyed significantly higher returns in all types of administrations than in receiverships, and the average duration of administration – an important indicator of the cost and efficiency of an insolvency process – was significantly shorter than the average duration of receivership.

With respect to the second question, while there are occasional bright spots in the data for proponents of pre-packs, the general answer is “no”, for several reasons. Firstly, returns to creditors in pre-packs were mixed, with marginally lower returns to preferential and unsecured creditors and higher returns for secured creditors compared to going concern sale and piecemeal sale administrations. On its face, this result is directly at odds with the Enterprise Act’s goals of reducing secured creditor control and improving outcomes for preferential and unsecured creditors. Although proponents of pre-packs may argue that pre-packs preserve jobs and do not significantly harm preferential and unsecured creditors, the data on realisations undermine this claim. In particular, as discussed earlier, pre-packs tended to generate significantly lower realisations than going concern sale administrations across almost all sizes of debtor companies. These results suggest that value is being lost in pre-packs that might otherwise flow to preferential and unsecured creditors.

⁴⁵⁹ Armour and Frisby (n 133) 74-75.

⁴⁶⁰ See Rizwaan J Mokal, “The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit” (2002) 22 OJLS 687, 720.

Secondly, although pre-packs tend to be completed more quickly than going concern sale and piecemeal sale administrations, the oft-touted cost savings of pre-packs compared to other types of administration are only modest, after pre-appointment fees are taken into account. The nature of pre-packs is that they tend to be front-loaded, in the sense that much of the IPs' work is completed prior to their appointment; consequently, it is easy to exaggerate the cost savings of pre-packs if pre-appointment costs are ignored.

Thirdly, pre-packs were strongly correlated with sales to connected parties. Along with sales in which consideration was deferred, connected purchasers had significantly lower survival rates than third-party purchasers, across all types of procedures. Furthermore, total costs were higher, and total realisations much lower, in connected party sales. Total returns across all classes of creditors were also lower in connected party sales compared to third-party sales.

In short, the data bear out many of the concerns raised about pre-packs in Chapters 1 and 2. Functionally, pre-packs resemble receiverships more than true administrations. For example, a purported feature of pre-packs highlighted in the Graham Report was that they “can be done without the involvement of the unsecured creditors or only limited involvement”.⁴⁶¹ Although the debtor's directors nominally control the process, they typically require the cooperation of the secured creditors in order for the sale to proceed, with the result that the secured creditors often control the method and timing of the sale “much in the same way that they previously used receivership.”⁴⁶² The Graham Report suggested that this was an advantage over other types of administration because the abridged process could reduce overall costs. However, Mokal et al. found that “the greater accountability and transparency in [traditional] administration does not come at a significantly higher cost” compared to pre-packs.⁴⁶³ In exchange for these modest cost savings, pre-packs sacrifice standards of transparency and accountability that could improve the position of junior creditors, and especially unsecured creditors. The Graham Report clearly recognized that pre-packs suffer from “a lack of transparency” which could leave unsecured creditors “feel[ing] disenfranchised by this secrecy, particularly where the purchaser is connected to the insolvent company.”⁴⁶⁴ The data on returns

⁴⁶¹ Graham Report (n 16) 3.5.

⁴⁶² Walters (n 8).

⁴⁶³ Mokal and others (n 385) 7.

⁴⁶⁴ Graham Report (n 16) 3.8.

to different classes of creditors discussed here suggest that preferential and unsecured creditors are right to be sceptical of pre-packs.

At the same time, the fact that pre-packs are disproportionately more likely than other types of administration to involve connected party sales is particularly troubling. One would expect that such sales would be subject to greater standards of transparency and accountability, but the opposite is true in the case of pre-packs because by their nature, pre-packs weaken the ability of junior creditors to scrutinize and challenge the terms of connected-party sales. Ultimately, these results suggest that pre-packs are inconsistent with the Enterprise Act's goals of strengthening the position of unsecured creditors and improving outcomes for them. This reality is unlikely to change in the near future despite the Graham Report's recommended changes to pre-pack practices – namely, improved marketing and valuation processes and the use of independent experts to review the terms of the sale, particularly where the sale is to a related party – because compliance is merely voluntary.⁴⁶⁵ Junior and especially unsecured creditors would be wise to ask in each case whether a traditional administration would serve them better than a pre-pack.

The foregoing findings point up the need to develop a stronger regulatory framework for pre-packs in the U.K., with an emphasis on mandatory disclosures to increase transparency, as well as more robust accountability mechanisms. In short, unsecured creditors need the ability to fully scrutinize and challenge the terms of pre-packs, or else pre-packs are likely to remain a “receivership-lite” process.

⁴⁶⁵ *ibid* 3.8-3.13.

CHAPTER 5:
REFORMING THE PRE-PACK REGIME

I. INTRODUCTION

Chapter 4 examined the quantitative outcomes of over 2,500 administration and administrative receivership proceedings in the U.K. An analysis of the data gathered in this study led to two important conclusions. Firstly, post-Enterprise Act administrations were correlated with significantly higher returns to creditors than administrative receiverships. Secondly, standard administrations performed better than pre-packs across a range of metrics, including, for example, total realisations across almost all sizes of debtor companies, as well as returns to preferential and unsecured creditors. These quantitative results appeared to bear out a key concern with pre-packs that was raised in Chapters 1 and 2, namely that pre-packs tend to favour secured creditors. Specifically, unlike in a standard administration – in which the debtor’s managers are displaced by the administrator, who will then determine how to resolve the debtor’s insolvency – in a pre-pack, the debtor’s managers have already set all of the key terms of the deal prior to initiating administration proceedings. In so doing, the managers will have negotiated with the secured creditors in advance as to the price at which the secureds would agree to be bought out and release their security interests over the debtor’s assets so that the sale could be completed. In short, pre-packs permit the debtor’s incumbent managers, who may well have been complicit in the debtor’s insolvency, to align their interests with those of the secured creditors. The end result is that pre-packs tend to yield greater returns to secured creditors, while preferential and unsecured creditors receive less than they would in standard administrations. In short, in many ways the pre-pack is a “functional substitute for receivership sales”⁴⁶⁶ which undermines the main thrust of the Enterprise Act to abolish administrative receivership.⁴⁶⁷ Seen in this light, it is unsurprising that pre-packs, like administrative receiverships in the past, are correlated with worse results for preferential and unsecured creditors compared to standard administrations.⁴⁶⁸

⁴⁶⁶ Walters (n 8).

⁴⁶⁷ Insolvency Service (n 129).

⁴⁶⁸ While there are certainly ways in which pre-packs differ from administrative receiverships – the key difference being that the secured creditor actually appoints the IP in a receivership and controls the process more directly – there may be many incentives for a debtor’s managers to align their interests with those of the secured creditors in a pre-pack. For example, as many pre-pack companies are small businesses, the secureds may well hold personal guarantees against the owner-operators of the insolvent debtor. In addition, as discussed in Chapter 3, where secured creditors hold blanket security interests over all of a

This chapter examines the policy responses to pre-packs in the wake of the Graham Report.⁴⁶⁹ The chapter begins by discussing the key findings and recommendations of the Graham Report and asks whether pre-pack practices have improved over the past five years. In light of the quantitative data set out in Chapter 4, this chapter goes on to argue that much of the recent literature on pre-packs, including the Graham Report, has exaggerated the potential benefits of pre-packs while minimising their potential harms. This chapter concludes by proposing reforms aimed at addressing the problems posed by pre-packs and, in particular, ensuring that pre-packs do not leave preferential and unsecured creditors worse off compared to standard administrations.

II. RECENT POLICY RESPONSES TO PRE-PACKS

1. Summary of the Graham Report's Key Findings and Recommendations

As discussed in Chapter 2, the U.K. government commissioned the Graham Report in response to widespread concerns about the propriety of pre-packs and their impact upon preferential and unsecured creditors. The Graham Report examined, among other things, quantitative data on the outcomes of 500 pre-packs gathered by Peter Walton and Chris Umfrville in the Wolverhampton Report.⁴⁷⁰ The Graham Report made the following key findings, which are discussed in further detail in Chapters 2 and 3:

- pre-packs comprised a significant proportion of administrations (600 out of 2,365 administrations);⁴⁷¹
- two-thirds of pre-packs (316 out of 499) involved sales to connected parties;⁴⁷²
- business sold in connected party pre-packs were nearly twice as likely to fail as those sold to third parties;⁴⁷³

troubled debtor's assets, there will be few incentives for new lenders to offer financing to the debtor. Consequently, the existing secured creditors can influence the debtor to pursue a pre-pack merely by indicating their unwillingness to advance the additional financing that the debtor would need to pursue a longer, standard administration.

⁴⁶⁹ Graham Report (n 16).

⁴⁷⁰ Wolverhampton Report (n 13)

⁴⁷¹ Graham Report (n 16) 3.1.

⁴⁷² *ibid* 7.50.

⁴⁷³ *ibid* 7.56.

- marketing efforts in most pre-packs were “insufficient”⁴⁷⁴ and “there was rarely any explanation as to the valuation methods used”;⁴⁷⁵ and
- pre-packs rarely resulted in distributions to unsecured creditors, with median payments of 4.3% in those rare cases that resulted in distributions.⁴⁷⁶

The Graham Report further stated that pre-packs delivered “paltry benefit[s]” to unsecured creditors and, in this regard, that pre-packs were “little different from the administrative receivership process that Enterprise Act 2002 style administration was supposed to supersede.”⁴⁷⁷

In light of the foregoing conclusions, one might have expected the Graham Report to propose an ambitious reform package aimed at definitively curbing the harms done by pre-packs to preferential and unsecured creditors. Regrettably, the Graham Report did nothing of the sort. Instead, the Graham Report merely recommended that insolvency practitioners (IPs) and other industry participants voluntarily adopt certain new best practices in pre-packs. These included the following recommended best practices:⁴⁷⁸

- 1) connected parties should approach a “pre-pack pool” before the sale and disclose details of the sale for the pool members to opine on;
- 2) connected parties should prepare a “viability review” of the new company, stating how the company will survive for the next 12 months;
- 3) IPs should adhere to a set of “good principles of marketing” designed to improve the quality of marketing in pre-packs and to maximise returns for creditors; and
- 4) asset valuations in pre-packs should be carried out by valuers with professional indemnity insurance, so as to assure creditors that valuations are fair.

2. Failure of the Graham Report’s Recommendations

For several reasons, the Graham Report’s recommendations have fallen far short of addressing the significant problems posed by pre-packs. Firstly, as noted above, compliance with the Graham Report’s recommended best practices is voluntary. The Graham Report suggested that if IPs and other market participants did not readily adopt its recommendations, then the government “should consider

⁴⁷⁴ *ibid* 7.72

⁴⁷⁵ *ibid* 7.80-7.81.

⁴⁷⁶ *ibid* 7.4-7.6.

⁴⁷⁷ *ibid* 7.36.

⁴⁷⁸ Graham Report (n 16) 9.1-9.39.

legislating”.⁴⁷⁹ Perhaps predictably, this lukewarm approach had little impact on pre-pack practices. For example, although market participants were quick to assemble the Pre-pack Pool (Pool) in the wake of the Graham Report,⁴⁸⁰ only 28% of connected party pre-packs were referred to the Pool between 1 November 2015 and 31 December 2016.⁴⁸¹ This inauspicious beginning was followed by abysmal results in 2017, when a mere 11% of connected party pre-packs were referred to the Pool.⁴⁸² Meanwhile, pre-packs comprised 28% of all administrations in 2017 compared with 22% in the previous period, with 57% of pre-packs in 2017 involving connected party sales (203 out of 356) compared with 51% (188 out of 371) in the previous period.⁴⁸³ Thus, even as pre-packs and especially connected party pre-packs became increasingly common, participation rates in the Pool dropped from their already low early numbers.⁴⁸⁴ Moreover, of the miniscule number of connected party pre-packs that were referred to the Pool in 2017, 51% were found to have “limitations in evidence” or received a “case not made” opinion from the Pool.⁴⁸⁵ While these numbers are troubling, it seems plausible that they may yet understate the problems with connected party pre-packs because approaching the Pool is voluntary. If IPs are reluctant to refer the worst cases to the Pool, then mandating referrals of all connected party pre-packs would further reduce the numbers of deals that are deemed acceptable by the Pool. In any case, based on the foregoing statistics alone, the Graham Report’s stated hope that IPs could be relied upon to refer connected party pre-packs to the Pool on a voluntary basis now seems untenable.

⁴⁷⁹ *ibid* 9.37.

⁴⁸⁰ The Pool was founded on 1 November 2015 by the Insolvency Service, the Insolvency Practitioners Association, the Institute of Chartered Accountants of England and Wales, the Institute of Chartered Accountants of Scotland, the Institute of Directors, the Association of Business Recovery Professionals (R3), the Association of Chartered Certified Accountants, the British Property Federation, the British Print Industry Federation, the Chartered Accountants Regulatory Board, and the Chartered Institute of Credit Management, online: <https://www.prepackpool.co.uk/>.

⁴⁸¹ *Pre-Pack Pool Annual Review 2017* (May 2018) online: <https://www.prepackpool.co.uk/uploads/files/documents/Pre-pack-Pool-Annual-Review-2017.pdf>. The report is based on Statement of Insolvency Practice 16 (SIP 16) filings during the relevant period. Every administrator is required to submit a SIP 16 form containing information on the pre-pack to the creditors of the insolvent company at the time that they are notified of the administration, with a copy submitted to the Insolvency Service.

⁴⁸² *ibid*.

⁴⁸³ *ibid*.

⁴⁸⁴ *ibid*.

⁴⁸⁵ *ibid*.

The Pool's shortcomings are thrown into sharp relief by the recent comments of its co-director, Stuart Hopewell:⁴⁸⁶

I have seen cases where the objective was avoidance of liabilities [of the pre-pack]...We are unable to stop the process going through even if our opinion is the objective of the process is to avoid liabilities. This is disappointing.

As the Pool's website rather flatly states, the Pool "has no powers, as such."⁴⁸⁷ Such statements are unsurprising in light of the Graham Report's hands-off approach to regulating pre-packs. The Graham Report suggested, for example, that Pool members would be expected to spend "no more than half a day reviewing [the] documents" relating to the deal and that they would only need to review the information submitted by the IP.⁴⁸⁸ Predictably, then, even in those rare cases where pre-packs are referred to the Pool, no mechanism exists to compel the IP to produce additional information or to stop a pre-pack from proceeding where the case for pursuing it has not been made. Although the IP must report a negative statement from the Pool in the SIP 16, as discussed in Chapter 2 it is quite difficult to scrutinise and challenge a pre-pack once it has been set in motion. Far from ameliorating the myriad problems with pre-packs that the Graham Report itself identified, the Pool may have merely added a thin veneer of propriety over some of the more dubious cases.

Secondly, the recommendation that connected parties prepare a viability review of the new company also left much to be desired. The Graham Report notes that "the empirical evidence shows that there is a clear link to future failure in connected party cases."⁴⁸⁹ Yet the viability review is to be prepared by connected parties only, and there is no expectation that the administrator or anyone else will scrutinise or comment upon it.⁴⁹⁰ In addition, there are no consequences if the pre-pack proceeds and the review later turns out to be inaccurate or misleading, despite the obvious incentives for connected parties to use the viability review as an opportunity to present the proposed deal in the best possible light. The Graham Report notes that if the new company were to become insolvent, the viability review would be available to assist in determining whether recovery action is possible against a director, and whether the director's

⁴⁸⁶ Josephine Cumbo, "Companies abusing insolvency pre-packs, independent panel says", *Financial Times*, 25 November 2018, online: <https://www.ft.com/content/0fee6146-f0bb-11e8-ae55-df4bf40f9d0d>.

⁴⁸⁷ Online: <<https://www.prepackpool.co.uk/questions-answers>> accessed 21 July 2019.

⁴⁸⁸ Graham Report (n 16) 9.8.

⁴⁸⁹ Graham Report (n 16) 9.13.

⁴⁹⁰ *ibid* 9.15-16.

conduct should be reported.⁴⁹¹ In these regards, it is important to note that the parties best positioned to pursue claims are likely to be repeat players such as secured creditors and IPs, as they will typically have access to more information and resources than other participants in the insolvency process. But the secured creditors will almost certainly have supported the pre-pack from the outset, and secured creditors may well also hold personal guarantees from the connected parties. Accordingly, it is unlikely in most cases that the secured creditors would suffer a loss or would otherwise need to bring an action for misfeasance against either the insolvent company's directors or the administrator. At the same time, the remedies available to junior creditors for director misconduct are limited.⁴⁹² Furthermore, wrongful and fraudulent trading claims under sections 213 and 214 of the Insolvency Act 1986 are difficult to prove, and historically the regime has been underused.⁴⁹³ At all events, such actions can only be brought by insolvency officeholders, and it would be unlikely for an administrator to bring a misconduct claim against himself or against the directors with whom he colluded. The possibility of a section 213 or 214 action by a liquidator against an administrator would be similarly remote in most cases given the limited funds that would be available to the liquidator to pursue such actions by that late stage of the insolvency process. In addition, while the Insolvency Service can investigate directors of insolvent companies and seek court orders disqualifying them for unfit behaviour or other misconduct,⁴⁹⁴ the process of director disqualification is a lengthy one and is dependent upon the Insolvency Service receiving adequate funding to pursue enforcement actions.⁴⁹⁵ Accordingly, the provision of additional information in the form of viability reviews,

⁴⁹¹ *ibid* 9.18.

⁴⁹² Section 212 of the Insolvency Act 1986 permits actions against directors and administrators, but in practice any action against the directors of the debtor would be limited, as their only significant act would have been the appointment of the administrator. Moreover, as discussed later, courts generally are reluctant to question the commercial decisions of administrators, which may present additional challenges for a creditor bringing a misfeasance action against an administrator.

⁴⁹³ Mokal found a total 52 reported decisions involving section 214 claims between 1986 and 2005, 7 of which were successful. Almost all of the cases – 49 of 52 – involved closely-held companies. Although these results were not statistically significant, it is reasonable to conclude that the wrongful and fraudulent trading regime is primarily relevant to directors “who are not subject to the full discipline of the managerial labour market.” See Mokal (n 4). More recently, Richard Williams has argued that the reforms of section 214 – in particular, extending the remedy to administration cases – are unlikely to improve civil recoveries for creditors or to significantly expand the use of the remedy, primarily because incidences of wrongful trading are not as widespread as is commonly believed: see Williams, “What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?” (2015) 78(1) MLR 55, 83.

⁴⁹⁴ Such actions are taken pursuant to the Company Directors Disqualification Act 1986.

⁴⁹⁵ A review of the Insolvency Service's annual reports from 2013 through 2018 discloses that roughly 1,200 directors have been disqualified in each year since 2013. Disqualification undertakings and orders secured

alone, does little to address the broader problems with pre-packs discussed here and in Chapter 4. Although the new section 110 of the Small Business, Enterprise and Employment Act 2015 provided additional avenues for creditors of insolvent companies to obtain compensation against disqualified directors, these were relatively limited changes. Specifically, the changes amended section 15 of the Company Directors Disqualification Act 1986 so as to permit the Secretary of State to seek court orders for compensation against disqualified directors of insolvent companies on behalf of one or more creditors. However, this remedy is limited insofar as the directors must first be disqualified before the Secretary of State can apply for the compensation order. Moreover, although section 15 of the Company Directors Disqualification Act does not require the Secretary of State to demonstrate that a director engaged in wrongful or fraudulent acts – in contrast to sections 213 and 214 of the Insolvency Act – practically speaking, it seems unlikely that the Secretary of State would bring an action under section 15 where a director was disqualified for conduct that fell short of wrongful trading or fraud.⁴⁹⁶

Thirdly, the recommendation that IPs adhere to principles of good marketing in pre-packs has no teeth. The Graham Report recommended that “any deviation from these principles be brought to creditors’ attention”, and presumably this would be done in the SIP 16.⁴⁹⁷ But beyond this, the Graham Report offered no guidance as to what should happen if an IP does not follow these principles. Indeed, the Graham Report stated that there may be cases in which marketing is not possible at all or may be harmful to creditors.⁴⁹⁸ The Graham Report should have elaborated on this point, given its later finding that “cases with no marketing return less to creditors.”⁴⁹⁹ As it stands, the judgment of whether and how to market the business and assets of the debtor in a pre-pack is left entirely to the administrator, and while the administrator must explain his actions in the SIP 16, there is no clear mechanism for challenging the administrator in this regard before the deal is completed.

against directors took roughly 6 years to complete. See, for example, Insolvency Service, *The Insolvency Service Annual Report and Accounts 2013-14* (HMSO 2014) 18.

⁴⁹⁶ Consider, for example, the likelihood of the Secretary of State seeking a compensation order under section 15 against directors who failed to keep proper books and records.

⁴⁹⁷ Graham Report (n 16) 9.23.

⁴⁹⁸ *ibid* 9.24.

⁴⁹⁹ *ibid* 9.25. There may be cases in which advertising the sale of an insolvent company’s assets will erode the value of those assets, but it is precisely for this reason that the Report should have elaborated on this point and provided specific guidelines for administrators in such cases.

The Graham Report's fourth recommendation, that asset valuations only be conducted by valuers with professional indemnity insurance, was intended to respond to the finding that the information on valuations in the pre-2010 SIP 16 reports "[lacked] transparency and consistency".⁵⁰⁰ This recommendation was a weak response to a serious problem. Notwithstanding that subsequent versions of the SIP 16 report have introduced new requirements to provide the name and qualifications of the valuer, as well as a summary of the basis for the valuation, there are no specific criteria that valuers are required to meet nor any means for objecting creditors to obtain their own alternative valuations that the administrator would be required to consider. Accordingly, the Graham Report could have gone further by recommending more robust requirements in respect of valuation procedures and disclosure, as well as methods for creditors to meaningfully scrutinise and challenge valuations before the deal is concluded.

All of the foregoing concerns are compounded by the fact that the Insolvency Service no longer monitors SIP 16 filings. Instead, following the Graham Report's recommendation in this regard, the Insolvency Service has ceded its monitoring and oversight duties to the professional regulatory bodies, namely, the Association of Chartered Certified Accountants, the Insolvency Practitioners Association, and the Institute of Chartered Accountants.⁵⁰¹ This important but little-discussed recommendation is surprising given that all of the problems with pre-packs identified in the Graham Report, such as the low returns to preferential and unsecured creditors and the high failure rate of connected party pre-packs, occurred under the Insolvency Service's watch. It is difficult to imagine that the self-regulating professional bodies would provide a greater monitoring and deterrence role in these regards than the Insolvency Service. If anything, the professional bodies may be reluctant to monitor their own members too strictly, and in any event, are generally focused on monitoring and enforcement of standards more broadly, rather than on pre-pack practices or the integrity of the insolvency regime specifically. Equally surprising was the Graham Report's recommendation that the Insolvency Service's annual reports on SIP 16 compliance, while helpful, were no longer needed because the professional bodies could do a better job of enforcing compliance.⁵⁰² Indeed, one would think that it would be especially important for the Insolvency Service to continue monitoring and reporting on SIP 16 compliance for at least a few years after the Graham Report was published, so as to

⁵⁰⁰ *ibid* 9.29.

⁵⁰¹ *ibid* 9.32.

⁵⁰² *ibid* 9.33-9.34.

ascertain the uptake of the Graham Report's recommendations. It is difficult to see how several different professional bodies, whose duties extend well beyond monitoring the insolvency regime, can monitor and report on SIP 16 compliance more efficiently and effectively than the Insolvency Service.

More generally, the Graham Report may have focused too closely on the question of how to maximise returns from sales, instead of asking the more fundamental question of whether pre-packs are appropriate at all, and if so, in what circumstances. Many of the early concerns voiced about returns to preferential and unsecured creditors, as well as transparency and accountability in pre-packs, were already borne out by the data collected in the Wolverhampton Report. Those concerns have now been substantiated more comprehensively in the data set out in Chapter 4. The dismal performance of the Pool only serves to underline how the Graham Report's recommendations have fallen far short of addressing the problems with pre-packs. Not only were the Graham Report's recommendations limited in the first place, the insolvency industry has clearly failed to "embrace" the recommendations, as the Graham Report hoped.⁵⁰³ Even the Graham Report's much more modest goal of "[c]leaning up the perception of pre-packs" – in itself a questionable objective with undertones of a public relations campaign rather than a major legislative reform effort – remains unfulfilled, as the public outcry surrounding pre-packs has persisted and may well have worsened since the Graham Report was published in 2014.⁵⁰⁴ Again, these results were predictable. As Bolanle Adebola pointed out following the Graham Report's publication, for example, the Pool was unlikely to provide effective oversight of pre-packs because it had no independent investigative powers, and its restricted role would "mute the effectiveness of the Graham proposals."⁵⁰⁵ More recently, Adebola has argued that the Graham Report's "comply or explain" approach to regulating pre-packs, while understandable, has failed to reform pre-pack practices because institutional support is lacking:⁵⁰⁶

⁵⁰³ *ibid* 8.14.

⁵⁰⁴ See, for example, Kadhim Shubber, "Administrators removed over sale of failed UK unicorn", *Financial Times*, 26 January 2018, online: <https://www.ft.com/content/9d2f637c-01c2-11e8-9650-9c0ad2d7c5b5>; Aliya Ram, "House of Fraser deal draws attention of pension watchdog", 12 August 2018, *Financial Times*, online: <https://www.ft.com/content/3fc045de-9e35-11e8-85da-eeb7a9ce36e4>; Tabby Kinder, "Creditors may lose millions in law firm's pre-pack deal", 3 January 2019, *The Times*, online: <https://www.thetimes.co.uk/article/creditors-may-lose-millions-in-law-firm-s-pre-pack-deal-69lvwkkdg>.

⁵⁰⁵ Bolanle Adebola, "Proposed feasibility oversight for pre-pack administrations in England and Wales: window dressing or effective reform" (2015) 8 JBL 591, 603.

⁵⁰⁶ Bolanle Adebola, "An Invitation to Encourage Due Consideration for the Survivability of Rescued Businesses in the Business Rescue System of England and Wales" (2017) 26:2 International Insolvency Review 129, 147-148.

Considerable institutional support is required to enable the system to work effectively. In corporate governance through which this approach was launched, the parties to whom the information is to be disclosed are empowered to take concrete action against the subject of the duty where compliance is weak. In the case of business rescue, the legal rights and powers of the pre-distress stakeholders terminate after the rescue proceedings. They have no legal rights against the new company even where the viability report and viability statement are insufficient.

[. . .]

While the pre-pack pool may exercise oversight over issues relating to the transparency of the decision to pre-pack where approached, its functions do not extend to matters related to recidivism. It has no oversight functions over the independent viability report or the viability statement or the explanations where those are presented in lieu. The administrator does not review the documents either. Her role is to present them to the creditors.

Adebola concludes that because crucial elements of the comply or explain approach are absent, it is doubtful that this approach can effectively regulate pre-packs.⁵⁰⁷ Given all of the foregoing, it is difficult to accept the Graham Report's premise that imposing mandatory rather than voluntary requirements, or introducing additional safeguards, would amount to "over-regulation" of pre-packs.⁵⁰⁸ On the contrary, mandating certain practices now seems to be the only way to ensure that the problems with pre-packs are properly addressed, and in particular, that pre-packs do not disproportionately harm preferential and unsecured creditors.

3. Shortcomings of Recent Scholarship on Pre-packs

Much of the recent scholarship on pre-packs has underestimated the potential harms of pre-packs while exaggerating their potential benefits. To some extent, this is understandable because the quantitative data on pre-packs have been relatively limited until the present study, leaving some room for reasonable disagreement as to the hypothetical merits and drawbacks of pre-packs. However, the data gathered in the present study are extensive and they disclose that many of the perceived benefits of pre-packs, such as speed and certainty, have been exaggerated in the literature and in any case have not translated into better outcomes for creditors as a whole. Meanwhile, the key problems with pre-packs are more significant than previously understood. As discussed earlier, the data in the present study are consistent with many of the key findings of earlier quantitative studies such as the Wolverhampton Report, which formed the basis for the Graham Report. Unfortunately, the Graham Report downplayed the significance of the

⁵⁰⁷ *ibid* 148.

⁵⁰⁸ Graham Report (n 16) 8.15: "... it is not my intention to over-regulate in this area."

warning signs in the data, and much of the recent scholarship on pre-packs has followed suit. This has resulted in a number of scholars overstating – and indeed misstating – the potential benefits of pre-packs, while minimising their potentially harmful effects. A related consequence is that many recent reform proposals have failed to accurately identify the core problems with pre-packs and, therefore, have failed to offer meaningful solutions.

For example, Bo Xie suggests that pre-packs have “some compelling merits” because they minimise the time spent in formal proceedings and provide certainty, thereby preserving the value of the insolvent debtor’s business and enhancing prospects for a going concern solution:⁵⁰⁹

Pre-packs... clearly aim at selling the distressed company’s business as a going concern and thus they can be held to be the best course for the interests of the creditors as a whole... Furthermore, its pre-determined nature offers a high level of certainty and control to the participants in the rescue process and therefore attracts essential support from the company’s main creditors.

Xie concludes that pre-packs offer the “clear benefit” of streamlining the administration process, making it “fast and more flexible” and thereby achieving “the goals of speed and transaction-cost economisation”.⁵¹⁰ Similarly, Alexandra Kastrinou and Stef Vullings assert that pre-packs can facilitate “a discreet and quick sale of the business” and thereby preserve value.⁵¹¹ However, as discussed in Chapter 4, the data on pre-packs simply do not support these assertions. Firstly, pre-packs are not much speedier than other types of processes, having median durations of 11.8 months compared with 12 months for going concern sales, piecemeal sales, and standard administrations, respectively. Secondly, the speed of pre-packs appears to yield only modest cost savings compared with other procedures, with average costs in pre-packs comprising approximately 61.5% of realisations, compared with 62.5% for piecemeal sale administrations and 64.6% for going concern sale administrations. Part of the explanation for these results may be that some of the apparent savings from the shorter pre-pack process are being consumed by professional fees

⁵⁰⁹ Bo Xie, *Comparative Insolvency Law: The Pre-pack Approach in Corporate Rescue* (Edward Elgar 2016) 90.

⁵¹⁰ *ibid* 295. See also Bo Xie, “The customisation effect of pre-arranged sales under Anglo-American insolvency law and practice: accountability deficits and possible remedies” (2018) *Journal of Corporate Law Studies*, DOI: <https://www.tandfonline.com/action/showCitFormats?doi=10.1080/14735970.2018.1520185>, 32: “[v]alue realisation by way of pre-arranged business sales under the formal insolvency procedure can be implemented and consummated more quickly and at far lower cost than a sale done as part of a formal procedure.”

⁵¹¹ Alexandra Kastrinou and Stef Vullings, “‘No Evil is Without Good’: A Comparative Analysis of Pre-pack Sales in the UK and the Netherlands” (2018) 27:3 *International Insolvency Review* 320, 325.

and related expenses at the pre-appointment stage, when most of the work on the pre-pack is completed. Regardless, it is easy to understate the transaction costs of pre-packs if only post-appointment fees are considered; once pre-appointment costs are taken into account, the relative savings of pre-packs are modest at best. Thirdly, and perhaps most importantly, pre-packs are correlated with significantly lower realisations than formal administration procedures across almost all sizes of debtor companies. In particular, for companies with debts of less than £500,000 – the most common candidates for pre-packs – pre-packs realised £549,678 on average, compared with £1,071,650 for going concern sale administrations. Based on the foregoing results, it is difficult to see the “clear benefits” of pre-packs in practice.

There may be a number of factors driving the growth of pre-packs that have little to do with the supposed benefits of pre-packs proffered by Xie and Kastrinou and Vullings. As discussed in Chapter 3, there have been 4 key factors in the rise of 363 sales in the U.S. over the past few decades, namely: (1) technological advances and globalization, which have disrupted traditional relationships between businesses and their local customers and suppliers; (2) the rise of distressed debt investing and changes in the traditional players in Chapter 11 reorganizations; (3) new lending practices that have given secured creditors greater influence over troubled debtors, allowing secureds to force quick sales rather than agree to support longer, costlier and uncertain traditional reorganizations; and (4) the shift from a manufacturing-based to a service-based economy, such that many companies are now mostly comprised of intangible assets, or highly fungible hard assets. At least some of these factors may be relevant in the U.K. context. Firstly, there is little doubt that technological changes and globalization, and the rise of large multinational companies, have disrupted local and regional economies and business relationships in the U.K. Although SMEs continue to employ the most workers and contribute the most value to the U.K.’s GDP, large businesses – that is, those with 250 employees or more – nonetheless employ 40% of the U.K.’s workforce and generate 48% of the country’s GDP.⁵¹² These numbers are somewhat lower than in the U.S., but they

⁵¹² Department for Business, Energy & Industrial Strategy, “Business Population Estimates for the UK and Regions 2018”, 11 October 2018. Online: <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/746599/OFFICIAL_SENSITIVE_-_BPE_2018_-_statistical_release_FINAL_FINAL.pdf> accessed 21 July 2019.

are still significant: in the U.S., large companies employ around 51% of the workforce⁵¹³ and contribute 52% of U.S. GDP.⁵¹⁴ In any case, even many of the SMEs in the U.K. are, like large multinationals, focused on doing business globally rather than locally or regionally. For example, according to the OECD, over 25% of SMEs in the U.K. are engaged in some form of “international collaboration for innovation”, which reflects the fact that “[g]lobalisation has increased the importance of cross-border collaboration in innovation – both in obtaining inputs for innovation (ideas, finance, skills technologies) from abroad and in exploiting its outputs (products and services, patents, licenses, etc.) in foreign markets.”⁵¹⁵ Like any other company, large or small, that is focused on doing business globally, these SMEs will be less concerned with local and regional relationships and economies. This, in turn, may contribute to the breakdown in traditional relationships between such businesses and their local customers and suppliers – when customers and suppliers can be sourced from virtually anywhere, the disappearance of local and regional options may not be as strongly felt as in the past, when access to global markets was more limited.

Secondly, although distressed debt investors typically play no role in pre-packs, which are primarily an SME phenomenon,⁵¹⁶ changes in lending practices may well have influenced the rise of pre-packs. In particular, the growth of pre-packs since 2003 may have been driven by a corresponding increase in the use of asset-based financing during the same period. The resulting fragmentation in the financing of companies presents potential complications and challenges in negotiating a rescue that did not exist to the same extent when all or most of the key assets of an insolvent debtor were subject to the security interests of a single lender such as the debtor’s bank. In scenarios where the debtor’s financing is fragmented and multiple parties have security over different key assets of the business, a pre-pack is an attractive solution

⁵¹³ Anthony Caruso, “Statistics of U.S. Businesses, Employment and Payroll Summary: 2012”, February 2015. Online: <<https://www.census.gov/content/dam/Census/library/publications/2015/econ/g12-susb.pdf>> accessed 21 July 2019.

⁵¹⁴ U.S. Small Business Administration, Office of Advocacy, “United States Small Business Profile”, 2016. Online: < https://www.sba.gov/sites/default/files/advocacy/United_States.pdf> accessed 21 July 2019.

⁵¹⁵ See Organization for Economic Cooperation and Development, “Enhancing the Contributions of SMEs in a Global and Digitalised Economy”, Paris 7-8 June 2017, 7. Online: < <https://www.oecd.org/mcm/documents/C-MIN-2017-8-EN.pdf>> accessed 21 July 2019.

⁵¹⁶ The typical pre-pack is arranged by incumbent management in consultation with the insolvent debtor’s bank, which will often finance the purchaser as well. See Sarah Paterson, “Debt Restructuring and Notions of Fairness” (2017) 80(4) MLR 600, 601-602.

for the debtor's incumbent managers and senior lenders, who can agree to a deal without notifying all of the other creditors and risking "complicated and potentially protracted negotiations".⁵¹⁷

Thirdly, like the U.S., the U.K. has also undergone a dramatic shift from a manufacturing-based to a services-based economy over the past several decades. As the Office for National Statistics noted recently, the services sector comprises roughly 80% U.K.'s total GDP.⁵¹⁸ This is the most of any G7 country and represents a significant increase from the middle of the twentieth century, when services made up only 46% of the U.K.'s GDP.⁵¹⁹ In particular, the information/communication and motion picture sectors grew by 79% and 101%, respectively, in the past decade alone.⁵²⁰ In general, companies in these sectors would seem to be strong candidates for pre-packs given that most of their value lies in intangible assets such as patents and other intellectual property, client lists, and contracts, all of which can be transferred more quickly and smoothly than hard assets such as heavy equipment or real estate.⁵²¹ In these regards, the quantitative study discussed in Chapter 4 found that pre-packs were very common for services-based companies, especially those in the information/communication and professional, scientific and technical sectors.⁵²² In addition, pre-packs were most common in the North East of England, comprising 29% of all cases in that region.⁵²³ While there may be many possible explanations for this finding, it is worth noting that the North East has the highest figures in the U.K. for technology start ups compared to the region's size.⁵²⁴

At the same time as they exaggerate the benefits of pre-packs, Xie and Kastrinou and Vullings also minimise the shortcomings. For example, in summarizing various criticisms of pre-packs, Xie concludes

⁵¹⁷ Adebola (n 506) 138; Kayode Akintola, "What is Left of the Floating Charge? An Empirical Outlook" (2015) BJIBFL 404.

⁵¹⁸ Office for National Statistics (ONS), "Services sector, UK: 2008 to 2018", 2 April 2019. Online: <<https://www.ons.gov.uk/economy/economicoutputandproductivity/output/articles/servicessectoruk/2008to2018>> accessed 21 July 2019.

⁵¹⁹ ONS, "Five facts about... The UK service sector", 29 September 2016. Online: <<https://www.ons.gov.uk/economy/economicoutputandproductivity/output/articles/fivefactsabouttheukservicesector/2016-09-29>> accessed 21 July 2019.

⁵²⁰ ONS (n 518), tracking the growth of these sectors from 2008 to 2018.

⁵²¹ It is also worth noting that pre-packs were least common in the construction and real estate sectors, making up only 19% and 15% of cases in those sectors, respectively. See Mokal and others (n 385) 20.

⁵²² Pre-packs comprised 32% and 28%, respectively, of all proceedings for insolvent companies in these sectors: *ibid.*

⁵²³ *ibid.*

⁵²⁴ European Commission, Regional Innovation Monitor Plus, "East of England". Online: <<https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/base-profile/east-england>> accessed 21 July 2019.

that pre-packs are “fraught with controversy” because “the democratic aspect, representativeness in the decision-making and procedural inclusiveness, is often aggravated.”⁵²⁵ Although Xie acknowledges that pre-packs “may prove prejudicial to the interests of unsecured creditors who are excluded from the decision-making process”, particularly in the period prior to the administrator’s formal appointment,⁵²⁶ her focus is clearly on unsecured creditors’ *perceptions* and public confidence in the insolvency system, rather than on the potentially harmful effects of pre-packs:⁵²⁷

To sum up, the controversy of pre-pack sales has tested the public confidence in the insolvency profession, and inspired a set of restrengthening measures to improve transparency of the process by imposing even more comprehensive ex post information disclosure requirements, and to strengthen the role of professional regulation in playing a particular effective part in their respective capacities. While the effect of these changes on providing a solid safeguard for the general unsecured creditors in pre-packs can only be properly evaluated in the fullness of time, as a first and firm step in the right direction, they should greatly improve public confidence in sanctioning insolvency practitioners’ questionable conduct and behaviour in pre-pack practice in the instances of abuse.

In short, Xie seems to think that if only IPs did a better job of explaining the decision to pre-pack after the fact, all stakeholders would be more likely to conclude that the process was legitimate, and the purportedly few instances of abuse could then be more easily identified and addressed. Likewise, Kastrinou and Vullings seem to view most criticisms of pre-packs in terms of the perceptions of the parties rather than the practical outcomes for preferential and unsecured creditors:⁵²⁸

While there is a clear advantage to be gained from the confidential nature of pre-packs, looking at the process from an apprehensive unsecured creditor’s perspective, it could be said that the lack of transparency within the pre-pack process makes it very difficult to determine how a deal was struck and whether the administrator has properly conducted all the necessary enquiries as well as complied with his statutory duties. Furthermore, whilst unsecured creditors are generally presented with the pre-pack as a *fait accompli*, the process cannot be completed without the involvement of the secured creditors... Therefore, secured creditors are always involved in the process, whereas unsecured creditors are not.

The authors conclude that although scepticism of pre-packs “might be unavoidable”, the U.K. has recognised the need for safeguards so as to “ensure that the pre-pack process is not abused” and “a number of steps have already been taken.”⁵²⁹ In these regards, Kastrinou and Vullings proceed in strange

⁵²⁵ Xie (n 509) 295.

⁵²⁶ Xie (n 509) 91.

⁵²⁷ *ibid* 169.

⁵²⁸ Kastrinou and Vullings (n 511).

⁵²⁹ *ibid* 338-339.

paradox – they argue, simultaneously, that: (1) there is a need for safeguards to prevent abuse of the pre-pack process; (2) secured creditors “have interest [sic] to ensure that there has not been an abuse of process”;⁵³⁰ and (3) secured creditors have a “very significant role” in pre-packs and “a high level of influence in the procedure”.⁵³¹ But if claims (2) and (3) are correct, then the first claim cannot be – if secured creditors generally are able to influence the pre-pack process, and if they also have a strong interest in preventing abuse, then additional safeguards to prevent abuse would be unnecessary. If we were to extend Kastrinou and Vullings’ logic, even basic disclosure requirements in pre-packs would be unnecessary because secured creditors would naturally ensure that the administrator acted appropriately and that the best possible deal was struck in each case. Indeed, the imposition of additional safeguards and disclosure requirements would be economically wasteful.

To be clear, Kastrinou and Vullings are correct that insofar as secured creditors have an interest in maximising their chances of recovery, they will also want to maintain the perceived legitimacy of the insolvency procedure. Accordingly, secured creditors will have an interest in curbing abuses by any party that could cause the pre-pack to be unwound after the fact.⁵³² But it does not follow from this that secured creditors will make decisions that lead to the best results for the creditors as a whole – only the administrator has such a duty. Rather, assuming that the secured creditors are acting in their individual self-interest, their desire to limit abuses or to pursue restructuring options that benefit other creditors will be limited to whatever is minimally required in order to maintain a level of perceived legitimacy that renders ex post challenges of the pre-pack practically impossible. In these regards, as a practical matter, pre-packs are rarely unwound after the fact. Unsecured creditors are a disparate group and are generally very poorly positioned to scrutinise and challenge pre-packs, whether before or after the sale is completed. As Finch notes, unsecured creditors “frequently lack detailed information on the financial state of the troubled company” and often lack the knowledge, expertise and resources necessary to participate effectively in the insolvency process.⁵³³ Interestingly, Xie also recognizes this problem, stating that the costs of legal action

⁵³⁰ *ibid* 325.

⁵³¹ *ibid* 332 and 335.

⁵³² See 327: “[i]n addition to the stringent regulatory process... secured creditors have a vested interest to prevent an abuse of process”; and 335: “it is in [banks’] best interests to ensure that there is no abuse of process and that the legality of the pre-pack process shall not be questioned.”

⁵³³ Vanessa Finch, “Corporate Rescue: who is interested?” (2012) 3 JBL 190, 197.

are high for small creditors, while the chances of a successful recovery are uncertain, and it is therefore “hard to expect [unsecured creditors] to play an active role in initiating a lawsuit”.⁵³⁴ Furthermore, when the administrator has made the commercial decision to pre-pack, courts generally defer to the administrator’s judgment and it is “very difficult for unsecured creditors to attack that commercial decision.”⁵³⁵ Sarah Paterson has summarized the recent case law in this area as follows:⁵³⁶

Moreover, case law has established that, even where English insolvency law does require a meeting to be held, when an administration sale is ‘pre-packaged’ the administrator is not required to hold the meeting before the sale is completed, so that creditors are effectively presented with a *fait accompli*... Crucially the administrator is entitled to move to a sale transaction if she ‘thinks’ it would achieve a better result for creditors as a whole, (essentially a rationality standard), and the courts are extremely reluctant to interfere in the administrator’s commercial decision making. Indeed, recent cases have shown just how difficult it is to unwind a certain pre-packaged administration sale in order to pursue a different, uncertain debt restructuring.

Accordingly, secured creditors will likely be content in most cases for the debtor to select a reputable administrator who has experience with pre-packs; beyond this, the secured creditors will have no interest in scrutinising the very deal which they have just negotiated with the debtor’s managers, or of questioning the actions of the administrator whom, in many cases, the secured creditors asked the debtor to appoint. Given the foregoing, it is hardly a stretch to see how pre-packs might favour the interests of secured creditors at the expense of preferential and unsecured creditors in many cases.⁵³⁷

In addition to downplaying the conceptual problems with pre-packs, Xie and Kastrinou and Vullings give short shrift to the available data on the practical outcomes of pre-packs. As detailed in Chapter 4, in practice pre-packs are typically correlated with worse outcomes for unsecured creditors and better outcomes for secured creditors than standard administrations. In particular, although returns to creditors as a whole were roughly comparable across all types of administrations, pre-packs rarely yielded returns to unsecured creditors – the Wolverhampton Report found that average unsecured returns amounted to 7.22%.⁵³⁸ Meanwhile, pre-packs yielded average returns for secured creditors of 39.7%, compared with

⁵³⁴ Xie (n 509) 133.

⁵³⁵ Mark Wellard and Peter Walton, “A Comparative Analysis of Anglo-Australian Pre-packs: Can the Means be Made to Justify the Ends?” (2012) 21:3 International Insolvency Review 143, 148.

⁵³⁶ Paterson (n 516) 608-609. See also *Four Private Investment Funds v Lomas* [2009] BCLC 161; *Case Management Conference In the Matter of Coniston Hotel* [2014] EWHC 397; *Hockin and others v Matsden and another* [2014] Bus LR 441; *Holgate and another v Reid and another* [2013] EWHC 4630 (Ch).

⁵³⁷ The theoretical and procedural reasons why pre-packs generally favour secured creditors are discussed in further detail in Chapter 2. See also Alfonso Nocilla (n 335).

⁵³⁸ Wolverhampton Report (n 13) 32.

38.1% in going concern sale administrations and 35.8% in piecemeal sale administrations, even as pre-packs yielded marginally lower total returns than either of those processes. Any benefits of pre-packs flowed largely to secured creditors, even as overall realisations were significantly lower than going concern sale administrations, leaving preferential and unsecured creditors with less. As discussed earlier, many of these warning signs were apparent in the Wolverhampton Report as well as other earlier studies of pre-packs.⁵³⁹ In short, by focusing primarily on the benefits and drawbacks of pre-packs in the abstract, rather than examining the available data on the outcomes of pre-packs, Xie and Kastrinou and Vullings have told only part of the story. The upshot is that their analyses tend to create the impression of a false equivalency between the potential harms and benefits of pre-packs.

Perhaps as a consequence of examining pre-packs mainly in the abstract, Xie and Kastrinou and Vullings seem primarily interested in improving perceptions of pre-packs among disaffected creditors and the wider public. For example, Kastrinou and Vullings emphasize the need to address “the perceived lack of accountability and transparency” of pre-packs,⁵⁴⁰ while Xie asserts that reforms should seek to safeguard “the reputation” of the pre-pack procedure “without prejudicing its distinct advantages in terms of procedural speed and business efficiency.”⁵⁴¹ In this sense, their approaches mirror the Graham Report in focusing “mainly on the improvement of transparency.”⁵⁴² For their part, Kastrinou and Vullings suggest that the current regime is functioning well in these regards. They argue that the introduction of mandatory SIP 16 reports in pre-packs has been “a key development” in improving transparency and, perhaps, in mollifying disaffected creditors:⁵⁴³

Crucially, SIP 16 requires administrators to provide creditors with a detailed explanation and justifications of not only the reasons why they considered the pre-pack to be the best outcome but also information prior to their formal appointment...

[. . .]

...In addition, contrary to the negativity that sometimes surrounds pre-packs, it transpires that only a few complaints relating to compliance with SIP 16 and pre-pack administrations have reached the Insolvency Service’s Complaints Gateway... although unsecured creditors may not always be provided with adequate information in relation

⁵³⁹ See, for example, Frisby (n 14) 67, in which Frisby found that that pre-packs tended to generate better returns for secured creditors and lower returns for unsecured creditors.

⁵⁴⁰ Kastrinou and Vullings (n 511) 327.

⁵⁴¹ Xie (n 509) 301.

⁵⁴² Adebola (n 505) 605.

⁵⁴³ Kastrinou and Vullings (n 511) 326-327.

to pre-pack administrations proceedings, it is rarely the case pre-packs have been inappropriately or unjustifiably concluded.

Of course, there are alternative explanations for why aggrieved creditors do not complain when an IP has failed to comply with the SIP 16 disclosure requirements, or when there are concerns surrounding the IP's competence and impartiality. As discussed earlier, unsecured creditors typically lack the knowledge, resources and expertise to effectively scrutinise and challenge pre-packs. As with court challenges, albeit to a lesser extent, there are costs associated with filing complaints against IPs. In addition, for unsecured creditors who have recovered little or nothing in the pre-pack, there would often be no benefit to filing a complaint against the administrator after the fact. Thus, Kastrinou and Vullings beg the question when they assert that inappropriate or abusive pre-packs are rare. The mere fact that formal complaints have been few in number to date may tell us little about whether the pre-pack regime is functioning properly. Indeed, as Kastrinou and Vullings acknowledge, only 62% of SIP 16 filings in 2016 were compliant.⁵⁴⁴ Regardless of whether such breaches can be characterized as “technical in nature”,⁵⁴⁵ if the Insolvency Service's Complaints Gateway were a truly robust mechanism, one would expect to see far more complaints surrounding IPs' failures to comply with SIP 16 disclosure in pre-packs. The reality may be that filing a complaint will simply make no material difference to the circumstances of preferential and unsecured creditors after a pre-pack has concluded. As will be discussed later, this points up the inadequacy of ex post disclosure requirements in correcting the fundamental imbalances between secured and unsecured creditors in pre-packs – it would be far more effective and efficient to provide ex ante mechanisms to identify and prevent abuse.

Xie, meanwhile, proposes three key reforms to the pre-pack regime, namely: (1) mandating that in connected party pre-packs, the directors and/or the insolvent debtor company may only appoint an administrator out-of-court where “there is no objection from major creditors, either HRMC or other unsecured creditors who are owed a considerable amount of credit”, thereby minimising the concern that the IP might be in a “self-serving alliance with any insiders”; (2) requiring the administrator to provide a “sensitivity analysis” in connected party pre-packs setting out the projections and appraisals underpinning

⁵⁴⁴ *ibid* 327, citing Insolvency Service, *2017 Annual Review of Insolvency Practitioner Regulation* (March 2017), 7.

⁵⁴⁵ *ibid*.

the decision to pre-pack, including their underlying assumptions such as “the likelihood of securing any new financing or the possibility of finding any other bidders”; and (3) strengthening and widening the powers of the Insolvency Service, acting on behalf of the Secretary of State, to investigate and sanction misconduct and abuse by IPs, rather than leaving these powers largely to the self-regulating professional bodies.⁵⁴⁶

Xie’s recommendations, if implemented, would be unlikely to resolve the underlying problems with pre-packs. Her first recommendation – appointing a different administrator than the IP who prepared the pre-pack – is limited to connected party deals only, yet the concern that a friendly administrator might align with the secured creditors and the debtor’s managers in a pre-pack could still arise even in cases where the purchaser is unconnected. This is because most of the work to prepare a pre-pack is done well in advance of the filing and the IP typically will have been working closely with the debtor’s managers and secured creditors for some time before the formal appointment is made.⁵⁴⁷ Even where the IP is not aligned with management and the senior creditors, and acts with the utmost integrity, arguably the IP has placed himself in a conflict of interest by arranging the pre-pack because doing so may fetter his discretion post-appointment to consider all rescue options.⁵⁴⁸ Moreover, even appointing as the administrator a different IP than the one who arranged the pre-pack may be a largely cosmetic act, regardless of whether the pre-pack involves connected parties. This is because, as Xie admits, administrators who are appointed on short notice “may have little time to investigate the full circumstances of the company” and may suffer from information flow disruptions as a result of the debtor’s management “possess[ing] strong incentives to preserve their control over the rescue process and therefore be[ing] disinclined to lay all their cards on the table.”⁵⁴⁹

Xie’s second recommendation is that the administrator prepare a “sensitivity analysis” in his final report. This sensitivity analysis would set out the administrator’s rationale for pursuing a pre-pack, including all of the projections and appraisals underpinning the administrator’s key decisions, such as determining the timing of the sale, entering into any related agreements such as a binding/lock-up agreement with a particular purchaser, soliciting other potential purchasers, and deciding whether to seek new financing.⁵⁵⁰

⁵⁴⁶ Xie (n 509) 300.

⁵⁴⁷ Paterson (n 516) 601-602.

⁵⁴⁸ Peter Walton, “Pre-packin’ in the UK” (2009) 18:2 *International Insolvency Review* 85, 93.

⁵⁴⁹ Xie (n 509) 139-140.

⁵⁵⁰ Xie (n 509) 300.

This recommendation is likewise limited to connected party pre-packs, and again lacks any sound rationale for this limitation. Xie states that the goal of this recommendation is to “allow creditors to gain additional insight into the various factors contributing to the final disposal of the business and assets of the company and enable them to comprehend the complexity of the commercial reality” in connected party pre-packs.⁵⁵¹ However, this goal could apply equally to all pre-packs because even unconnected pre-packs are extraordinary procedures that bypass the typical safeguards of standard administration proceedings:⁵⁵²

...[in] the SME case a limited number of stakeholders has the chance actively to participate: the owner/managers, the bank, and an administrator chosen by them (with whom we might assume the bank has a pre-existing relationship). An administrator is required to hold a meeting of creditors to discuss her proposals for the administration, but not where the company is so insolvent that no return to unsecured creditors is anticipated (other than a legislatively fixed small return)... Challenging the administrator’s decision to pursue the sale transaction rather than, for example, a different debt restructuring is also fraught with difficulty, so that the unpaid suppliers lack an effective right to appeal.

In short, if the purpose of a sensitivity analysis is to assuage the concerns of disaffected creditors, then the sensitivity analysis should be provided in all pre-packs, not simply connected party pre-packs. In addition, and more importantly, Xie’s proposal contemplates that the administrator will deliver the sensitivity analysis only after the pre-pack is completed. Accordingly, the sensitivity analysis will be of no assistance to creditors who were excluded from the deliberations leading to the pre-pack and who might well have objected to the terms of the deal ex ante, had they been given the opportunity to do so. Although disaffected creditors could still avail themselves of the sensitivity analysis in attempting to unwind the pre-pack after the fact, as discussed earlier, courts are quite reluctant to unwind pre-packs. On its face, then, Xie’s second recommendation seems primarily aimed at assuaging the concerns of creditors who were excluded from the deliberations in the most objectionable of connected party pre-packs, thereby minimizing the potential complaints and controversy that often surround such deals. In other words, the recommendation aims to improve the reputation of pre-packs by reducing the chances of creditors complaining after the fact, rather than on correcting the informational asymmetries that fuel the power imbalance between those creditors who are excluded from the pre-pack deliberations and the insiders.

⁵⁵¹ *ibid.*

⁵⁵² Paterson (n 516) 608-609.

Xie's third recommendation, namely, strengthening and widening the role of the Insolvency Service to investigate and sanction IP misconduct, also falls short of addressing the underlying problems with pre-packs because it is an ex post solution. Although the threat of stricter enforcement may deter abuse and misconduct, in general it would be more efficient to prevent abuse and misconduct before they occur, that is, before a pre-pack deal is concluded. The best way in which to do so would be to empower disaffected creditors who were excluded from the pre-pack deliberations to scrutinise and challenge the terms of the pre-pack ex ante. Where such excluded creditors are given a full picture of the circumstances and terms of the proposed pre-pack in advance, and where they have cause to believe that the pre-pack may be abusive or that the administrator may have engaged in some form of misconduct, then those creditors should be able to complain to the administrator, the Insolvency Service or a court before the deal is completed. In these regards, it is not enough to object, as Xie seems to suggest, that permitting creditors to challenge pre-packs before they are completed would cause unnecessary delays and impose additional costs upon the parties in otherwise benign pre-packs. On the contrary, since every pre-pack is technically a formal proceeding conducted under the auspices of the Insolvency Act 1986, it behooves the courts and regulators to provide meaningful oversight and to prevent any abuses of the insolvency regime, both because ex ante enforcement would more effectively maintain public confidence in the integrity of the regime and because ultimately it would be more cost-effective, on the whole, than any ex post corrective measures.

In summary, as the reform proposals offered by Xie and Kastrinou and Vullings are focused mainly on improving the reputation of pre-packs, they fail to identify and address the serious underlying problems with pre-packs. Ironically, if these reform proposals were implemented, aside from failing to address the underlying problems with pre-packs, they would also likely fail to improve the reputation of pre-packs because pre-packs will continue to attract public scrutiny and controversy unless their underlying problems are addressed. Indeed, it is difficult to imagine that pre-packs would attract much controversy at all if they routinely delivered better results for preferential and unsecured creditors than standard administrations. More generally, even though Xie's recommendations may well enhance the transparency of pre-packs, transparency is not an end in itself. Rather, the goal of transparency should be pursued so as to empower those creditors who are excluded from the pre-pack deliberations, so that they can challenge the deal where

it is appropriate to do so, that is, where the deal is unlikely to deliver the best possible results for all stakeholders. Put another way, transparency is a means to prevent harm and enhance recoveries for all stakeholders, particularly those with already limited capacities to protect their interests in pre-packs, such as preferential and unsecured creditors.

III. REFORM PROPOSALS

The foregoing discussion of recent reform proposals points up the need for a more robust and comprehensive approach to regulating pre-packs. There is no indication that Parliament contemplated the dramatic rise of pre-packs when it passed the Enterprise Act in 2002. Indeed, pre-packs are creatures of judicial decision-making and their emergence is peculiar given their functional similarities to administrative receivership, which the Enterprise Act effectively abolished. Accordingly, and in light of the new data on pre-packs set out in Chapter 4, as well as the continuing public controversy surrounding pre-packs, strong safeguards should be implemented to protect preferential and unsecured creditors and to minimise the potential harms of pre-packs.

As discussed in further detail in Chapter 1, insolvency law generally aims to achieve the following three broad objectives:⁵⁵³

- 1) the preservation and maximisation of the value of insolvent enterprises;
- 2) the fair treatment of all stakeholders, including especially the fair distribution of assets among them; and
- 3) the investigation of the causes of insolvency, so as to minimise harm and abuse in the future.

Currently, pre-packs have the potential to undermine all three of these goals. With respect to value maximisation, the data set out in Chapter 4 disclosed that pre-packs were correlated with significantly lower realisations than going concern sale administrations across almost all sizes of debtor companies. At the same time, the total costs of pre-packs, taking into account pre-appointment fees, were only modestly lower than the costs of standard administrations. As for the fair treatment of stakeholders, on average secured creditors clearly obtained better returns in pre-packs compared with other procedures, whereas preferential and unsecured creditors obtained lower returns because of the lower total realisations in pre-packs. Perversely, average returns for creditors as a whole were only marginally lower in pre-packs than other

⁵⁵³ See Chapter 1 for further discussion.

procedures, suggesting that the value lost by preferential and unsecured creditors flowed to secured creditors. Put another way, preferential and unsecured creditors were worse off while any benefits of the pre-pack flowed to the secureds. Lastly, the goal of investigating the causes of insolvency is undermined when only 62% of SIP 16 reports are compliant and, in particular, where only 11% of connected party pre-packs are referred to the Pool. Furthermore, as discussed earlier, the Pool currently has no investigative powers and the Insolvency Service has ceded monitoring of SIP 16 filings to the professional regulatory bodies. In the circumstances, it strains credulity to suggest that current pre-pack practices facilitate the investigation of the causes of insolvency in most cases.

Several steps should be taken immediately in order to address the problems with connected party pre-packs. As noted earlier, connected party pre-packs are correlated with significantly worse outcomes for creditors as a whole than other types of administration. The Graham Report found that two-thirds of pre-packs were made to connected parties, and that businesses sold in connected sales were nearly twice as likely to fail as businesses that were sold to third parties. These findings were supported by the data set out in Chapter 4, which showed that nearly half of all pre-packs were made to connected parties – a far higher percentage than in other types of procedures – and that connected purchasers had significantly lower survival rates than unconnected purchasers after 60 and 120 months. Perhaps most striking was the finding that unconnected pre-packs resulted in average total realisations that were twice as high as realisations in connected party pre-packs, controlling for debtor size and other variables.⁵⁵⁴ Given the dismally low numbers of connected party pre-packs that were referred to the Pool in the years since it was formed, it is clear that referrals and ex ante disclosure should be mandatory in cases of connected party pre-packs in order to permit basic oversight and to prevent abusive and other value-destructive outcomes. In particular, the following three steps should be taken to regulate connected party pre-packs.

Firstly, as Adebola has suggested, the Graham Report's recommendations should be made mandatory. Specifically, all connected party pre-packs should be submitted to the Pool in advance of the sale, along with a viability report stating how the purchaser and the business will survive for the next 12 months. In addition, following Xie's suggestion, the administrator should be required to prepare a sensitivity analysis setting out the projections and appraisals underpinning the decision to pre-pack, including any

⁵⁵⁴ Mokal and others (n 385) 52.

assumptions about the likelihood of securing new financing or finding other buyers. However, while Xie recommends that the administrator only submit this report to the creditors after the pre-pack has concluded, a better approach would be for the administrator to submit the report to the Pool for its consideration and comments in advance of the sale. Likewise, the administrator should submit the SIP 16 report, or the key information typically included in it – such as the details of the sale process, the justification for the pre-pack, and details of the administrator’s fees – to the Pool prior to the sale.

Secondly, the powers of the Pool should be expanded significantly. The administrator and debtor company should be required to fully disclose the details of the connected party pre-pack to the Pool ex ante, and confidentially, for the Pool’s review, comments and approval. In addition to acting as the primary gatekeeper of connected party pre-packs, the Pool should be empowered to request additional information from the administrator, debtor and purchaser and to consult with all interested parties, if and when the Pool deems it appropriate to do so. The Pool could then determine whether the deal should proceed and affected parties could appeal the Pool’s decision in court, if necessary. The Pool could be further empowered to refer cases of suspected abuse or misconduct to the Insolvency Service. This approach would have several benefits. As an independent body, the Pool could act in the best interests of the creditors as a whole and without any question of impropriety, thereby maintaining the confidence of creditors and the wider public in the integrity of the pre-pack regime. As unsecured creditors are often diffuse and lack the resources and expertise to successfully challenge pre-packs, the Pool would be well placed to safeguard their interests, in particular, thereby fulfilling an underlying goal of the Enterprise Act to protect unsecured creditors. At the same time, expanding the role of the Pool would also address the concern that requiring ex ante disclosure of the terms of the proposed pre-pack to all creditors might imperil the deal or otherwise harm the business through the disclosure of commercially sensitive information. The Pool could receive all of the details of the proposed pre-pack on a confidential basis and only advise affected stakeholders of the details pertinent to them, or instruct the administrator to do so, if and when the Pool deems it appropriate. In addition, empowering the Pool in this manner would also eliminate the need for Xie’s suggestion to appoint a different administrator than the IP who prepared the pre-pack, because the Pool would serve as the primary gatekeeper and supervisor of the pre-pack rather than the administrator. The corresponding concern that mandating the appointment of different IPs for pre- and post-appointment work might impose

onerous costs on the debtor company and its creditors would also be eliminated, as the costs for maintaining the Pool could be spread across all pre-packs, thereby defraying the costs in each individual proceeding.

In tandem with expanding the powers of the Pool, Parliament should take steps to make Pool members accountable for providing comprehensive and fair assessments of proposed pre-packs. Affected parties should be able to demand full transparency from Pool members regarding the bases for their assessments and to bring actions against Pool members for negligence or misconduct, whether directly through the courts or indirectly by complaining to the Insolvency Service, the latter of which could then investigate and impose fines and sanctions where warranted. Clear guidelines should be provided to Pool members with respect to conducting and reporting on their assessments of pre-packs so as to enhance transparency, predictability and public confidence in the integrity of the Pool's work. One option would be to require the Pool to submit confidential reports of its assessments to the Insolvency Service, so that comprehensive records are available for the Insolvency Service's review in the event that any stakeholders lodge complaints or so that the Insolvency Service can conduct periodic audits of Pool members' activities and adherence to established guidelines and practices. Conversely, the Pool and its members should be immunized from actions brought by administrators or other parties in favour of the proposed pre-pack, as those parties are likely to be "insiders" who were involved in negotiating the pre-pack without the involvement of most other stakeholders of the insolvent debtor. Protecting the Pool and its members in these ways would strengthen the Pool's independence and encourage Pool members to carefully scrutinise the terms of proposed pre-packs with a view to protecting "outsiders" and those stakeholders who are most likely to bear the brunt of the downside risks and losses that may flow from the pre-pack.

Thirdly, in line with Xie's suggestion, the powers of the Insolvency Service to investigate and sanction abuse and misconduct should be strengthened and expanded. The Insolvency Service's responsibilities in these regards would be simplified if the above recommendations regarding ex ante disclosure requirements in connected party pre-packs were also adopted. The Pool would be in a position to do much of the initial investigative work and to provide the Insolvency Service with its findings. The Insolvency Service could then determine whether the evidence warrants further investigation or whether to pursue proceedings against the administrator or other parties in the pre-pack. Similarly, as discussed

immediately above, the Insolvency Service should also monitor the conduct of Pool members, hear complaints from stakeholders, and investigate and impose fines and sanctions where appropriate. Expanding the role of the Insolvency Service in this way, in tandem with the above recommendations, would likely serve as a powerful deterrent of misconduct and abuse in connected party pre-packs.

Lastly, Parliament should consider implementing the above requirements for all pre-packs, not simply connected party pre-packs. The data set out in Chapter 4 and in the Wolverhampton Report suggest that all pre-packs, are correlated with worse outcomes for creditors as a whole, and for unsecured creditors in particular. At the same time, pre-packs are correlated with better outcomes for secured creditors than other procedures. In short, pre-packs are functionally quite similar to administrative receiverships. This is especially peculiar because the Enterprise Act sought to “tip the balance firmly in favour of collective insolvency proceedings” and to improve the position of unsecured creditors by abolishing administrative receivership.⁵⁵⁵ By generally excluding junior creditors from the initial deliberations and withholding disclosure of the details of the proposed deal, pre-packs fundamentally undermine the collective nature of the post-Enterprise Act administration regime. The natural power imbalances between the secured creditors who typically negotiate the pre-pack with the debtor’s managers and the junior creditors who are excluded are exacerbated not only by informational asymmetries, but also by the reduced capacity of junior creditors to scrutinise and challenge the terms of the deal because they often lack the required resources, knowledge, and expertise to participate in the insolvency process.⁵⁵⁶ These power imbalances can be mitigated by imposing the ex ante disclosure requirements discussed above and by empowering the Pool to act in the best interests of unsecured creditors where, for example, coordination problems prevent unsecured creditors from acting for themselves.

Some obvious concerns with the foregoing recommendations are that they might impose onerous costs on parties in pre-packs and delay the completion of deals that would preserve the going concern value of the insolvent debtor’s business. In other words, stricter regulation of pre-packs, no matter how

⁵⁵⁵ Insolvency Service (n 129).

⁵⁵⁶ This is a general point about the capacity of junior creditors in most SME pre-packs, which comprise the majority of pre-packs. It is entirely possible that in some pre-packs, particularly those involving very large debtor companies, some of the junior creditors will be much more sophisticated and will not be relatively as disadvantaged. See Paterson (n 516) 614-615. For a detailed examination of the particular needs of insolvent SMEs, see Riz Mokal and others, *Micro, Small and Medium Enterprise Insolvency: A Modular Approach* (OUP 2018).

well-intentioned, may stifle good deals and ultimately cause more harm than good. This may be particularly concerning because most pre-packs involve SMEs, and these entities are least able to bear the additional costs of complying with stricter regulations. Upon reflection, however, such concerns are overstated. The statistics concerning referrals to the Pool show that basic monitoring and oversight functions are absent for the vast majority of pre-packs in the critical period of time prior to the completion of the deal. Moreover, although ex post challenges of pre-packs are hypothetically possible, in practice they are likely to be severely hampered by coordination problems among preferential and unsecured creditors, by informational asymmetries owing, among other things, to non-compliant SIP 16 reports, and by the deference that courts will typically extend to the administrator's commercial decision to pursue a pre-pack. In short, it is no answer to the problems discussed here and in Chapter 4 to say that effective regulation of pre-packs would be too expensive or onerous. On the contrary, preventing abuse and other value-destructive practices before they occur would be a far less expensive approach, on the whole, than relying on sporadic ex post challenges of pre-packs by disaffected creditors, by the professional regulatory bodies or by the Insolvency Service. Furthermore, implementing robust mechanisms to improve transparency and accountability – for example, additional disclosure requirements, granting investigative powers to the Pool, and charging the Pool with considering the best interests of unsecured creditors – would undoubtedly enhance the confidence of participants and the wider public in the integrity of the pre-pack regime.

IV. CONCLUSION

This chapter began by examining recent proposals to reform the pre-pack regime, with emphasis on the Graham Report and its findings, recommendations and impact. This discussion concluded that the Graham Report failed to achieve its ultimate objectives of improving pre-pack outcomes and enhancing public confidence in the pre-pack regime through the adoption of voluntary best practices by IPs and other market participants. This chapter further argued that much of the recent literature on pre-packs in the wake of the Graham Report has failed to fully appreciate the potential harms of pre-packs, while exaggerating their purported benefits. Accordingly, recent reform proposals premised on the notion that pre-packs are generally benign have placed undue emphasis on improving the reputation of pre-packs rather than on addressing the problems with pre-packs. In many ways, pre-packs exacerbate the natural power

imbalances among creditors in insolvency and can lead to worse outcomes for preferential and unsecured creditors compared with standard administrations.

The Graham Report itself recognized that if its “comply or explain” approach did not lead to the voluntary adoption of its recommendations, then Parliament should consider legislating. The low numbers of referrals to the Pool and the poor SIP 16 compliance rates demonstrate that the market has not voluntarily adopted the Graham Report’s recommendations. In the years since the Graham Report was issued, the public controversy surrounding pre-packs has not abated. Meanwhile, the data disclosed in Chapter 4 do little to instill confidence in preferential and unsecured creditors that the pre-pack process, in its current form, will lead to positive outcomes for them. In the circumstances, the proposed reforms discussed here are appropriate policy responses to the ongoing problems with pre-packs.

CHAPTER 6:
REORGANISATIONS, SALES, AND THE CHANGING FACE OF RESTRUCTURING IN CANADA:
QUANTITATIVE OUTCOMES OF 2012 AND 2013 CCAA PROCEEDINGS⁵⁵⁷

I. INTRODUCTION

The Companies' Creditors Arrangement Act⁵⁵⁸ ("CCAA") is the principal legal mechanism for restructuring large, insolvent corporations in Canada.⁵⁵⁹ As discussed in Chapter 2, historically CCAA restructurings involved lengthy negotiations among the creditors and other stakeholders of insolvent debtors, culminating in a formal restructuring plan on which the creditors would vote. In most cases, the aim was to restore the debtor company to profitability and continue operating. More recently, the emphasis of most CCAA proceedings has shifted away from the objective of reorganizing the debtor company as such toward the sale of the debtor's assets, whether piecemeal or on a going concern basis. These "liquidating CCAAs" are typically planned before the debtor company has applied for CCAA protection. Once CCAA protection is granted, an abridged process is carried out in which the debtor's assets are marketed and sold. Often, there is either no formal plan of arrangement or the plan simply provides for the distribution of the sale proceeds to the debtor's creditors. In this way, the CCAA is said to have evolved into a more flexible mechanism that permits traditional reorganisations as well as sales of substantially all the assets of insolvent debtor companies.⁵⁶⁰

Somewhere amidst this evolution in CCAA law, important questions have been left unanswered. Proponents of liquidating CCAAs maintain that sales generate better returns for creditors compared with reorganisations while still preserving the debtor's underlying business in many cases, thereby saving jobs and avoiding many of the negative consequences of a liquidation in bankruptcy.⁵⁶¹ Central to this view of

⁵⁵⁷ An earlier version of this chapter was presented at the 2018 Purdy Crawford Emerging Business Law Scholars Workshop hosted by the Schulich School of Law at Dalhousie University. A revised version is forthcoming in the 2019 Dalhousie Law Journal. See Appendix B.

⁵⁵⁸ CCAA (n 1).

⁵⁵⁹ The terms "company", "corporation" and "entity" are used interchangeably throughout this chapter. Pursuant to Section 3(1) of the Act, any "debtor company" or affiliated debtor companies having at least \$5 million in debt can apply for CCAA protection. Although the definition of "debtor company" in Section 2(1) does not expressly include entities such as partnerships, the courts have used their inherent jurisdiction to extend protection to partnerships that are part of corporate groups in CCAA proceedings. See, for example: *Re Lehndorff General Partners Ltd* (1993) 9 BLR (2d) 275 (SCJ); *Re Canwest Global Communications Corp*, 2009 CanLII 55114 (ON SC), *Re Calpine Energy Canada Ltd* (2006) 19 CBR (5th) 187.

⁵⁶⁰ *Re 8640025 Canada Inc.*, 2018 BCCA 93 para 45.

⁵⁶¹ Anthony Duggan and others, *Canadian Bankruptcy and Insolvency Law: Cases, Text and Materials* (3rd edn, Emond Montgomery 2015) 614.

liquidating CCAAs is the implication that any harm to junior creditors that might result from the abridged process is minimal and, in any event, is outweighed by the supposed benefits of the quick sale. Thus far, however, there has been no empirical evidence presented in support of such assertions. The reality is that, despite years of debate over the propriety of liquidating CCAAs, there remains a paucity of data on the outcomes of CCAA proceedings. Liquidating CCAAs and their most recent derivative, pre-packaged sales or “pre-packs”, continue to proliferate even though quantitative evidence of their supposed benefits is noticeably absent from the jurisprudence and the scholarship.⁵⁶²

This chapter examines the quantitative outcomes of CCAA proceedings commenced between January 1, 2012 and December 31, 2013. Specifically, this chapter examines data on the duration, costs, and outcomes of CCAA sales and full reorganisations. Necessarily, the decision to pursue any given restructuring option consigns “all other possible outcomes... to the realm of the hypothetical”.⁵⁶³ Accordingly, the key data points examined in this chapter serve as proxies for evaluating the relative success of liquidating CCAAs compared with full reorganisation proceedings.

Part II below provides a general overview of the CCAA regime and discusses the emergence of liquidating CCAAs and their implications. Part III describes the methodology of the quantitative study undertaken here and the results, asking whether the data support assertions that liquidating CCAAs are indeed faster, cheaper and more likely to maximise value for creditors than traditional reorganisations. Part IV considers the implications of the quantitative results presented here and proposes reforms of the CCAA regime. Part V concludes.

II. OVERVIEW OF CANADIAN RESTRUCTURING LAW

1. Structure and Purposes of the CCAA

The CCAA is the primary mechanism for resolving large, complex corporate insolvencies in Canada. Alternatively, insolvent corporations may file a commercial proposal under the Bankruptcy and

⁵⁶² See Tushara Weerasooriya and others, “Pre-Packs under the *Companies’ Creditors Arrangement Act*: Has the Push for Efficiency Undermined Fairness?” in Janis P Sarra and Honourable Barbara Romaine (eds), *Annual Review of Insolvency Law 2016* (Carswell 2017) 349: “further empirical analysis is required in order to validate and better understand the benefits of pre-packaged transactions.” See Chapter 2 for a further discussion of the theoretical concerns with liquidating CCAAs.

⁵⁶³ Jones (n 225) 481.

Insolvency Act⁵⁶⁴ (BIA). While the BIA commercial proposal process is popular with small and mid-sized enterprises, it is rarely used by large corporations or corporate groups. Accordingly, there are typically many more BIA proposals than CCAA proceedings annually, but the average size of the debtor corporations is much higher in CCAA proceedings. For example, the Office of the Superintendent of Bankruptcy Canada (OSB) reported that there were 32 CCAA proceedings initiated in 2013, compared with 754 commercial proposal proceedings; however, the average total value of assets in BIA proposals was \$875,649, compared with \$105,234,468 in CCAA proceedings.⁵⁶⁵

There are several reasons why the CCAA is the preferred tool for large, complex restructurings. As discussed in Chapter 2, the BIA prescribes various strict deadlines that a debtor must meet in order to remain under court protection.⁵⁶⁶ In contrast, the CCAA has no hard deadlines, and the CCAA process can be extended by court order for as long as may be necessary to facilitate the restructuring. In addition, if the creditors vote against a commercial proposal under the BIA, the debtor is automatically assigned into bankruptcy.⁵⁶⁷ Under the CCAA, meanwhile, a debtor whose creditors have rejected its restructuring plan may remain under court protection, and may continue negotiating with its creditors with a view to revising its plan.

The broad discretion accorded to CCAA judges also makes the CCAA a more flexible restructuring tool than the BIA. As the Supreme Court of Canada explained in *Century Services Inc v Canada (Attorney*

⁵⁶⁴ BIA (n 53) Part III, Division I.

⁵⁶⁵ See Roderick J Wood, "Receiverships in Canada: Myth and Reality" (2017) Sask L Rev 231, 243-245, citing Office of the Superintendent of Bankruptcy, *CCAA Statistics in Canada: Fourth Quarter of 2015* (Ottawa: Industry Canada), online: Government of Canada Publications <<http://publications.gc.ca/site/eng/9.507922/publication.html>>. In fact, the average value for CCAA companies in 2013 was low – in 2014, the average value was \$156,559,320, and in 2015 it was \$579,444,450. This fluctuation may be explained, in part, by the relatively small number of cases in each year, such that a few very large insolvencies skew the average. Nonetheless, these average values show that the CCAA tends to be used by only the largest companies in Canada.

⁵⁶⁶ For example, see: s 50.4(2)(b), which requires the debtor to file a cash flow statement within 10 days of filing its notice of intention to file a proposal, and s 50.4(8), which provides that the debtor must file its proposal within 30 days from the notice date, failing which the debtor will be assigned to bankruptcy automatically.

⁵⁶⁷ BIA (n 53) s 61(2)(b).

General),⁵⁶⁸ the CCAA is a relatively short statute which empowers supervising judges to grant orders approving restructuring steps that may not be specifically authorized in the explicit language of the Act.⁵⁶⁹

Courts frequently observe that “[t]he CCAA is skeletal in nature” and does not “contain a comprehensive code that lays out all that is permitted or barred” (*Metcalfe & Mansfield Alternative Investments II Corp. (Re)*, 2008 ONCA 587 (CanLII), 92 O.R. (3d) 513, at para. 44, *per* Blair J.A.). Accordingly, “[t]he history of CCAA law has been an evolution of judicial interpretation” (*Dylex Ltd., Re* (1995), 1995 CanLII 7370 (ON SC), 31 C.B.R. (3d) 106 (Ont. Ct. (Gen. Div.)), at para. 10, *per* Farley J.).

CCAA decisions are often based on discretionary grants of jurisdiction. The incremental exercise of judicial discretion in commercial courts under conditions one practitioner aptly describes as “the hothouse of real-time litigation” has been the primary method by which the CCAA has been adapted and has evolved to meet contemporary business and social needs (see Jones, at p. 484).

The broad discretion granted to CCAA judges corresponds with the broad remedial purposes of the Act, namely, to permit insolvent debtors “to continue to carry on business and, where possible, avoid the social and economic costs of liquidating [their] assets.”⁵⁷⁰ In pursuing these objectives, courts must give “an appropriately purposive and liberal interpretation” to the Act’s provisions.⁵⁷¹ The “broad reading of CCAA authority developed by the jurisprudence” has been recognized by Parliament in Section 11 of the Act, which empowers the CCAA court to “make any order that it considers appropriate in the circumstances”.⁵⁷²

The structure of the CCAA reflects its purpose of facilitating traditional reorganisations, in which creditors negotiate among themselves over the fate of the insolvent debtor company.⁵⁷³

The whole CCAA process is geared towards the development of a plan of arrangement that will be presented before the creditors for their acceptance or rejection. That this is the objective of the legislation is confirmed in the parliamentary debates, and in judicial statements at the highest level. Indeed, the very title of the Act anticipates the negotiation of a consensual arrangement amongst the creditors and the debtor. The statute sets out rules as to the mandatory features of the plan of arrangement and it contains the rules for the classification of claims, voting, and court approval of the plan.

Central to the CCAA’s reorganisation purpose was the view, prevalent at the time of its enactment, that reorganisation would permit companies to “retain more value as going concerns” and avoid the loss of

⁵⁶⁸ *Century Services* (n 55).

⁵⁶⁹ *ibid* paras 57-58.

⁵⁷⁰ *ibid* para 16.

⁵⁷¹ *ibid* para 65.

⁵⁷² *ibid* para 68.

⁵⁷³ Wood (n 8) 410-411.

goodwill and other intangibles that would result from liquidation.⁵⁷⁴ In this regard, the CCAA's purposes mirrored those of the reorganisation laws enacted by the U.S. Congress in the 1930s, as discussed in Chapter 3. The basic catalysts for enacting the CCAA were also similar, insofar as both Canada and the U.S. were deeply affected by the Great Depression at the same time, and bondholder reorganisations were complicated and cumbersome because they were governed by provincial law, just as reorganisations in the U.S. were governed by state law until Congress – the enactment of a federal reorganisation regime streamlined the process significantly in both countries.⁵⁷⁵

More recently, the CCAA jurisprudence has gradually come to recognise that, in addition to a traditional reorganisation, it is also possible to preserve the value of an insolvent enterprise through a sale of the underlying business on a going concern basis. However, given the CCAA's origins, structure and purposes, all of which are geared towards reorganisations, the emergence of liquidating CCAAs has given rise to several important issues that remain unresolved thus far. As a general matter, sales can also be carried out through court-appointed receivership proceedings and bankruptcy proceedings under the BIA. Accordingly, it is important to ask why many debtors seek to sell their assets through more expensive CCAA proceedings than through the more obvious alternative mechanisms under the BIA.

2. Emergence of CCAA Sales and Their Implications

As with many features of the modern CCAA regime, liquidating CCAAs are creatures of judicial decision-making that were introduced *ad hoc* in response to the exigencies of a rapidly changing restructuring landscape. However, the shift toward sales and away from reorganisations is one of the more remarkable judicially-driven “evolutions” of the CCAA because reorganisation and liquidation are fundamentally different processes.⁵⁷⁶ These two different uses of the CCAA can be described as follows:⁵⁷⁷

⁵⁷⁴ *Century Services* (n 55) para 18.

⁵⁷⁵ For a detailed discussion of the early history of the CCAA, see Virginia Torrie, “Protagonists of company reorganisation: A history of the *Companies' Creditors Arrangement Act* (Canada) and the role of large secured creditors (PhD Thesis, Kent Law School, September 2015) 79-105.

⁵⁷⁶ To be clear, judicial decisions introducing new features to the CCAA process typically have been in response to requests from the insolvent debtor or its stakeholders. But CCAA courts are often so willing to grant whatever relief is sought that the outcomes of such requests are almost foregone conclusions in many cases. In this sense, as one senior restructuring lawyer asserts, the “court's statutory discretion is to be exercised in furtherance of whatever the debtor wants.” See David Bish, “In Search of the Limits of Judicial Discretion in Insolvency Law” (2018) 7 J Insol Inst Can 181,197.

⁵⁷⁷ Duggan and others (n 561) 612-613, citing *Nocilla* (n 219) 384-385.

(a) *Reorganization*: Traditionally, the debtor would prepare a plan of arrangement designed to rehabilitate the debtor corporation so that it could continue in business and avoid bankruptcy. The debtor would present this plan at a meeting of its creditors for their approval. If a majority of each class of creditors representing two thirds of the value of the debt held vote in favour of the plan, the court may sanction the plan and the debtor may proceed to implement it.

[. . .]

(c) *Liquidating CCAA*: As discussed above, this is a relatively new type of proceeding in which the debtor's assets are sold either piecemeal or on a going concern basis under the CCAA court's supervision. The sales may occur pursuant to a plan that has been approved by the creditors, or they may occur in the absence of a plan. Notably, many recent CCAA proceedings have been liquidating CCAs from the outset. That is, the debtor never intended to present a reorganisation plan to its creditors, and merely applied for CCAA protection so that it could begin a marketing process to sell substantially all of its assets. In such cases, the debtor might present a post-sale plan to its creditors that is essentially a plan of distribution of the sale proceeds, or the debtor may simply enter bankruptcy proceedings.

As noted earlier, it is clear that the CCAA was never intended to be used as a liquidation tool. Nonetheless, courts now regularly approve CCAA sales as alternatives to reorganisations.⁵⁷⁸

In recent years, the CCAA has often been invoked in so-called "liquidating CCAs" in which the sale of substantially all the assets of the debtor company takes place and the company ceases to operate. Although this development has been questioned as contrary to the original purpose of the CCAA (see A. Nocilla, "Is Corporate Rescue Working in Canada?" (2013) 53 *Can. Bus. L.J.* 382), innovation has been the hallmark of the evolution of the CCAA and in some instances, a liquidation may turn out to be the best way to avoid the "social and economic cost" attendant upon an insolvency.

At the same time, the use of other mechanisms to restructure or liquidate the assets of debtor companies, such as court-appointed receivers, has all but disappeared for large companies. Several reasons may explain this shift away from receiverships, including, for example, the flexibility of the CCAA and the broad powers of the CCAA judge compared with receivers. Perhaps most importantly, however, successor employer liability is less of a concern for the debtor company carrying out a liquidating CCAA, whereas a similar sale through a receivership could attract successor employer liability for the receiver under provincial labour and employment laws. As such, since the Supreme Court of Canada's 2006 decision in *TCT*

⁵⁷⁸ *Re 8640025 Canada Inc* (n 4). See also *Arrangement relatif à Bloom Lake*, 2017 QCCS 4057 para 174: "[t]he Court notes that there is nothing in any way pejorative about qualifying the CCAA as a liquidating CCAA. That is a legitimate and increasingly frequent use of CCAA proceedings."

Logistics,⁵⁷⁹ which held that receivers could be found liable as successor employers, receiverships have seen a marked decline while CCAA sales have been on the rise.⁵⁸⁰

The shift to using the CCAA predominately for sales rather than reorganisations presents a number of issues. Firstly, although amendments to the Act in 2009 codified the court's authority to approve CCAA sales under Section 36, as I have argued elsewhere, Section 36 is deeply flawed.⁵⁸¹ In adding Section 36 to the Act, Parliament seems not to have fully appreciated the implications of using the CCAA to sell the assets of insolvent companies wholesale, a process that was previously carried out in receivership and bankruptcy proceedings. Specifically, Parliament failed to provide substantive guidance to CCAA judges in determining whether to approve liquidating CCAAs or even to specify which test courts should use – although Section 36(3) sets out various factors that courts should consider when asked to approve a sale, these factors overlap significantly with the older test used in receivership sales, which is based on the Ontario Court of Appeal's decision in *Royal Bank v Soundair*.⁵⁸² The result is that courts have taken to applying both tests in many cases, apparently unsure of which one ought to govern, with some courts stating that Section 36 is not determinative at all.⁵⁸³ In practice, the court will rely heavily upon the Monitor's opinion in deciding whether to grant the order authorizing the sale. The deference shown by courts to Monitors in CCAA sales mirrors the deference shown to receivers:⁵⁸⁴

If the court were to reject the recommendations of the Receiver in any but the most exceptional circumstances, it would materially diminish and weaken the role and function of the Receiver both in the perception of receivers and in the perception of any others who might have occasion to deal with them. It would lead to the conclusion that the decision of the Receiver was of little weight and that the real decision was always

⁵⁷⁹ *GMAC Commercial Credit Corp – Canada v TCT Logistics Inc*, 2006 SCC 35.

⁵⁸⁰ See *Bish* (n 226) 232 and *Carhart* (n 224). It should be noted that the shift from receiverships to CCAA sales is primarily a large company phenomenon, as private and court-appointed receiverships remain popular tools for smaller companies, see *Wood* (n 565).

⁵⁸¹ The amendments were introduced in Bill C-12, which passed on October 27, 2007 and subsequently became Chapter 36, An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005, 39th Parl, 1st Sess (27 October 2007), which came into force on September 18, 2009.

⁵⁸² (1991) 7 CBR (3d) 1 (Ont CA).

⁵⁸³ See *Re White Birch Paper Holding Co*, 2010 QCCS 4915 para 48: "The elements which can be found in Section 36 CCAA are, first of all, not limitative and secondly need not be all fulfilled in order to grant or not grant an order under this section." For further discussion, see also: Alfonso Nocilla, "Asset Sales Under the Companies' Creditors Arrangement Act and the Failure of Section 36" (2012) 52 CBLJ 226; Fitzpatrick (n 225).

⁵⁸⁴ *Calpine Canada Energy Limited (Companies' Creditors Arrangement Act)*, 2007 ABQB 49 para 52, citing *Crown Trust Co v Rosenberg* (1986), 60 OR (2d) 87 (Ont HC) 112.

made upon the motion for approval. That would be a consequence susceptible of immensely damaging results to the disposition of assets by court-appointed receivers.

There are at least some parallels here with pre-packs in the U.K. – the concept of a “pre-packaged administration” does not appear anywhere in the Insolvency Act 1986, and there are no statutory tests for approval of pre-packs, nor clear guidelines to assess the propriety or efficacy of proposed pre-packs. Rather, U.K. courts have taken the view that administrators must act according to their commercial judgment, and it is not for the courts to interfere in administrators’ commercial decision making.⁵⁸⁵

Secondly, whereas the BIA provides a detailed priority ranking scheme for distributing the proceeds from the sale of the bankrupt’s assets among its creditors, the CCAA contains no such distribution scheme.⁵⁸⁶ Accordingly, when a liquidating CCAA concludes, either the debtor will enter bankruptcy or receivership proceedings for the purposes of distributing the sale proceeds, or the debtor will file a formal plan of arrangement under the CCAA for the sole purpose of proposing how to distribute the proceeds among the debtor’s creditors. This state of affairs has led the Supreme Court of Canada to state that even though a liquidating CCAA may achieve essentially the same result as a BIA liquidation – a sale of substantially all of the debtor’s assets – the distribution scheme used in liquidating CCAAs need not be the same as the scheme set out in Section 136 of the BIA:⁵⁸⁷

In order to avoid a race to liquidation under the *BIA*, courts will favour an interpretation of the *CCAA* that affords creditors analogous entitlements. Yet this does not mean that courts may read bankruptcy priorities into the *CCAA* at will. Provincial legislation defines the priorities to which creditors are entitled until that legislation is ousted by Parliament. Parliament did not expressly apply all bankruptcy priorities either to *CCAA* proceedings or to proposals under the *BIA*. Although the creditors of a corporation that is attempting to reorganize may bargain in the shadow of their bankruptcy entitlements, those entitlements remain only shadows until bankruptcy occurs... [The debtor] chose to sell its assets under the *CCAA*, not the *BIA*.

The foregoing interpretation of the interplay between the BIA and CCAA is perplexing. In short, it is not at all clear why functionally equivalent processes under the BIA and CCAA should yield asymmetrical

⁵⁸⁵ See *Re Transbus* (n 17), in which the court held that an administrator may sell the debtor’s assets without creditor or court approval, where in the administrator’s opinion the unsecured creditors are likely to be paid in full or receive no payment; and *Re T&D Industries Plc* [2000] 1 WLR 646, 654: “a person appointed to act as an administrator may be called upon to make important and urgent decisions. He has a responsible and potentially demanding role. Commercial and administrative decisions are for him, and the court is not there to act as a sort of bomb shelter for him.” For further discussion, see Paterson (n 516) 608-609.

⁵⁸⁶ The BIA’s priority ranking scheme is set out in Section 136.

⁵⁸⁷ *Sun Indalex Finance, LLC v United Steelworkers*, 2013 SCC 6 para 51.

outcomes for stakeholders. Indeed, the foregoing statement in *Indalex* seems inconsistent with the Supreme Court's earlier statements in *Century Services*. In particular, the Supreme Court stated in *Century Services* that: (1) the BIA and CCAA form "part of an integrated body of insolvency law"; and (2) although the BIA and CCAA contain different reorganisation procedures because "reorganisations of differing complexity require different legal mechanisms", "only one statutory scheme has been found to be needed to liquidate a bankrupt debtor's estate."⁵⁸⁸ More recently, the Quebec Superior Court's decision in *Bloom Lake* pointed up the "strange asymmetry"⁵⁸⁹ that would result if the BIA scheme of distribution were not applied in liquidating CCAA proceedings.⁵⁹⁰

There is no statutory scheme of distribution under the CCAA because the CCAA is not intended to be the vehicle for a liquidation of assets and distribution of the proceeds. The CCAA is intended as a vehicle for the restructuring of the debtor...

[. . .]

The bottom line is that a liquidating CCAA requires a scheme of distribution and the only one which makes sense is the scheme of distribution under the BIA. As a result, and unless there is a contradiction between the CCAA and the BIA, the BIA scheme of distribution should apply in a liquidating CCAA.

Thus far, these apparently inconsistent approaches to the question of which distribution scheme ought to apply in liquidating CCAs remain unresolved.⁵⁹¹

Thirdly, and more generally, important protections available to stakeholders in full CCAA proceedings may be absent in liquidating CCAs. A traditional CCAA process may involve dozens of court appearances over the course of several months or even years. At each stage, the supervising judge would review the debtor's progress towards developing a viable plan of arrangement that treats all stakeholders fairly. In a liquidation, the goal is to complete the sale as quickly as possible. Most of the negotiations leading to the proposed sale would likely have occurred prior to the debtor's CCAA filing. Those negotiations would include the senior secured creditors and perhaps a few other key stakeholders, but would necessarily exclude most of the junior and unsecured creditors, as well as many other stakeholders. Moreover, in contrast to full CCAA proceedings, the negotiations in a liquidating CCAA would have taken

⁵⁸⁸ *Century Services* (n 12) para 78.

⁵⁸⁹ *Bloom Lake* (n 578) para 205, citing *Century Services* (n 12) para 47.

⁵⁹⁰ *ibid* paras 203-208.

⁵⁹¹ For further discussion, see DaRe and Nocilla (n 384).

place without the court's supervision. In short, the structure and procedures of the CCAA are poorly suited to sales and the likely losers in quick sales are those stakeholders who possess the least amount of leverage vis-à-vis the debtor and senior creditors.⁵⁹² While Parliament could certainly address these deficiencies in the structure and procedures of the CCAA to account for liquidating CCAs, doing so would require a comprehensive approach to amending the Act for which Parliament appears to have no appetite.⁵⁹³

In light of the foregoing issues, it is prudent to ask whether the CCAA is truly the most appropriate mechanism for liquidating CCAs, and if not, what can be done to remedy the situation. The answers to these questions depend, at least in part, upon how liquidating CCAs are affecting different types of stakeholders in practice compared with traditional CCAA proceedings. Yet, as discussed below, the available data on the outcomes of CCAA proceedings remain scarce.

III. QUANTITATIVE OUTCOMES OF 2012 AND 2013 CCAA PROCEEDINGS

1. Methodology

The OSB maintains an online public record of all CCAA proceedings initiated since September 18, 2009.⁵⁹⁴ A review of the OSB's online CCAA records list identified 77 separate filings between January 1, 2012 and December 31, 2013. These dates were selected for several reasons. Firstly, cases begun in 2012 and 2013 were almost all likely to have been completed by the time of this study, permitting collection of all available data on costs, returns to creditors and duration of proceedings. Secondly, although examining cases over several years would have been preferable to focusing on only two years, there were practical limitations to conducting a longer multi-year study. Although 77 CCAA proceedings may seem like a low number, many proceedings involved joint filings by complex corporate groups. In addition, as noted earlier, average asset values were significantly higher in CCAA proceedings than in other types of

⁵⁹² Wood (n 8) 412-415.

⁵⁹³ Historically, such comprehensive attempts at reforming the bankruptcy and insolvency regime have been non-starters in Ottawa. Arguably, the last major attempts at comprehensive reforms occurred in the 1980s, and all of them ended in failure. Consequently, since that time, successive governments have favoured a piecemeal approach to insolvency law reform. See Jacob S Ziegel, "The Travails of Bill C-12" (1983) 8 CBLJ 374; Jacob S Ziegel, "Canada's Phased-In Bankruptcy Law Reform" (1996) 70 Am Bankr LJ 383; Nocilla (n 23).

⁵⁹⁴ <https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/h_br02281.html>. The OSB is required to collect and maintain this public record pursuant to s 26(1) of the CCAA, which came into force on September 18, 2009.

insolvency proceedings, such as BIA commercial proposals. CCAA filings are accordingly complex, and the 77 proceedings examined from 2012 and 2013 included hundreds of Monitors'⁵⁹⁵ reports, court orders and motion materials, all of which were reviewed individually in order to manually record the relevant data. Document review, manual data extraction and verifying database entries consumed over 230 hours of research time, or roughly 3 hours per CCAA proceeding, although actual times per case varied significantly because some cases were much longer and more complex than others.

A list of CCAA proceedings was created in Excel based on the OSB's records. Electronic versions of records of each proceeding were then gathered from the websites of the Monitors appointed in each case.⁵⁹⁶ These records included court orders, notices to creditors, and Monitors' reports detailing the progress of each case. The following data were manually collected and entered into the database, where available:

- a. ID Number: Each case was assigned a unique identification number. Corporate group filings were treated as a single case/filing because the restructurings of different entities within the same corporate groups were conducted through collective CCAA proceedings in each case.
- b. Name of company: The name(s) of the entity or entities identified in the Monitor's reports.
- c. Commencement Date: Date on which CCAA proceedings were initiated, based on the court order granting CCAA protection.

⁵⁹⁵ The Monitor is an accountant and licensed trustee in bankruptcy appointed at the time of the initial CCAA order pursuant to Section 11.7. Although originally a judicial creation, the role and duties of the Monitor have since been codified in the CCAA. As an officer of the court, the Monitor is tasked with various duties under Section 23 of the Act, including especially the duties to report to the court on the debtor's business and affairs, investigate the causes of the debtor's insolvency, and generally to assist the debtor in its restructuring and advise the court as to the reasonableness and fairness of any proposed arrangement between the debtor and its creditors. The Monitor owes a fiduciary duty to the stakeholders of the insolvent debtor, must act independently, and must treat all parties in the CCAA proceedings reasonably and fairly. See *Winalta Inc (Re)*, 2011 ABQB 399 paras 67-77.

⁵⁹⁶ Among its other duties, the Monitor in each CCAA proceeding must make its reports and various other materials, including court orders and motion materials, publicly available on its website. The OSB's online CCAA records list includes links to the Monitor's website in each proceeding. However, as discussed later, Monitors' websites are typically taken down after a period of time has elapsed following the conclusion of the CCAA process, and accordingly, the relevant documents from each proceeding are not always readily available.

- d. End Date: Date on which the CCAA proceedings terminated, based on the court order terminating proceedings. For the 10 cases that remained ongoing at the time that this chapter was written, the current date (May 9, 2019) was used in order to calculate duration.⁵⁹⁷
- e. Incorporation Date: Date on which the debtor (for corporate groups, the parent company) was incorporated, as reported by the Monitor.
- f. Industry Sector: Business sector of the debtor, if recorded by the Monitor.
- g. Type of Proceeding: Each case was classified based upon a review of the Monitor's reports. Cases were classified as either traditional restructurings or liquidating CCAAs. Liquidating CCAAs were further divided into going-concern sales and piecemeal sales.
- h. Secured Debt: Total amount of secured debt at the time of filing.
- i. Preferred Debt: Total amount of preferred debt at the time of filing.
- j. Unsecured Debt: Total amount of unsecured debt at the time of filing.
- k. Secured Returns: Total returns to secured creditors upon termination of proceedings.
- l. Preferred Returns: Total returns to preferred creditors upon termination.
- m. Unsecured Returns: Total returns to unsecured creditors upon termination.
- n. Total Costs: Total costs incurred by the debtor in the CCAA process, including Monitor's fees and legal and other professional expenses.
- o. Name of Monitor and Law Firm: The names of the accounting firm and individual appointed as the debtor's Monitor, as well as the Monitor's legal counsel.
- p. Province: The province in which proceedings were initiated.

In general, the foregoing methodology and data points followed the methodology of the U.K. quantitative study set out in Chapter 3. There were three key differences between the U.K. and Canadian quantitative studies. Firstly, there were fewer Canadian cases, as only 77 total CCAA proceedings were commenced in 2012 and 2013; this number was generally in line with historical averages. Secondly, although the CCAA

⁵⁹⁷ In statistical terms, the durations of the ongoing cases are censored data – they are unknown. Various statistical methods may need to be applied in order to account for these data and avoid bias, see Mokai and others (n 385) 55. However, the numbers of cases in the present study are likely too small to model censored observations.

cases were fewer in number than administrations in the U.K., each CCAA restructuring tended to be far larger in scope and complexity than the typical U.K. administration. For example, the mean and median total debt in a CCAA restructuring were roughly \$152,000,000 and \$27,000,000, respectively, whereas pre-packs typically involved companies with total debts of less than £500,000. Thirdly, as described below, obtaining data on CCAA cases was generally more challenging, as full records were not always available online, and cases tended to be longer, with dozens of reports files over several years. In addition, there is no central repository for CCAA filings similar to Companies House's online system. Accordingly, digital copies of the CCAA court records had to be downloaded from the websites of the Monitor in each proceeding, or requested from the Monitor by email where the websites were no longer active or certain records were missing. The records were then reviewed and all data on the CCAA filings were manually collected and recorded.

2. Challenges with Data Collection and Cautionary Notes

Manual data collection and entry was a time-consuming process. For several reasons, it was often difficult and occasionally impossible to collect the relevant data. Firstly, successive Monitors' reports in each case rarely summarized the information that was presented in previous reports. Consequently, each successive report had to be reviewed in order to identify and manually enter the data. Secondly, many records were inconsistent both in terms of the data that they presented and the manner in which they presented it – despite their general similarities in formatting, Monitors' reports were rarely uniform across different cases. Thirdly, although Monitors are required during the term of the CCAA proceedings to maintain their reports, as well as court orders and other information for creditors on their websites, many Monitors' websites become inactive after the conclusion of proceedings. Accordingly, the relevant records could only be obtained by requesting them from individual accounting firms. Moreover, records of cases that had concluded several years ago and for which the Monitors' website had become inactive were often sparse.

Lastly, it should be noted that there are limits to what can be extrapolated from examining the data from only two years of CCAA proceedings because business cycles in different industries can strongly influence insolvency filings each year. Even during broad economic downturns, it is common for insolvency cases to be concentrated in only certain industry sectors. Consequently, the average size of debtor

companies, types of assets and duration of proceedings, among things, may vary significantly depending on the time period under examination. For example, CCAA cases in the early 1990s were dominated by the commercial real estate crash; the early 2000s, meanwhile, saw the failures of major technology and telecommunications firms such as Nortel and Canwest.⁵⁹⁸ Examining only certain years in isolation may, therefore, result in bias and limit the potential to generalise findings.⁵⁹⁹ Nonetheless, as discussed below, the data presented here offer several useful insights.

3. Results

Procedures By Type, Year and Province

Of the 33 CCAA proceedings initiated in 2013, 22 were liquidating CCAs (67%), 9 were traditional reorganisations (27%), and 2 were terminated shortly after commencement and entered bankruptcy or receivership (6%). Of the 44 CCAA proceedings initiated in 2012, 28 were liquidating CCAs (64%), 7 were reorganisations (16%), and 9 failed and entered bankruptcy or receivership (20%). Ontario had the most total filings (30) as well as the most liquidating CCAs (22) over both years, followed by Alberta (18 and 10, respectively), British Columbia (13 and 9, respectively), and Quebec (10 and 5, respectively). Total proceedings by type, province and year of filing are shown below in Table 1.

[see table on next page]

⁵⁹⁸ *Re Olympia & York Developments Ltd* (1993) 12 OR (3d) 500; *Re Canwest Global Communications Corp* (2009) 59 CBR (5th) 72; *Re Nortel Networks Corporation* (2009) 50 CBR (5th) 77.

⁵⁹⁹ Restructuring practitioners will often note that their business is cyclical and that periods of high activity are often, if not always, marked by major downturns in specific industries. Given the significant differences in the assets and operations of companies in the forestry industry compared with those in financial services, for example, examining only certain years of CCAA proceedings could lead to “lumpiness” in the data because the sample is skewed towards companies with specific characteristics. A much longer longitudinal study would be preferable for this reason alone, but it would require a significantly greater investment in time and resources than any quantitative studies of CCAA cases to date.

Table 1 – CCAA Filings By Type, Province and Year: January 1, 2012 to December 31, 2013

Province	Type of Filing	2013	2012	Total Both Years
ALTA.	Sale	3	7	10
	Bkptcy/Rec'p	1	4	5
	Reorganisation	2	1	3
B.C.	Sale	4	5	9
	Bkptcy/Rec'p	0	0	0
	Reorganisation	2	2	4
MAN.	Sale	1	2	3
	Bkptcy/Rec'p	0	0	0
	Reorganisation	0	0	0
N.B.	Sale	0	1	1
	Bkptcy/Rec'p	0	0	0
	Reorganisation	0	0	0
N.S.	Sale	0	0	0
	Bkptcy/Rec'p	0	1	1
	Reorganisation	0	0	0
ON.	Sale	11	11	22
	Bkptcy/Rec'p	0	2	2
	Reorganisation	2	4	6
P.E.I.	Sale	0	0	0
	Bkptcy/Rec'p	0	0	0
	Reorganisation	1	0	1
QUE.	Sale	3	2	5
	Bkptcy/Rec'p	1	0	1
	Reorganisation	2	2	4
TOTAL	Sale	22	28	50
	Bkptcy/Rec'p	2	7	9
	Reorganisation	9	9	18

Duration of Proceedings

Duration was calculated using the start date of proceedings, that is, the date on which the court granted the initial CCAA order, and the end date, that is, the date when the court terminated the CCAA proceedings. Data on duration were available for all 50 liquidating CCAAs. The total average duration across for these cases was 36 months, with a median duration of roughly 28 months. By comparison, the total average duration was 31 months for reorganisations, with a median duration of 21 months. For the 9 bankruptcies/receiverships, total average duration was roughly 21 months, with a median of roughly 25 months.

Total Costs

Total costs were calculated as a percentage of total returns to all classes of creditors. Full data were available for 37 of the 50 liquidating CCAAs. For these cases, total costs averaged roughly 13% of

returns. By comparison, average total costs were roughly 14% for reorganisations (6 cases) and roughly 30% for bankruptcies/receiverships (4 cases).

Total Returns by Type of Proceeding and Class of Creditor

Returns were calculated as percentages of the debts owing to each class of creditors. For liquidating CCAAs, overall returns to all classes of creditors were roughly 35% of debt (based on 37 cases), with average returns to secured creditors amounting to roughly 72% (17 cases), compared with roughly 41% for unsecured creditors (8 cases). By comparison, total returns in reorganisations were roughly 21% of total debt (8 cases) with roughly 54% for secureds (5 cases) and 56% for unsecureds (5 cases). For the bankruptcies/receiverships, average total returns were roughly 30% (4 of 9 cases).⁶⁰⁰

Company Size By Procedure

Total debt was used as a proxy for company size, with total debt of the corporate group as a whole used for measuring size in group filings. Average total debt in liquidating CCAAs was \$123,981,154, with a median of \$24,880,044 (for 46 of 50 available cases). By comparison, total average debt in reorganisations was \$348,752,998.31, with a median of \$153,253,000 (11 of 17 cases). For bankruptcies/receiverships, average total debt was \$55,578,414, with a median of \$26,171,027.50 (8 of 9 cases).

4. Comments and Analysis

CCAA Sales are Now the Norm

The foregoing data disclose that a solid majority of CCAA proceedings initiated in 2012 and 2013 were liquidating CCAAs – 64% and 67%, respectively. By comparison, an earlier study by the author found that roughly 33% of CCAA proceedings between 2002 and 2012 were liquidating CCAAs, while 31% were traditional reorganisations.⁶⁰¹ In addition, more recently, Janis Sarra reported that 78% of CCAA proceedings initiated between January 1, 2014 and November 1, 2016 were liquidating CCAAs.⁶⁰² In short,

⁶⁰⁰ The data on returns to different classes of creditors in bankruptcies/receiverships were too scarce to calculate average returns by class.

⁶⁰¹ See Nocilla (n 219) 388-389. It should be noted that this earlier study only examined reported decisions, whereas the present study gathered the available data on all proceedings initiated in 2012 and 2013.

⁶⁰² Janis Sarra, “The Oscillating Pendulum: Canada’s Sesquicentennial and Finding the Equilibrium for Insolvency Law”, Janis P Sarra and Honourable Barbara Romaine (eds) *Annual Review of Insolvency Law 2016* (Carswell 2017).

the trend towards using the CCAA as a mechanism for selling substantially all of the assets of the insolvent debtor company appears to be accelerating, such that CCAA sales are now the dominant form of proceeding. The data also disclose that while liquidating CCAAs are still most common in Ontario, they are now routinely carried out in provinces where courts had been reluctant to approve them in past, such as Alberta, British Columbia and Quebec.

CCAA Sales Took Longer Than Reorganisations

Interestingly, companies that sold all or substantially all of their assets spent more time in CCAA protection than companies that reorganized – an average of 36 months with a median of 28, compared with an average of 33 months and a median of 23, respectively. Speed is often touted as one of the supposed benefits of liquidating CCAAs, but these results suggest that liquidating CCAAs are, in fact, significantly lengthier procedures than full reorganisations. This finding, however, should be qualified by noting that the duration of CCAA proceedings does not necessarily reflect the time and resources spent on the sale process itself – for example, it is possible that many companies simply remained under CCAA protection for extended periods of time after selling off their assets, with minimal work done by the Monitor and legal counsel after the sale was completed. The reason for remaining in CCAA protection in many of these cases may simply have been to facilitate the distribution of the sale proceeds to the creditors.⁶⁰³ Nonetheless, it is interesting to note that CCAA sales do not appear to be faster than traditional reorganisations.

Total Costs Were Roughly Comparable in CCAA Sales and Reorganisations

Another supposed benefit of CCAA sales is that they are more cost-effective than full reorganisations, partly because they can be completed more quickly than reorganisations. Again, this assertion does not appear to be supported in the data collected here. In fact, it appears that overall costs, as a percentage of the returns generated by each procedure, were roughly comparable in each type of proceeding – 13% for liquidating CCAAs compared with 14% for reorganisations. Of course, this study only

⁶⁰³ This area is ripe for further investigation in future quantitative studies of CCAA proceedings. In order to obtain a comprehensive picture of the costs, durations and total returns of liquidating CCAAs, it would be necessary to review all of the relevant records from any concurrent or subsequent receivership or bankruptcy proceedings. Where less than all of the debtor's assets were sold in the CCAA proceedings, the remaining assets would be liquidated through bankruptcy or receivership, and the sales proceeds might then be distributed to the creditors through one of those processes rather than through the CCAA proceedings.

measured the direct costs of proceedings in the form of Monitors' fees, legal fees and other restructuring expenses. There may well have been significant indirect costs incurred by companies that underwent traditional reorganisations, such as the loss of goodwill and damage to relationships with suppliers and customers, that were not borne by companies which conducted quick sales of their assets; such indirect costs were not tracked in this study. To the extent that a sale can quickly transfer the debtor's underlying business on a going concern basis to a new solvent entity, untarnished by the insolvent debtor's troubles and with different management, then the business would not suffer the foregoing indirect costs. Accordingly, there may be additional cost savings in liquidating CCAAs that could not be tracked in this study. Nonetheless, these are interesting results, as we might still have expected to see lower direct costs for liquidating CCAAs because a quick sale would typically truncate the expensive CCAA process and reduce the number of court appearances required, thereby reducing direct costs significantly compared with a traditional reorganisation. It seems unlikely that these results can be explained by the longer duration of CCAA sales proceedings that was noted above; rather, a more likely explanation may be that CCAA sales are "front-loaded" in the sense that most of the work by the Monitors and legal counsel is being done at the outset of the process. Another explanation may be found in the fact that, as discussed below, typical candidates for liquidating CCAAs tended to be smaller companies than those that reorganized. In short, the CCAA remains an expensive process, and some costs are essentially fixed, such that smaller companies are likely to incur higher costs as a proportion of the overall value of their assets and, therefore, of the returns to their creditors following a sale, compared with larger companies. At all events, these data suggest that while CCAA sales might well be completed more quickly than traditional reorganisations, there are no significant savings in CCAA sales in terms of direct costs.

Overall Returns Were Higher in CCAA Sales, But Unsecured Creditors Were Worse Off

As noted earlier, overall average returns in liquidating CCAAs were significantly higher than in reorganisations – 35% compared with 21%. However, this overall number masked significant differences in terms of how different classes of creditors performed under each procedure. Specifically, in liquidating CCAAs, secured creditors enjoyed average returns of 72% of debt, while unsecureds averaged 41%. By comparison, average returns in reorganisations were 54% for secureds and 56% for unsecureds. Although care should be taken in interpreting these results due to the low numbers of cases for which the relevant

data were available, these results suggest that any benefits obtained in liquidating CCAAs flowed to secured creditors, whereas unsecureds were worse off compared with how they fared in reorganisations. Moreover, since a debtor that successfully reorganized would exit the CCAA process and continue to operate, it might reasonably be expected that the long-term prospects for unsecured creditors, and especially equity holders, would be much better in reorganisations than in liquidating CCAAs. Accordingly, although total overall returns were appeared to be significantly higher in liquidating CCAAs, there are some important caveats to that finding. Based on the admittedly limited data here, it would seem that secured creditors fared far better in liquidating CCAAs than in reorganisations, and to some extent this came at the expense of unsecured creditors.

IV. IMPLICATIONS AND REFORM RECOMMENDATIONS

Comparisons to Pre-Packs in the U.K. and 363 Sales in the U.S.

Although the available data in the present study were comparatively limited, the results here disclose some broad similarities in the outcomes of liquidating CCAAs in Canada, pre-packs in the U.K., and 363 sales in the U.S. As with pre-packs and 363 sales, liquidating CCAAs have clearly grown in popularity. At the same time, the average total costs of liquidating CCAAs were roughly comparable to those of traditional reorganisations. By comparison, the costs of pre-packs in the U.K. were only modestly lower than those of standard administrations, averaging 69.6% of total realizations, compared with 72.2% for standard administrations.⁶⁰⁴ While overall returns to creditors appeared to be higher in liquidating CCAAs than in traditional reorganisations, unsecured creditors ended up worse off in liquidating CCAAs. Likewise, pre-packs yielded particularly poor returns for preferential and unsecured creditors and marginally lower overall returns compared with standard administrations,⁶⁰⁵ while 363 sales yielded lower prices than Chapter 11 plan sales, even correcting for the financial health of the debtor companies examined.⁶⁰⁶ Lastly, pre-packs were only marginally faster than going concern sale administrations, having median durations of 11.8 months compared with 12 months, respectively,⁶⁰⁷ while liquidating CCAAs actually took longer than traditional reorganisations, with median durations of 28 and 23 months, respectively. The relative speed of

⁶⁰⁴ Mokal and others (n 385) 72, Figure 38.

⁶⁰⁵ *ibid* 111.

⁶⁰⁶ Anderson and Ma (n 198) 17.

⁶⁰⁷ Mokal and others (n 385) 13-14, Figure 4.

each procedure was the only significant difference in the results for liquidating CCAAs and pre-packs, on the one hand, and 363 sales, on the other: it is clear that 363 sales are significantly faster than full Chapter 11 plan sales, as the latter require far more steps to be completed, such as the development of a formal plan and a creditor vote, before the sale can be completed. Consequently, a Chapter 11 plan sale could take at least 3 months to complete, compared with mean and median durations of 82 and 74 days, respectively, for 363 sales.⁶⁰⁸

In short, the typical justifications of both liquidating CCAAs and pre-packs – namely, that they are faster, more cost-effective and more likely to yield higher returns than traditional reorganisation procedures – were not supported by the data gathered in either Canada or the U.K. This conclusion is particularly interesting given that the average sizes of debtor companies differed significantly between Canada and the U.K., with most CCAA companies having average total debts that were many times higher than those of the typical company in administration in the U.K. In other words, the data seemed to bear out some of the theoretical concerns with quick sale processes that were discussed in Chapter 2. Specifically, these types of procedures may favour secured creditors at the expense of unsecured creditors, perhaps precisely because these procedures remove the typical safeguards present in full CCAA or administration proceedings.⁶⁰⁹

In Canada, a result of changes to debt markets has been that the CCAA has become largely a senior creditors' statute, with increasing liquidations driven not by the local creditors of early bankruptcy legislation, but often by foreign creditors, resulting, in some instances, in diminution of economic activity and exit of assets. Rather than a race to assets by horse and buggy, the rapidity of distressed debt trading and the rush to litigation or threat of litigation is now pushing the pendulum back to a new kind of race to the assets. Many policies that facilitated trade and the movement of capital across borders, policies that underpinned Canada's economic growth, set the stage for what is occurring now. Courts are confronted with *fait accompli* applications before them, in effect bypassing many of the checks and balances of the system. Sales under these conditions often do not have the protections built into a CCAA plan that prevent misconduct.

At the same time, although 363 sales in the U.S. are clearly faster than Chapter 11 plan sales, 363 sales – like pre-packs and liquidating CCAAs – tend to leave unsecured creditors worse off than full Chapter 11

⁶⁰⁸ ABI Report (n 12) 84-86. See also Stephanie Ben-Ishai and Stephen J Lubben, "Sales or Plans: A Comparative Account of the "New" Corporate Reorganisation" (2011) 56:3 McGill LJ 591, 627 commenting on the greater speed of 363 sales compared with liquidating CCAAs.

⁶⁰⁹ Sarra (n 602).

plans. Indeed, 363 sales seem to generate lower returns for creditors overall because they bypass the typical protections that preferred and unsecured creditors possess in full Chapter 11 plan proceedings.⁶¹⁰

All of the foregoing results raise the question of why liquidating CCAAs, like pre-packs and 363 sales, continue to proliferate. Here, again, many of the same broad economic factors identified in Chapter 3 as drivers of 363 sales are also present in Canada. Firstly, it is plausible that the shift from a manufacturing-based to a services-based economy has also had downstream effects on the Canadian restructuring landscape. The Canadian services industry now comprises roughly 70% of GDP and employs 93% of the nation's workforce, compared with 80% of GDP and 95% of employment in the U.K. and 78% of GDP and 86% of employment in the U.S.⁶¹¹ In general, the shift towards a services-based economy means that more Canadian companies are comprised of intangible assets and highly fungible hard assets than in the past. While this does not mean that full reorganisation proceedings under the CCAA will necessarily disappear, going concern sales are an increasingly viable alternative given the ease and speed with which the intangible assets of troubled debtors can be transferred to new entities.⁶¹²

Secondly, as Janis Sarra notes, globalisation and changes in lending practices have significantly altered the restructuring playing field in Canada.⁶¹³

New products and strategies in the structure of finance, including syndication, securitization and collateralization, have profoundly altered the nature of debt. With the globalization of business, many cross-border enterprises have grown, both originating in Canada and as subsidiaries of large multinational enterprises. The result has been a fundamental shift in credit relationships from the many years of relational lending to a situation where both domestic and foreign creditors have little interest or direct connection with the debtor company and its stakeholders, other than an interest in short-term returns on their investment.

In an environment in which many lenders are primarily interested in a quick return, a liquidating CCAA represents an attractive alternative to a full reorganisation – even if a quick sale results in lower returns in some cases, the certainty of a swift resolution of the debtor's insolvency may be worth it to certain secured

⁶¹⁰ Anderson and Ma (n 198).

⁶¹¹ OECD National Accounts Statistics. Online: <<https://data.oecd.org/natincome/value-added-by-activity.htm>> accessed 21 July 2019. See also: Statistics Canada. Online: <<https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610043403>> and <<https://www150.statcan.gc.ca/n1/pub/11-402-x/2012000/chap/services/services-eng.htm>> accessed 21 July 2019; ONS (n 519).

⁶¹² The fact that a company is comprised largely of intangible assets and highly fungible hard assets does not necessarily entail a loss of going concern value: see Miller and Waisman (n 240) 192.

⁶¹³ Sarra (n 602) 7.

creditors.⁶¹⁴ At the same time, to the extent that new forms of lending, especially asset-based lending, have contributed to the fragmenting of insolvent debtors' financing structures, management and senior secured creditors may favour liquidating CCAAs as a way of both minimising the time spent negotiating with increasingly disparate groups of stakeholders and of enhancing the likelihood of a desired outcome, whether it be a quick payout of the senior secureds' claims or the continuation of the debtor's underlying business as a going concern, or both. In this way, a quick sale may be one response to the problem of the fragmentation of claims against an insolvent debtor limiting the range of resolution options and undermining the formation a stable coalition of stakeholders in support of a restructuring plan – in other words, the “empty core” problem identified by Baird and Rasmussen.⁶¹⁵ The threat of a quick sale by the court to force stakeholders back to the negotiating table or otherwise to resolve an impasse can be a particularly effective tactic.⁶¹⁶

Ordering the sale of the firm to the highest bidder is a way of putting a gun to the parties' heads. Judge Milton Pollock did essentially this in the bankruptcy of Drexel Burnham. He told the parties that if they could not reach agreement in short order, he would sell the firm's assets and retired to his chambers for a few minutes. Parties found the judge's threat credible and feared that a sale would make them all worse off (believing that the particular junk bonds were worth far more than the market would pay for them). Notwithstanding weeks of deadlock, they reached an agreement that was scribbled on a yellow legal pad just before time expired.

Thirdly, DIP financing has played a similar role in the Canadian restructuring world as it has in the U.S., by strengthening the position of pre-existing secured creditors in CCAA proceedings. One prominent Canadian restructuring lawyer asserts that DIP lending practices have given secured creditors a “stranglehold over debtors” by permitting secureds to obtain priority over all of a troubled debtor's assets in exchange for financing that the court deems is essential for funding the CCAA process.⁶¹⁷ DIP lenders can used their dominant position to impose various positive and negative covenants on debtors that limit the debtor's cash flow and require it to meet different financial stress tests and complete the CCAA process

⁶¹⁴ In short, many lenders “want one thing: to get paid”. See Lipson (n 278) 289.

⁶¹⁵ See Baird and Rasmussen (n 280) 687-694, especially 690 fn 190: “An “empty core” exists when three or more parties cannot reach a stable agreement with each other because some other agreement always exists that at least one party prefers. In other words, at least one person will always defect from any tentative agreement that might be made and, hence, none ever is reached.”

⁶¹⁶ *ibid* 697.

⁶¹⁷ Bish (n 226).

within a specified timeframe.⁶¹⁸ Moreover, DIP lenders can directly and indirectly influence the debtor's management and advisors in numerous ways, for example by requiring the debtor to: retain the lender's preferred Monitor;⁶¹⁹ change the composition of the debtor's board of directors; and, as in Chapter 11 proceedings in the U.S., alter the compensation and terms of employment of the debtor's senior managers through key employee retention plans (KERPs).⁶²⁰

The foregoing broad economic factors all help to explain the trend toward liquidating CCAAs in Canada.⁶²¹ But as with 363 sales in the U.S., the foregoing factors are necessary but insufficient causes for the increasing use of liquidating CCAAs. This is especially clear in Canada because, unlike in the U.S. where Chapter 11 is the only venue in which to carry out going concern sales in insolvency, in Canada the same can be accomplished through a court-appointed receivership or commercial proposal proceedings under the BIA. Rather, it is the specific and unique features of liquidating CCAAs that make them the more attractive tool for effecting sales from the perspective of certain stakeholders. As discussed earlier, the CCAA's DIP financing rules clearly provide benefits for an insolvent debtor's managers and secured creditors in many cases. However, DIP financing is not unique to CCAA proceedings – in fact, courts will commonly approve super-priority charges in receivership proceedings in Canada, and indeed, court-appointed receiverships may be a more efficient tool for effecting going concern sales than liquidating CCAAs.⁶²² On the other hand, KERPs are unique to CCAA proceedings and they may be particularly useful for ensuring that an insolvent debtor's key employees remain in place during the CCAA process. It is now well established that a court sitting in CCAA proceedings has broad discretion to approve KERPs, as well as key employee incentive plans (KEIPs), using the court's general power under Section 11 of the CCAA

⁶¹⁸ Wood (n 8) 409-410.

⁶¹⁹ *Re Winalta* (n 595) para 11.

⁶²⁰ See Wood (n 8) 410, identifying the Crystallex restructuring as a prominent example: *Crystallex International Corp, Re* (2012) ONCA 404 para 24, add'l reasons 2012 ONCA 527, leave ref'd 2012 CarswellOnt 11931 (SCC). The tactics of Canadian DIP lenders in these regards mirror those of DIP lenders in the U.S., see e.g. Baird (n 284) and Kuney (n 285).

⁶²¹ For a further discussion of how the growth of secured credit, changes in the nature of corporate assets, and financial innovations are driving the shift from traditional reorganisations to sales, see Jassmine Girgis, "The Evolution of Corporate Rescue in Canada and the United States" in Jennifer LL Gant and Paul J Omar (eds) *Research Handbook on Corporate Restructuring* (forthcoming, Elgar Publishing, 2019).

⁶²² Wood (n 8) 412.

to “make any order that it considers appropriate in the circumstances”.⁶²³ In short, KERPs and KEIPs can be useful tools in protecting the key employees of an insolvent debtor from being poached by competing businesses. As Justice Dunphy stated in *Aralez Pharmaceuticals*, the “early stages of an insolvency filing are chaotic enough without having added pressures of trying [to] stem the hemorrhage of key employees.”⁶²⁴

At the same time, and for the same reasons as are discussed in Chapter 3 with respect to KERPs in the U.S., the rationale for using KERPs in CCAA proceedings is not always clear.⁶²⁵ It may be that in at least some cases, a KERP is simply a useful tool for aligning the interests of the debtor’s senior managers with those of the secured creditors – powerful managers may be able to negotiate substantial bonuses for themselves on the basis that their continued employment is essential to the debtor, and the senior lenders may be willing to support management knowing full well that ultimately, the costs of the KERP or KEIP may be borne primarily by the debtor’s unsecured creditors.⁶²⁶ This is because in granting the KERP or KEIP, the court exercising its general power under Section 11 can grant a charge over the debtor’s assets priming any other claims in favour of the KERP or KEIP. In these regards, one might view KERPs under the CCAA as “Wild West” variations of their U.S. Chapter 11 equivalents – so long as the CCAA court is satisfied that a KERP is appropriate, it will approve it, whereas in the U.S. the court must first conclude that the KERP satisfies the strict requirements of Section 503 of the Code.⁶²⁷ In general, the CCAA court will rely heavily upon the Monitor’s business judgment when deciding whether or not to grant the KERP order:⁶²⁸

It is here that the essential role of the Monitor as the proverbial “eyes and ears of the court” comes to the fore. The court cannot shed its robe and wade into the debate in a substantive way. The Monitor on the other hand can shape the manner in which the

⁶²³ See *Aralez Pharmaceuticals Inc (Re)*, 2018 ONSC 6980, *Cinram International Inc (Re)* 2012 ONSC 3767, *Grant Forest Products Inc (Re)* 2009 CanLII 42046 (ON SC). It should be noted that unlike in the U.S., where specific rules apply as to the substantive terms of KERPs and KEIPs – the main difference being that KEIPs must predominantly seek to incentivise, but not necessarily retain, key employees – in Canada, the CCAA makes no such distinctions and typically treats KERPs and KEIPs in the same way: see *Aralez* para 12.

⁶²⁴ *ibid* para 24.

⁶²⁵ See Kuney (285).

⁶²⁶ Wood (n 8) 410. It might also be observed that the value of retaining the same managers who may have been complicit in the debtor’s insolvency is sometimes dubious, at best.

⁶²⁷ 11 USC § 503. If, however, the plan is in fact a KEIP because it seeks to “incentivise” rather than “retain” management, then the plan need only satisfy a business judgment review under § 363: see *In re Global Home Products, LLC*, 369 BR 778 (2007) (Del Bankr Ct).

⁶²⁸ *Aralez* (n 623) paras 26-28.

debate is conducted and in which the decisions presented to the court for approval are made.

What the court is unable to supply on its own can be summed up in the phrase “business judgment”. Outside of bankruptcy, the debtor company is entitled to exercise its own business judgment in designing such programs subject to the oversight of shareholders and the directors they appoint. Inside bankruptcy, the oversight of the court is required to assess the reasonableness of the exercise of the debtor company’s business judgment. In my view, the court’s role in assessing a request to approve a KERP or KEIP program is to assess the totality of circumstances to determine whether the process has provided a reasonable means for *objective* business judgment to be brought to bear and whether the end result is objectively reasonable.

The CCAA court’s reliance upon the Monitor in deciding whether to grant a KERP order, as with many other types of CCAA orders, is sometimes questionable. Although the Monitor is an officer of the court, it is also appointed by the incumbent managers of the insolvent debtor and, as noted earlier, often at the behest of the debtor’s senior lenders.⁶²⁹ Consequently, it is conceivable that when contemplating a KERP as part of a planned restructuring, the debtor’s managers and secured creditors may select a Monitor whom they expect will be more supportive of the KERP, not to mention other terms of the restructuring that might favour management and the secured creditors. Since the concept of “business judgment” is malleable and the CCAA court generally will rely quite heavily upon the Monitor’s opinion, the debtor’s managers and secured creditors can enhance the likelihood of obtaining court approval of the terms of the KERP by selecting a more supportive Monitor. In the absence of any statutory restrictions on KERPs under the CCAA, such as those contained in Section 503 of Chapter 11 in the U.S., it will be all the more challenging for CCAA courts in these circumstances to ensure that proposed KERPs are reasonable and fair to all stakeholders.

More generally, there is a concern that the Monitor’s role is continually expanding, as CCAA courts routinely turn to Monitors as a sort of panacea when a party in a restructuring asks the court to approve a new, challenging or controversial step. In extreme cases, such as *Re Nortel Networks Corp*, courts have created a “super monitor”, authorising the Monitor to “exercise any powers which may be exercised by a board of directors” of the insolvent debtor.⁶³⁰ Such heavy reliance on Monitors has led, almost inevitably, to questions about the ability of Monitors to remain impartial and independent in some cases. In *Nelson Education*, for example, the court replaced Alvarez & Marsal with a new Monitor because of its intimate

⁶²⁹ *Re Winalta* (n 595) para 11.

⁶³⁰ 2014 ONSC 6973 para 31.

involvement in the negotiations leading to the proposed sale of the debtor's business. The court concluded that A&M could not independently and impartially advise the court on the proposed transactions given its central role in structuring those very transactions.⁶³¹ *Nelson Education* points up the sometimes awkward position of the Monitor in having to provide the court with a kind of (supposedly) impartial imprimatur for decisions of the debtor in which the Monitor itself may have been intimately involved. Although the court ultimately must be satisfied with whatever course of action the debtor proposes to take, the CCAA court's jurisdiction "[e]xcept where provided specifically to the contrary... is unlimited and unrestricted in substantive law in civil matters."⁶³² As David Bish puts it, while this jurisdiction applies generally in the Canadian legal system, "what differentiates insolvency law from other areas of law is the absence of any meaningful limitations on the exercise of such jurisdiction."⁶³³ In short, the integrity of the CCAA regime depends mostly upon seasoned judges knowing when and how to exercise their broad discretion – as in the case of *Nelson Education* – to prevent impartiality and abuse of the system, or the appearance thereof. Critically, however, *Nelson Education* was an outlier, and in most cases courts will not inquire so closely into the actions of the Monitor as the court did in that case. In these regards, it is worth noting that the impetus for scrutinising the Monitor's actions in *Nelson Education*, and ultimately for replacing the Monitor, was a motion by a senior secured creditor of the debtor, the Royal Bank of Canada ("RBC"). In other words, the extraordinary step of replacing the Monitor only came about because one of the senior lenders was opposed to the proposed sale of the debtor's business and decided to expend significant time and resources to bring a motion to replace the Monitor and for various other relief. One might well ask whether the court would have taken the extraordinary step that it did in *Nelson Education* had RBC, instead, decided to support the proposed sale.

⁶³¹ *Nelson Education Limited (Re)*, 2015 ONSC 3580 para 31: "There is no suggestion that A&M are not professional or not aware of their responsibilities to act independently in the role of a monitor. A&M is frequently involved in CCAA matters and is understandably proud of its high standard of professionalism. However, that is not the issue. In my view, A&M should not be put in the position of being required to step back and give advice to the Court on the essential issue before the Court in light of its central role in the whole process that will be considered."

⁶³² *Nortel Networks Corp, Re*, 2015 ONSC 2987 para 206.

⁶³³ Bish (n 576) 208.

Reform Recommendations

Although the data set out in this chapter shed important light on liquidating CCAAs, further study is needed in order to confirm whether the results discussed here are statistically significant and broadly representative. In particular, although pre-packaged sales under the CCAA are only just emerging now, it seems likely that they will ultimately become the dominant form of liquidating CCAA in the future. Accordingly, future quantitative studies should examine the outcomes of CCAA pre-packs once a sufficient number of these cases have been completed, so as to provide a fuller picture of how the CCAA regime is operating. Having said this, several reform recommendations can be made based upon these results and the broader theoretical concerns with liquidating CCAAs raised here and in Chapter 2.

Firstly, the OSB should establish an online repository for CCAA records similar to the one maintained by Companies House in the U.K. Although the OSB's website currently provides basic information on CCAA proceedings such as the dates of initiation of proceedings and the names of the Monitors, there is no central repository for records, nor are the Monitors' websites which contain the records maintained after the proceedings have concluded. As a result, it is often challenging to obtain full records of CCAA cases after they have concluded, complicating attempts to discern what is occurring in CCAA cases and to determine whether changes are needed.

Secondly, along the same lines, the OSB should establish clearer standards for Monitors in reporting the outcomes of CCAA proceedings. In a typical CCAA proceeding, the Monitor may issue a dozen reports or more, such that gathering useful data involves reviewing hundreds of pages of materials. In short, regular, comprehensive data collection for the purposes of informing policymakers would be prohibitively expensive in terms of the time and resources required. A simple solution to facilitate data collection would be to require the Monitor to include, in its final report, a summary of all of the actions taken over the course of the CCAA proceedings and the key results of the proceedings. To the extent that this approach might raise privacy and confidentiality issues, the OSB could maintain the confidentiality of the Monitor's reports, or the relevant portions thereof, and merely report on the anonymized data in the aggregate. Alternatively, the OSB could provide access to the relevant reports or redacted portions thereof to researchers who would be bound by confidentiality and non-disclosure obligations. In either case, the OSB would have a single, central repository with easily accessible information on the outcomes of all CCAA

proceedings, significantly reducing the costs and complications of data collection. The foregoing database would permit larger, more detailed and likely more accurate quantitative studies of the outcomes of different types of CCAA proceedings that would aid policymakers in understanding how this area of the law is functioning and evolving. At the same time, participants in CCAA proceedings will benefit from a better understanding of how the regime typically affects similarly situated stakeholders, enhancing the certainty and predictability of the regime. An improved public understanding of the CCAA regime may also improve public perceptions of the regime's integrity and its overall importance to the Canadian economy. On the other hand, in the absence of such a database, future reform efforts will continue to be informed by only sporadic studies that provide glimpses of the actual impact of the current CCAA regime, but that fall short of reaching definitive and comprehensive conclusions. Moreover, tracking the impact of any future reforms of the CCAA regime will remain challenging, to say the least.

Thirdly, Parliament should consider comprehensively amending the CCAA to address the growing trend toward liquidating CCAs, and more recently, pre-packs under the CCAA. Only comprehensive amendments to the Act can properly address the issues with CCAA sales because, as discussed earlier, the Act in its current form is still geared towards traditional reorganisations. For example, the CCAA does not contain any priority scheme for distributing the proceeds from liquidating CCAs. Parliament must consider whether to introduce a distinct distribution scheme for the CCAA or whether to import the scheme from the BIA – the latter seems like the better approach because, as discussed earlier, a strange asymmetry would result from imposing different schemes in functionally equivalent processes, whereas Parliament and the courts have clearly stated that the goal of recent reforms has been to harmonize common aspects of the BIA and CCAA.⁶³⁴ In addition, it is unclear which test courts should apply when asked to approve a liquidating CCAA; typically, courts will apply both Section 36 of the Act and the *Soundair* test, suggesting that neither test is determinative.⁶³⁵ Parliament should provide needed clarity here by incorporating the relevant factors of the *Soundair* test into Section 36, eliminating the need for courts to apply two distinct, though very similar, tests. Furthermore, Parliament should consider whether further changes are needed to Section 36 so as to ensure that the basic protections for unsecured creditors and other vulnerable

⁶³⁴ *Century Services* (n 12) para 24.

⁶³⁵ See *Royal Bank v Soundair* (n 582).

stakeholders in full reorganisations remain available in liquidating CCAAs. In particular, the condensed timelines of CCAA sales make it especially difficult for objecting creditors to successfully oppose the planned sales. One solution would be to require prior disclosure to the relevant parties of the terms of the proposed sale, so that those parties could seek professional advice regarding possible alternatives, as a precondition for seeking court approval of the sale. Another option would be for the court to appoint an independent accounting firm, other than the Monitor, to review and provide its opinion to the court and all stakeholders on the terms of the proposed deal. This would provide the unsecured creditors, in particular, with an impartial expert opinion other than that of the Monitor. Ultimately, and more broadly, Parliament should consider whether the role of the Monitor has expanded beyond what can be reasonably expected of a single actor, and whether it would be more appropriate to bifurcate the Monitor's role throughout the CCAA process, and not simply in cases of sales. While this may seem a drastic step, it is in fact not a new suggestion at all, and was recommended some time ago by former Justice James Farley, one of the most influential Canadian commercial insolvency jurists of the past three decades.⁶³⁶ It may well help to address several of the problems raised in this chapter, from the propriety of KERPs, to DIP financing orders and finally quick sales.

V. CONCLUSION

The quantitative results set out in this chapter suggest that much of the conventional wisdom about liquidating CCAAs may be mistaken. In particular, the data examined thus far do not support assertions that liquidating CCAAs are significantly faster and more cost-effective than traditional reorganisations. Although more work is needed to gain a full picture of what is transpiring in liquidating CCAAs, the results thus far are concerning in light of the continued trend towards using the CCAA as a mechanism to sell substantially all of the assets of insolvent debtor companies, a procedure for which the CCAA was never designed. As noted earlier, the structure of the CCAA reflects its original purpose of facilitating compromises between insolvent companies and their creditors, i.e., reorganisations. Rather than address the inconsistency between current CCAA practice and the history and structure of the Act, much of the jurisprudence approving liquidating CCAAs has contributed to an “intentional confusing of realization and

⁶³⁶ Hon James Farley QC, “Musings (a.k.a. Ravings) about The Present Culture of Restructurings” (2010) 22 Com Insolv Rep 57.

restructuring”.⁶³⁷ At the same time, proponents of liquidating CCAAs have offered no evidence that these processes are generating better results for creditors as a whole than traditional reorganisations; on the contrary, the results disclosed here seem to suggest that secured creditors are benefitting from liquidating CCAAs while unsecureds are worse off compared with reorganisations. Again, while more data will need to be gathered, these preliminary results lend weight to the concern that liquidating CCAAs may have become “a creditor’s tool of choice for realizing on its security” rather than a true restructuring mechanism.⁶³⁸ In short, proponents of CCAA sales have “conflate[d] the objects of the Act with the wishes of the principal economic actor”, and the cost of this may be worse outcomes for other stakeholders.⁶³⁹ As with pre-packs in the U.K. and 363 sales in the U.S., there appears to be a real risk that secured creditors of insolvent debtors and incumbent senior management may be able to align their interests to their mutual advantage in liquidating CCAAs, maximising outcomes for themselves at the expense of the larger group of stakeholders. As incumbent management may have been complicit in a debtor’s insolvency in the first place, and secured creditors already have various other tools for realizing upon the assets of their insolvent debtors, this seems a wholly inappropriate use of the CCAA. Until Parliament legislates clearer, more comprehensive rules governing CCAA sales, the task of curbing such potential abuses of the regime will fall, as usual, on the judiciary.

⁶³⁷ Bish (n 226) 223-224.

⁶³⁸ *ibid* 232.

⁶³⁹ Bish (n 576) 197. For further discussion, see Nocilla and DaRe (n 384).

CONCLUSION

This thesis began by examining the major competing theories of corporate insolvency law. The analysis in Chapter 1 concluded that insolvency law should pursue three fundamental goals, namely: (1) preserving and maximising the value of insolvent enterprises; (2) ensuring the fair treatment of all stakeholders, including especially by ensuring fair distributions of the debtor's assets or proceeds from the sale thereof to claimants; and (3) investigating the causes of insolvency so as to minimise harm and abuse. The thesis then turned to the question of whether pre-packs are consistent with these goals.

Chapter 2 raised several normative concerns in these regards, namely, that the abridged nature of pre-packs had the potential to undermine the goals of insolvency law by giving too much control over the insolvency process to the incumbent managers and secured creditors of the insolvent debtor. In particular, in the absence of robust mechanisms to strengthen the position of other stakeholders, pre-packs permit managers and secured creditors to negotiate sale terms designed to maximise their own individual interests, even if doing so may lead to worse outcomes for the other stakeholders. A comparison of pre-packs to liquidating CCAAs in Canada and 363 sales in the U.S. further suggested that the theoretical concerns raised in Chapter 2 also extended to these other sales procedures which, like pre-packs, truncate traditional insolvency resolution processes and limit the ability of most stakeholders to participate.

Chapter 3 examined 363 sales in greater detail, considering their implications in light of the history and purposes of Chapter 11 of the U.S. Bankruptcy Code. Specifically, Chapter 3 argued that 363 sales by their nature discourage more vulnerable stakeholders such as unsecured creditors from participating in the process, limiting their access to information about the proposed sale as well as their ability to scrutinise and challenge the terms of the deal. Chapter 3 went on to assess recent reform proposals to the 363 regime, arguing that greater transparency with respect to the terms of the proposed sale and increased opportunities for stakeholder participation would curb potential abuses and enhance prospects for value-maximising sales. In particular, imposing a minimum closing date of 60 days from the date of filing would help to ensure that the "outsider" stakeholders who were not involved in negotiating the proposed sale would have an opportunity to investigate and object to the deal, rather than being faced with a *fait accompli*. More generally, Chapter 3 concluded that 363 sales should extend the same protections to stakeholders that they would have had in full Chapter 11 plan proceedings.

Chapter 4 set out the results of a quantitative empirical study of the outcomes of over 2,000 administrations and 500 receivership cases in the U.K. That study found that many of the theoretical concerns with pre-packs raised in Chapter 2 were borne out by the data. Specifically, pre-packs were correlated with lower overall realisations than standard administrations, but better outcomes for secured creditors, at the expense of preferential and unsecured creditors. In other words, pre-packs seem to undermine the basic goals of insolvency law as well as the stated objectives of the Enterprise Act 2002 to improve the positions of preferential and unsecured creditors compared with pre-Enterprise Act the administration procedure. Given the amount of control that pre-packs give to the senior managers and secured creditors of the insolvent debtor, and the enhanced returns that they provide for secured creditors notwithstanding the lower overall realisations yielded by pre-packs, pre-packs resemble a sort of variation on the administrative receiverships of old. Although the secured creditors do not directly control the pre-pack process as they did in administrative receiverships, the end result for secured is often the same – the pre-pack provides a quick collection mechanism that enhances their returns beyond what they might obtain in a standard administration. The difference with pre-packs is that the process is driven by the debtor's senior managers, who firstly negotiate the terms of the deal, that is, effectively the price at which the secureds will agree to release their security interests over the debtor's assets, and secondly appoint the administrator of their choice to implement the deal. Often, the sale is made to a connected party and the same managers then continue operating the business as part of the purchaser entity.

Chapter 5 proposed comprehensive reforms to pre-packs in light of the theoretical concerns raised in Chapter 2 and the quantitative data set out in Chapter 4. It argued that the Graham Report's recommendations, as well as other recent reform proposals, failed not only to correctly identify and appreciate the nature of the problems with pre-packs, but to offer real solutions. Of particular note was the fact that the Graham Report recommended that the insolvency industry adopt its proposals voluntarily, and that Parliament need not legislate. Now, several years after the Graham Report was issued, it is clear that the industry has been slow to adopt meaningful changes. Perhaps the clearest example of this is the Pre-pack Pool, which continues to suffer from dismal participation rates and whose key figures have lamented that the Pool is powerless to stop proposed pre-packs even where it is obvious that the pre-pack is, in

effect, abusive.⁶⁴⁰ Specifically, Chapter 5 proposed that all connected party pre-packs be submitted to the Pool for its review, comments and approval in advance of the sale. In addition, the Pool should be empowered to request further information from the parties to the pre-pack and to refer cases of suspected abuse or misconduct to the Insolvency Service. At the same time, Pool members should be subject to clear and comprehensive guidelines in order to maintain the Pool's transparency and accountability and so as to enhance public confidence in the integrity of the insolvency system. The Pool's activities, in turn, should be monitored and periodically audited by the Insolvency Service, and the Insolvency Service should be further empowered to hear complaints from stakeholders about pre-packs and/or the Pool, and to investigate and impose fines and sanctions where appropriate.

Chapter 6 set out the results of a quantitative study of the outcomes of CCAA proceedings in Canada. This study followed the same methodology as the U.K. study discussed in Chapter 4, on a smaller scale and with a smaller sample of cases. The quantitative results for Canada suggested that liquidating CCAs, like pre-packs and 363 sales, tended to lead to worse outcomes for unsecured creditors than full CCAA proceedings. While the Canadian data were likely too small to permit sweeping conclusions, the data provided some reasons to question much of the conventional wisdom surrounding liquidating CCAs – namely, that liquidating CCAs are faster, more cost-effective and more likely to maximise realisations than full CCAA proceedings. In light of these findings, Chapter 6 recommended reforms to the CCAA regime that would ensure junior stakeholders in liquidating CCAs are adequately protected, and that the CCAA regime is not used to effect sales when some other mechanism, such as commercial proposals or court-appointed receiverships under the BIA, would be more appropriate. In addition, to the extent that the CCAA will continue to be used for sales, Chapter 6 recommended that Parliament establish clear rules surrounding sales, including especially the adoption of a statutory scheme for distributing the proceeds of sales to the creditors in liquidating CCAs, using the same scheme as is contained in Section 136 of the BIA.

The key thread linking the reform recommendations for pre-packs, 363 sales and liquidating CCAs in this thesis is the need to improve transparency, accountability and stakeholder participation in these types of sales proceedings. Encouraging greater participation from more vulnerable stakeholders, such as

⁶⁴⁰ Cumbo (n 486).

unsecured creditors, and providing them with the tools to adequately scrutinise and challenge the terms of a proposed sale, can be expected to help curb abusive behaviours such as rent-seeking by the senior managers and secured creditors influencing the process, as well as ensure that fair distributions are made to all stakeholders. In addition, greater stakeholder participation and scrutiny are more likely to result in sales that will maximise realisations for all stakeholders. In short, the reforms proposed in this thesis, if implemented, could be expected to improve the functioning of pre-packs, 363 sales and liquidating CCAs and enhance the likelihood that these procedures will further the fundamental goals of insolvency law.

APPENDIX A – NOTES ON CHAPTER 4 AND CODIRE PROJECT

It is important to distinguish Chapter 4 from the EU-funded project “Contractualised Distress Resolution in the Shadow of the Law” (“CoDiRe”) carried out by Mokal et al.⁶⁴¹ That project focused on providing quantitative data on U.K. insolvency proceedings to support the policies, guidelines and best practices recommended to the European Commission in the CoDiRe final report⁶⁴² in order to inform domestic insolvency law reform efforts in the EU. Research teams in Italy, Spain and Germany collected data on insolvency proceedings in each of those countries toward the same goal.⁶⁴³

The discussion in Chapter 4, by contrast, focuses squarely on the implications of the data for the U.K.’s insolvency law regime, with emphasis on pre-packs and the questions posed in Part I of Chapter 4. In answering these questions, Chapter 4 necessarily refers to the findings of Mokal et al. and reproduces several of their figures in Part III in order to illustrate key findings. For clarity, the author designed the U.K. study and database in consultation with Mokal and Balmer and then populated the database as described in Part II. As such, Part II of Chapter 4 has been reproduced, in part, in Mokal et al. All statistical analyses were performed by Balmer, with input from the author regarding database design as well as with respect to deriving and defining the variables to be analysed. Specifically, the author collaborated with Balmer in selecting the key variables that formed the bases for the statistical modelling, namely the following models:

- Debtor size;
- Survival of purchasers;
- Total realisations;
- Total costs (including fees); and

⁶⁴¹ Mokal and others (n 384).

⁶⁴² See Lorenzo Stanghellini, Rizwaan Mokal, Christoph G. Paulus and Ignacio Tirado (eds), *Best Practices in European Restructuring: Contractualised Distress Resolution in the Shadow of the Law* (Wolters Kluwer 2018). Online: <<https://www.codire.eu/wp-content/uploads/2018/11/Stanghellini-Mokal-Paulus-Tirado-Best-practices-in-European-restructuring.-Contractualised-distress-resolution-in-the-shadow-of-the-law-2018-1.pdf>> accessed 21 July 2019.

⁶⁴³ The different research teams were located at the the Università degli Studi di Firenze, Humboldt-Universität zu Berlin, Universidad Autonoma de Madrid, Banca d’Italia and Consejo General del Poder Judicial, and compared the results of different types of insolvency proceedings in the U.K., Italy, Spain and Germany. The project was conducted pursuant to European Commission Grant JUST/2014/JCOO/AG/CIVI/7627.

- Total returns to creditors (by class of creditor).

Lastly, and importantly, aside from the statistical analyses conducted by Balmer, the research design, discussion and analysis in this chapter are the author's own, and do not necessarily reflect the views of Mokal and Balmer.

APPENDIX B – PUBLICATIONS AND PRESENTATIONS OF THESIS CHAPTERS

A paper based on Chapters 1 and 2 won the 2015 Ian Strang Founders' Award from the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL International) and was presented at INSOL's 2016 Academics' Colloquium. A revised version was published: Alfonso Nocilla, "Asset Sales and Secured Creditor Control in Restructuring: A Comparison of the UK, US and Canadian Models" (2017) 26:1 *International Insolvency Review* 60.

A paper incorporating parts of Chapter 4 was presented at the 2018 Annual Review of Insolvency Law Conference and was published: Alfonso Nocilla and Vern DaRe, "The Trouble with Pre-Packs", Janis P Sarra and others (eds), *Annual Review of Insolvency Law 2018* (Thomson Reuters, 2019) 621.

A paper based on Chapter 6 was presented at the 2018 Purdy Crawford Emerging Business Scholars Workshop, Schulich School of Law, Dalhousie University, Halifax. A revised version is forthcoming in the 2019 *Dalhousie Law Journal*: Alfonso Nocilla, "Reorganizations, Sales, and the Changing Face of Corporate Restructuring in Canada: Quantitative Outcomes of 2012 and 2013 CCAA Proceedings".

APPENDIX C – LIST OF CASES AND INSTRUMENTS

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Four Private Investment Funds v Lomas [2009] BCLC 161
Holgate and another v Reid and another [2013] EWHC 4630 (Ch)
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- Canada

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Royal Bank v Soundair (1991) 7 CBR (3d) 1 (Ont CA)
Re Olympia & York Developments Ltd (1993) 12 OR (3d) 500
Re Lehndorff General Partners Ltd (1993) 9 BLR (2d) 275 (SCJ)
Canadian Red Cross Society (1998) 5 CBR (4th) 299 (Ont Gen Div [Commercial List])
Re Calpine Energy Canada Ltd (2006) 19 CBR (5th) 187
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Calpine Canada Energy Limited (Companies' Creditors Arrangement Act), 2007 ABQB 49
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Re Canwest Global Communications Corp, 2009 CanLII 55114 (ON SC)
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Re Nortel Networks Corporation (2009) 50 CBR (5th) 77
Medical Intelligence Technologies inc, Re, 2009 QCCS 2725 (Que SC)
Grant Forest Products Inc (Re) 2009 CanLII 42046 (ON SC)
Century Services Inc v Canada (Attorney General), 2010 SCC 60
Re White Birch Paper Holding Co, 2010 QCCS 4915
Winalta Inc (Re), 2011 ABQB 399
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Re Northstar Aerospace Inc, 2012 ONSC 4546
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Re Nortel Networks Corp, 2014 ONSC 6973
Nelson Education Limited (Re), 2015 ONSC 3580
Nortel Networks Corp, Re, 2015 ONSC 2987
Arrangement relatif à Bloom Lake, 2017 QCCS 4057
Re 8640025 Canada Inc, 2018 BCCA 93
Aralez Pharmaceuticals Inc (Re), 2018 ONSC 6980

- United States

NLRB v Bildisco & Bildisco, 465 US 513, 528 (1984)
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Instruments

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Bankruptcy and Insolvency Act, RSC 1985 c B-3 (Canada)

Companies' Creditors Arrangement Act, RSC 1985, c C-36 (Canada)

Companies Act 2006 (United Kingdom)

Company Directors Disqualification Act 1986 (United Kingdom)

Enterprise Act 2002 (United Kingdom)

Insolvency Act 1986 (United Kingdom)

U.S. Bankruptcy Code, 11 USC §§ 101 *et seq* (United States)

Chandler Act of 1938, Pub L No 75-696, 52 Stat 840 (1938) (repealed 1978) (United States)

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