Consistency of Principle in Corporate Insolvency

by

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Dedication

To my parents,
Prof. Shabnam Iqbal
and
Prof. Sardar Muhammad Iqbal Khan Mokal:

everything good there is, I owe to them.

And to my brother Sultaan.

Abstract

The objective of this thesis is to produce a systematic and principled study of the theory of some of the most important aspects of English corporate insolvency law. It aims to present this body of law as a coherent whole, stemming from common fundamental principles, and amenable to being justified or criticised on that basis.

At a high level of abstraction, the principle which is argued to underlie the law governing corporate insolvency is that all the parties affected by it are to be regarded as worthy of equal care and concern. This implies that equal attention and respect must be accorded to the interests of them all. To the extent that it succeeds in being egalitarian in this way, the law is fair and just. The argument draws on the work of John Rawls and Ronald Dworkin to construct a framework within which the relevant rules and principles of insolvency law can be tested for compliance with this fundamental requirement. The argument is also very much alive to considerations of economic efficiency.

The thesis consists of seven chapters. English insolvency law is of course very diverse and has evolved over a considerable period of time. It would be surprising if it did not reflect the influence of the numerous political and ideological struggles which would have been part of the legislative and judicial context at various stages of its development. Given this undeniable fact, the very notion that some common fundamental principles could be found woven into it as a whole has been questioned. The first chapter presents a way of understanding the project of the thesis, and thus of meeting this objection. The second chapter examines and criticises the Creditors' Bargain, the best-known analytical and justificatory model in insolvency law. The third constructs an alternative (referred to as the Authentic Consent Model) while seeking to avoid the various shortcomings which it identifies in the Bargain and in other approaches extant in the literature. Chapters four, five, and six deploy the new Model alongside of economic analysis to examine three of the most basic features of English insolvency law, namely, the *pari passu* principle, the priority accorded to secured claims, and the liability of directors for wrongful trading. The seventh chapter concludes.

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As already noted, I was fortunate in having had, accepted for publication, articles derived from the first six chapters of this thesis. I thankfully acknowledge the (often detailed) comments I received from the editors and anonymous referees of the following journals: *Cambridge Law Journal*, *Legal Studies*, and *Oxford Journal of Legal Studies*. Most of these comments are reflected in the following chapters. I should also point out that I have sometimes been persuaded by the responses to these articles to change my mind about some of the positions I took in them. All those changes have also been incorporated in the following pages, and the more important ones are mentioned in footnotes. Needless to say, my current views on the matters addressed below are as described here.

I am grateful to acknowledge the financial support I received from the following sources: the Denys Holland Trust, for the Denys Holland Scholarship 1998-9; the Committee of Principals and Vice-Chancellors (as it then was), for an Overseas Research Scholarship 1998-2001; and the Dean (Dawn Oliver, then Jeffrey Jowell) and Director of Research Studies (Roger Rideout, then Dawn Oliver) of the UCL Faculty of Laws, for the Dean's Scholarships, 1998-2001. All these helped considerably with the very great financial burden of being a non-European student in London.

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ensure that I would get to the stage where I am now. In only one of those sacrifices I have shared: tolerating separation from members of the family one loves more than anything else. For all these reasons and more, attempting to repay my debts to them, and to my brother, would bankrupt me many times over. So I will merely content myself by saying: thank you.

Rizwaan Jameel Mokal.

(London, December 2001)

Chapter I: Introduction -- Consistency of Principle in Corporate Insolvency

1. Introduction

The project of this thesis is to show the corpus of corporate insolvency law as a coherent whole, based on an interlocking web of common principles, and amenable to being justified or criticised on that basis. For reasons to be explained below, both these aspects -- the justification of existing law, and a critique of it -- are equal partners in this enterprise. The thesis has both a positive and a normative dimension. It takes a position about what it would be for this jurisdiction to have a just and efficient system of corporate insolvency law. This is the realm of the normative, the domain of what some political philosophers call 'ideal theory'. But that is not all. The analysis here aims not to be merely a philosophical flight of fantasy about how things ought to be. The thesis also claims to provide an analysis of this branch of the law *as it exists today*. In other words, the arguments here *fit* current corporate insolvency law. So this analysis can be used as one method amongst others, both, to understand statutory provisions and judicial decisions in this area, and to suggest how new problems should be resolved in the future, judicially and legislatively.

Given that 'consistency of principle' is given pride of place in this thesis, it might be asked exactly what is it for principles to be 'consistent' in the relevant sense. And why should such consistency be valued? The answer that will be sketched out below incorporates three elements. First, it is argued that this body of law is coherent, based on principles which are internally consistent, which *hang together* without contradiction. Second and more importantly, the thesis invokes the ideal that all those affected by corporate insolvency law must be treated as equals.[1] The notion of consistency employed here requires the principles embedded in this branch of the law to cohere with this ideal. Consistency of principle exists in the relevant sense if the fundamentals of insolvency law can be argued to be acceptable to all those affected by this law conceived of as equals. Insofar as the interests of all these parties are given equal respect and consideration in the choice of those fundamental principles, they are deemed acceptable to all the parties treated as equals. To the extent that this line of argument is successful, it would then provide a compelling answer to the related question about why consistency should be valued. If

[1] Unless the context clearly suggests otherwise, 'parties' here is used interchangeably with the more cumbersome 'those affected by peculiar insolvency issues'.

such consistency is required for the relevant parties to be treated as equals, then any part of the law not displaying it does not treat some of those it governs as equals, as deserving of the same dignity and respect due to all of its subjects. Third and finally, consistency requires that the principles of corporate insolvency law all fulfil the requirements of efficiency. For reasons to be explained in Section 6 below, this thesis rejects the Pareto and Kaldor-Hicks versions of efficiency, the two most commonly employed in Law and Economics. Instead, a conception of *transaction cost efficiency* is described and defended. The claim made here will be that only those principles which are efficient on this conception could be considered acceptable to the relevant parties.

The task of designing a mechanism to identify what principles would be acceptable to all the parties treated as equals is left to Chapter III. This Chapter begins by sketching out the notion of equality employed here. In this thesis, equality is taken to be the central feature of a particular conception of the person. This conception is itself tied firmly to the notion of a society regarded as a fair system of co-operation amongst citizens who regard themselves and each other as free and reasonable, and therefore equal. The first task undertaken below is therefore to explain the role of insolvency law in such a society, and how that affects the ideal of equality crucial to the argument of the thesis. Two related objections are then considered, both of which deny that any consistency of principle can realistically be expected to be found in a diverse and long-evolving body of law such as that governing corporate insolvency. These objections are met by explaining how insolvency law is interpreted in this thesis. Since the thesis also concerns itself with the efficiency of the law, the relevant notion of efficiency is then described and defended. The Chapter concludes with an overview of the thesis.

2. The role of insolvency law in society

In this thesis, corporate insolvency law is seen as dealing with that peculiar set of social, commercial, and legal circumstances which arise when a company becomes insolvent.[2]

[2] The notion of 'insolvency' employed here draws on Insolvency Act 1986, ss. 123(1)(e) and 123(2): a company is insolvent, either, if it is unable to pay its debts as they fall due, or, if the value of its assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities (for a discussion of these two conceptions, see Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet & Maxwell, 2001), 84-91). For one view of the type of issue that might be regarded as peculiar to insolvency, see G.E. Brunstad, "Bankruptcy and the problems of economic futility: A theory on the unique role of bankruptcy law" (2000) 55 Business Lawyer 499. However, this thesis leaves the question what issues might in fact fall to be classified thus as one to be decided on a case by case basis. It

Insolvency law is regarded as laying down the fair terms of co-operation amongst all the parties affected by these peculiar circumstances. The parties themselves are considered equal, and as fully co-operating members of society. Insolvency law is one limb of the whole legal corpus, and (like the legal system in its entirety) provides the guidelines for how the institutions within its province are to realise the value of equality. Now the commercial world is characterised by competition and often, conflict. In the circumstances of a firm's insolvency, some claimants (to take its defining characteristic) do not get back all (or any) of what they are owed. Conflict seems almost to be built into the nature of things. It might seem unrealistic to posit co-operation to the parties playing this (apparently) zero-sum game. So it is essential to be clear about the nature of the co-operation which this thesis regards as being at the core of insolvency law.

All the parties facing a set of peculiar insolvency issues co-operate by accepting, regarding as proper, and being guided by certain public rules and procedures. Co-operation takes place on terms "each participant may reasonably accept, provided that everyone else likewise accepts them."[3] Each party which complies with the publicly recognised rules is to benefit in an appropriate way, usually by being allowed to advance its own conception of the good in those circumstances. As conceived here, then, parties governed by insolvency law who are in a position of potential conflict *inter se*, nevertheless co-operate by each being guided by just insolvency law principles in pursuing their own self-interest, and thereby allowing all others similarly to pursue their self-interest guided by the same principles.

Note that reciprocity of this sort is key. Each party is motivated to seek their self-interest only in accordance with insolvency law principles regarded as just (by the method to be specified in Chapter III below), because they consider it fair to do so, but *only* if (most) others are also seen to accept as fair and abide by the same set of principles. If one of the participants in the institutions of insolvency law asks why he should abide by the principles on which the institutions operate, he can be told:

> You have the opportunity to pursue your self-interest only because others constrain themselves in ways that make for a fair cooperative venture for mutual advantage.

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provides, in Ch. III below, a mechanism for testing *any* proposed principle to ascertain whether it is suitable for inclusion in the body of corporate insolvency law. The model sketched out in Ch. III would approve of any principle only if, *inter alia*, it can be shown to address issues which either arise only in insolvency, or arise there in a manner unique to insolvency.

[3] J. Rawls, *Political Liberalism* (New York, Columbia University Press, 1996) (hereafter, *PL*), p 16.

> Constrain yourself by those same principles in return, and you give them fair return for what they give you.[4]

Now there is no doubt that “reciprocity is a form of fairness”.[5] But it has been subject to some criticism as the basis for a just political order. (Insolvency law of course would be part of such an order.) It has been noted that those incapable of providing reciprocal benefits are excluded from any conception of justice based on reciprocity.[6] Even when, as in the position taken here, the ‘benefit’ parties must provide to each other is to accept as fair, and abide by, the same set of principles as everyone else similarly placed, some are excluded. These would include the congenitally handicapped of some variety, and animals, both incapable of upholding any principles.[7] For those who “hope[] for a conception of justice that admits these cases as central”, reciprocity is unsatisfactory.[8]

There are a number of ways of responding to this criticism. The most obvious is to point out that in the specific context of corporate insolvency, it has little relevance. Here, even the weakest party -- the literature mentions the tort victim, the unskilled employee-creditor and the weak trade creditor as paradigms -- is capable of reciprocating by suspending their efforts individually to pursue whatever claims they have against the insolvent, and by regulating their activities in accordance with fair insolvency principles.

Even on a more general, society-wide level, the criticism that reciprocity would exclude those incapable of reciprocating from the realm of *justice*, still seems irrelevant. Claims on behalf of groups such as the congenitally disabled, and animals, have often been phrased in terms of justice. But justice is not the *only* social or political virtue. Not every instance of social, or even political, interaction need be governed by it. There are other virtues, like mercy, benevolence, empathy, altruism, charity, etc. A society might accept any of these as political virtues. Claims on behalf of animals might still be made in terms of the moral obligations of human beings, for example, but these obligations would flow from empathy (say) and not justice.

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[4] This paraphrases A. Gibbard, “Constructing justice” (1991) 3 Philosophy and Public Affairs 264, 269.
[5] B. Barry, *Justice as Impartiality* (Oxford: Clarendon, 1995), p 50; the significance is that Barry is one of the leading critics of what political philosophers refer to as ‘justice as reciprocity’ theories.
[6] *Ibid*., p 50.
[7] *Ibid*. See also Kymlicka, *Contemporary Political Philosophy* (Oxford, Clarendon, 1990), 129.
[8] Gibbard, “Justice”, p 272.

There does not, for this reason, seem to be any need for those campaigning on behalf of such groups to cover their claims with the cloak of justice.[9]

We can move on, then, keeping in mind what motivates the view of insolvency law presented here. Insolvency law is seen as a fair system of co-operation about insolvency issues. All those participating in its institutions are taken to be motivated by the desire to further their self-interest bound by a set of fair principles, and in the knowledge that everyone else is similarly bound.

[9] There may be other reasons why they would want to do so, stemming either from *their* inability to identify other political virtues, or from their suspicion that *society* generally does not recognise virtues other than justice. Further discussion of these questions is beyond the scope of this thesis.

3. The place of 'equality'

Like justice, fairness, liberty, and other concepts that are interesting to political and legal philosophy, the notion of equality too is inherently controversial.[10] "People who praise it or disparage it disagree about what they are praising or disparaging."[11] It is obvious that equality is a comparative concept, concerned with the relationship between one action, social institution, or set of circumstances, and one or some others.[12] It is also clear that to say that A and B are equal is to indicate that they are like each other in one or some respects, but not in others. For them to be alike in all possible respects would be for them to be identical, not equal. In the same vein, equality can be distinguished from mere similarity: for the attribute or characteristic being compared, equality implies exact, not just approximate, sameness. Putting all this together, 'equality' can be understood as "the relationship of identity that obtains among two or more persons or things by reference to a given standard or measure."[13]

This much is clear. But it is also uninteresting. What concerns us here is the question whether some type of equality constitutes a distinct virtue of political and legal morality. In order to make sense of this question, we must take the empty 'formal' shell of a definition just given, and fill it in with (substantive) content.[14] As a start, let us take the proposition 'likes should be treated alike'. This egalitarian formula is "said to be a universal moral truth", one that can "be intuitively known with perfect clearness and certainty".[15] However, it is obvious the proposition is still formal (in the sense identified above), and still empty. To see exactly how indetermined it is, consider who might be considered 'like' another so as to merit being treated 'alike'. First, we

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[10] For just two opposing views, see Ronald Dworkin, *Sovereign Virtue: The Theory and Practice of Equality* (Harvard University Press, Cambridge, Mass., 2000), and Joseph Raz, *The Morality of Freedom* (Oxford, Clarendon, 1988), Ch. 9. A very useful overview of the issues is found in Gosepath, "Equality", in Zalta (ed.), *The Stanford Encyclopedia of Philosophy*; URL = http://plato.stanford.edu/entries/equality/ . Because of the arguments there (see esp. Section 5) and others, it is submitted Raz's attack on equality as a distinct political and moral virtue is simply untenable.

[11] Dworkin, *Sovereign Virtue*, p. 2. On liberty, compare e.g. Abraham Lincoln: "We all declare for liberty; but in using the same *word* we do not all mean the same *thing*"; Roy Basler (ed.), *The Collected Works of Abraham Lincoln* (Rutgers, New Brunswick, 1953), Vol. VII, p. 301.

[12] See e.g. Gosepath, "Equality".

[13] Peter Westen, "To lure the tarantula from its hole: A response" (1983) 83 Columbia LR 1186, 1188.

[14] A 'formal' principle contains variables which remain unspecified until designated to represent some feature or attribute; see e.g. Westen, "The empty idea of equality" (1982) 95 Harvard LR 537, 577-8, including the references in fn. 138.

[15] Westen, "Empty", p. 543, including fn. 20, citing, among others, Perelman, *The Idea of Justice and the Problem of Argument* (London, Routledge & Kegan Paul, 1963) (translated by J. Petrie), 12. Note that Westen is a leading critic of the view that equality is a distinct political and legal virtue, and treats the claims just quoted sceptically.

could stipulate that a person is like another if the two are the same in every possible way (in other words, that they are identical). However, on this interpretation, the formula would identify a null set, since no two persons are identical in every respect. At the very least, they do not both have the same spatio-temporal location. If they did, they would of course not be two persons but one. Second, we might consider two persons alike if they are like each other in some respects, though not all. The problem with the set defined thus is that it includes everyone, and in fact, all material things. All are like each other in *some* respects (e.g. they all have an existence in space and time). This grossly over-inclusive view of likeness is not very helpful, then, since it can barely distinguish anything from anything else in the universe, and directs all persons and things to be treated alike! Finally, though, we might say that some persons are to be considered alike others insofar as they possess certain morally relevant characteristics. We might then be able to conclude that by virtue of possessing these characteristics and thus being alike, they ought all to be treated alike.[16]

The discussion so far does no more than point in the right direction. It reveals that in order to understand what substance the virtue of equality might have, we must first identify these relevant characteristics, and show why they should be considered relevant. The consequences of a finding that a person or thing is equal to some others must then be spelt out. It would be useful at this point to set out the features the possession of which will be regarded in this thesis as qualifying the possessor to the status of an equal.[17] There are two such features, which, along with equality itself, are referred to as *constructive attributes*.[18] Constructive attributes are stipulated features of the theory of insolvency law propounded here (in particular, in Chapter III). In order to construct the relevant attributes, the model sketched out in Chapter III to analyse and justify insolvency law presupposes a survey of the whole legal and political culture of society. This would gather together all the data which seems relevant. This might include any of legislative enactments and judicial precedents, administrative and executive acts of government, the binding commitments of the State in the realm of public international law, and so on. The model then analyses this raw material and distils it to its essentials. The quest is to define "the political conception of the person".[19] It is to define a certain ideal of the individual: the ideal of

[16] See e.g. H.L.A. Hart, *Concept of Law* (Oxford, Clarendon, 1994) (2nd. ed.), p. 159, and Westen, "Equality", p. 544.
[17] Equal to all those similarly endowed, it might rather redundantly be added here.
[18] The terminology and the discussion borrow from *PL*, p. xxii. See also Rawls, *A Theory of Justice* (Cambridge, Mass: Harvard Univ. Press, 1971 (hereafter '*Theory*'), p 18.
[19] The phrase is Rawls'; see *PL*, p 29.

the citizen as legislator in a democratic society.[20] Whatever characteristics seem relevant to this ideal are then attributed to the parties who will become subject to insolvency law and must therefore be consulted on the choice of the principles of this law. It is claimed here that such an exercise would identify the attributes to be described below. At the very least, these attributes concretise "certain conceptions and principles congenial to [society's] most essential convictions and historical traditions."[21]

Note that the theory propounded here does not presuppose any metaphysical doctrine of the person, realist, idealist, or materialist.[22] Nor does it assume the characteristics constructively to be attributed to the parties really do exist in all (or most) actual individuals to an equal degree.[23] Constructive attributes constitute an *ideal* of the person. They define a normative view of how parties must be placed before being asked to give consent to principles of justice. To the extent that real-life individuals are deficient with respect to these attributes, they fall short of what society expects of its legislators. So to insist that (some) actual people are not free or reasonable in the sense defined below is to point out a deficiency in actual society, not in the model. Constructive attributes define a contingent view of the person, based firmly in the political and legal culture of society and answering to its highest conceptions. The model claims a particular society accepts it should be governed by principles which could be regarded as acceptable to citizens thus defined. It then reverses the burden of proof, challenging those who disagree to contest this claim. It is then up to them to show that society does not consider citizens conceived in this way as fit to choose the governing principles of justice. Till such time that persuasive arguments are made that the notions of liberty, reasonableness, and thus of equality, as defined below, are not normatively attractive in this way, it is submitted the assumptions made about them should stand.[24]

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[20] See *Theory*, pp 261-5 and 584 for the phrase "ideal of the person". See also T. Scanlon "Rawls" theory of justice", in N. Daniels (ed.), *Reading Rawls: Critical Studies on Rawls' 'A Theory of Justice'* (Stanford, Stanford Univ. Press, 1989), 169, at p 177.

[21] J. Rawls, "Kantian constructivism in moral theory" (1980) 77 J. Philosophy 515, 518.

[22] *PL*, p 29 and fn. 31.

[23] Compare R. Dworkin, "The original position", in N. Daniels (ed.), *Reading Rawls: Critical Studies on Rawls' "A Theory of Justice"* (Stanford Univ. Press, Stanford, 1989), 16, 28, describing the "constructive model".

[24] Compare *ibid*., pp 52-3. D. Carlson, "Philosophy in bankruptcy" (1987) 85 Michigan LR 1341, 1342, criticises contractarian theories for "present[ing] an *essence* of the human personality in the abstract, devoid of historic characteristics. These personalities are defined by a very limited number of attributes that the theorist perceives to be universal among humans" (emphasis in the original). Criticism based on this premise has no force against the model of insolvency law constructed in Chapter III, since that model starts with an admittedly *ideal* and avowedly *contingent* view of the nature of citizens as legislators. So Carlson's

a. Liberty

The first constructive attribute is that of liberty.[25] Parties affected by peculiar insolvency issues are to be conceived of as free in three respects. First, they are regarded as "having the moral power to have a conception of the good." They are also "seen as capable of revising and changing this conception".[26] One's conception of the good is one's idea of one's rational advantage. In being free in this sense, the parties are regarded as having the ability to decide what they regard as valuable in the relevant sphere of human life. They can choose what they want to achieve, the attachments they want to form, and the loyalties they wish to owe.[27] They are also regarded as having the right to be seen as independent of these aims, attachments, and loyalties, and thus having the right to review and revise them, while still retaining their political identity.[28]

In the less abstract but arguably no less profound terms appropriate to the realm of corporate insolvency, this aspect of liberty models the parties' ability to choose to contribute financial capital to a company as secured or unsecured creditors or shareholders, or to contribute human capital as directors or employees. It indicates that involuntary and non-consensual creditors accept that contingencies of the sort affecting them (though often regrettable) are inevitable in any society, and that they have the capacity to revise their conception of the good to decide what best serves their interests once such contingencies have occurred.[29] This aspect of liberty also models the possibility that the same individual may be a victim of an insolvent's tort and have interests in common with others in a similar position, and simultaneously be a secured creditor (directly or through a corporate entity) of another insolvent with a range of interests appropriate to that status. One of the implications of this aspect of liberty is therefore to counter

argument that "If you don't agree that human beings have been abstracted fairly in the contractarian model, then the model fails to have any rhetorical value" (*Ibid*., footnote omitted) would get the direction of reasoning in that model the wrong way around. Here, the attempt is not to capture the essence of (all) actual human beings, but rather to identify the aspirations of a particular type of society concerning its citizens.

[25] See *PL*, pp. 29-35.

[26] *Ibid*., p. 30.

[27] *Ibid*., p. 19.

[28] *Ibid*., p. 30.

[29] Of course such a revised conception would build upon (*inter alia*) the reasonable expectation that the harm done would be compensated for in some appropriate way.

the insidious tendency of viewing various groups of affected parties as mutually exclusive, and as necessarily having "incommensurable" aims.[30]

Secondly, parties are free in that they are regarded as "self-authenticating sources of valid claims". In the present context, this means that either directly or through the medium of a company (e.g. a bank), they are equally "entitled to make claims on [insolvency law] institutions so as to advance their conception of the good".[31]

Finally, parties are free in that they are regarded as "capable of taking responsibility for their ends".[32] Citizens are thought to be capable of adjusting their aims and aspirations in the light of what they can reasonably expect to provide for. In particular, liberty entails that the parties "can adjust their ends so that those ends can be pursued by the means they can reasonably expect to acquire in return for what they can reasonably expect to contribute."[33]

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[30] See, e.g., D. Korobkin, "Contractarianism and the normative foundations of bankruptcy law" (1993) 71 Texas LR 541, 570.
[31] *PL*, p. 32.
[32] *Ibid*., p 33.
[33] *PL*, pp 33-4.

b. Reasonableness

Parties are regarded as being "ready to propose principles and standards as fair terms of co-operation and to abide by them willingly, given the assurance that others will likewise do so".[34] That parties have the constructive attribute of being reasonable in this way flows from the idea of them being citizens of a society viewed as a fair system of co-operation. Reasonable individuals are not altruistic, they are "not moved by the general good as such". They demand reciprocity from other free and equal citizens, so all can pursue their self-interest bound by the same set of principles similarly acceptable to all.[35] Given that insolvency law (like all other parts of the legal system) is conceived of as a scheme of fair co-operation in a particular set of circumstances, the parties' ability to reciprocate in this way is essential if they are to engage at all in the (fair) give and take that co-operation necessarily requires.

c. Equality

Equality emerges as the constructive attribute of all those who are free and reasonable in the ways described above. The crucial consequence is that all of them "have a right to equal concern and respect in the design and administration of the political institutions that govern them."[36] It might now be asked why those attributes are being given the significance they are. Why should *all*, but *only*, those who have them be regarded as equals? While a reasonably full defence of the position adopted here would constitute a separate thesis in its own right,[37] the following few words should suffice to show its adequacy in the corporate insolvency context.

Recall that insolvency law is thought of as laying down the fair terms of social co-operation in the peculiar circumstances of corporate insolvency. All the parties affected by such circumstances are equal in that, *inter alia*, all have a capacity for forming a conception of their

[34] *PL*, p. 49.
[35] *Ibid*., p. 50.
[36] Dworkin, "Position", p. 50.
[37] For instructive defences of more or less similar positions, see T. Scanlon, *What We Owe To Each Other* (Cambridge, Harvard University Press, 1998), Chs. 4-5, esp. pp. 177-187 (the position taken here is effectively that given in category 3 on p. 179, which is also the one Scanlon himself favours as defining the scope of what he calls the morality of what we owe to each other); D.C. Dennett, "Conditions of personhood", in *Brainstorms: Philosophical Essays on Mind and Psychology* (London, Penguin, 1978), 267-285; R. Scruton, *Animal Rights and Wrongs* (London, Metro, 2000) (3rd. ed.), esp. Chs. 2-4 and 7; C. Korsgaard, *The Sources of Normativity* (Cambridge, CUP, 1996); also useful is Korsgaard, *Creating the Kingdom of Ends* (New York, CUP, 1996), Chs. 2-4.

good under these circumstances, as mentioned above.[38] This can be understood by noting that it is only if a being has this capacity to have a conception of its own good that it has an interest in influencing the scheme of co-operation (at least partly) enshrined in the law which enables it, and shapes and restricts its ability, to pursue that conception. Those considered equal also all have the capacity to be moved by considerations of reciprocity. For our purposes, this is again straight-forward. Those to be regarded as equals accept as proper, and "act from (and not merely in accordance with)", the principles of justice enshrined in insolvency law.[39] By doing thus, they acquire certain rights, for example, the right to be allowed to pursue their own conception of the good. But for the same reason, they also accrue obligations, notably, the obligation to allow others similarly to pursue *their* conceptions of their good. Crucially and inevitably, this requires that they be willing to make adjustments to what they expect to achieve, and to accept the propriety of having to do so in the interests of fair co-operation. The relevant parties must have the ability to appreciate such demands of justice. They must be able to see the need for, and have the ability to, reciprocate. Unless they do, they simply cannot *co-operate*, and thus could not possibly be regarded as *equal* partners in a fair scheme of co-operation.[40] This shows why *only* those free and reasonable in the sense defined above are regarded as equal.

Finally, we should note that *all* those free and reasonable in this way are to be considered equal. No further demands can justifiably be made of them in order for them to qualify for this status. Their interests must all be accorded equal care and respect in deciding upon insolvency law principles.[41] This point, which is explained and defended throughout Chapters II and III below, can be left for the moment with this simple challenge: what other reasons might possibly be invoked to allow the interests of some of those affected by insolvency law to be accorded a greater weight in the choice of insolvency principles than the interests of others similarly affected? In this regard, it would be helpful to remember that having one's interests accorded equal consideration in the choice of insolvency law principles does *not* equate to being given identical treatment under insolvency law. It has been famously pointed out that "There is a difference between treating people equally, with respect to one or another commodity or

[38] *PL*, p. 79.
[39] See J. Rawls, "Kantian constructivism in moral theory" (1980) 77 J. Philosophy 515, 525.
[40] A very similar point is made by Dennett, "Personhood", p. 283.
[41] This is qualified only by the situational constraint, arising out of the nature of insolvency law itself, that the interests of only those affected by a peculiar insolvency issue are to be considered in deciding upon insolvency law principles. This is discussed at length in Ch. III, below.

opportunity, and treating them as equals."[42] The position taken here is that the former is not *by itself* either coherent or attractive as an ideal, and so not something *any* part of the law should aspire to achieve.[43] The latter, on the other hand, is the minimum necessary for any part of the law to be justifiable. To treat the relevant parties as equals requires them to be accorded a right to what might be called equal justification: it must be demonstrated, in a way which none of them could reasonably reject, that their interests have been accorded equal care and respect during the selection of the core principles of, in this case, insolvency law. So the challenge just made should be understood correctly, not as asking why some parties might be treated differently under insolvency law than others,[44] but rather, why some of them should have a greater consideration of their interests in the selection of insolvency law principles than others.

We can conclude this sub-Section with the observation that equality is the most important of the parties' constructive attributes. As free and reasonable, they qualify as equals, and as equals, their interests must be accorded equal care and respect in the choice of principles.

4. Could insolvency law really be consistent?

This thesis claims to show that the core principles underlying corporate insolvency law are *consistent*. This has been designated to mean that they uphold the moral equality of all those subject to them by showing equal respect and concern for their interests. But surely such a claim is absurd because unrealistic?

> Considering the tens of thousands of [legislators], judges and lawyers who have contributed to the content of bankruptcy law, it would [be] a miracle if all of them were driven by the same ethical impulse every time a legislative decision was made.[45]

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[42] R. Dworkin, *Sovereign Virtue: The Theory and Practice of Equality* (Harvard University Press, Cambridge, Mass., 2000), 11.

[43] For a classic statement, see Dworkin, *Virtue*, Chs. 1 and 2.

[44] There might be numerous grounds justifying differing treatment: for examples, see the analysis of the *pari passu* principle in Chapter IV below, and the defence of the priority of secured claims in Chapter V. For extended discussion, see e.g. Dworkin, *Virtue*, Ch. 2, esp. p. 89 (on why schemes of justice must be 'ambition-sensitive'); G.A. Cohen, *If You're an Egalitarian, How Come You're So Rich?* (Cambridge, Harvard University Press, 2000).

[45] Carlson, "Philosophy", p. 1389 (footnote omitted), writing in the US context. See also Finch, "Measures", p. 239, echoing the same concern, this time presumably in the context of insolvency law in this jurisdiction.

Different law-makers would have brought different moral attitudes to their law-making activities: their vote on some legislation or their judgment in a case or their advice to their clients would have reflected their own moral opinions. Since these attitudes and opinions are unlikely all to have cohered perfectly with each other even concerning the very core principles underlying insolvency law, it seems to follow that any claim that this law could itself display any consistency of principle must be regarded as incredible. Let us call this the Psychological Objection, since it challenges the basic claim of this thesis by pointing to the actual variety of mental (moral) attitudes the law-makers would undoubtedly have had as they put flesh on the bare bones of insolvency law over the years.

We should also note another closely-related challenge, which could be labelled the Historical Objection. It is obvious "legal texts are situated in history". They are created over time through a historical process "based on entropy, anomie, conflict, and confusion, as well as the dictates of logic and reason." [46] It appears difficult (if not impossible) to claim that any historical process -- including that which created, and is still creating, insolvency law -- results in any consistency of moral principle. Amongst historical processes, this seems especially true for law-making, which is the product of politics. What the law on a particular point is would, it seems, inevitably have been determined by the balance of power in the political struggles from which it resulted. As that balance shifted over time, so would the nature of the principles embedded in the legal corpus. Again, then, the claim that a whole body of law, like that governing corporate insolvency, could be consistent, seems unacceptable, since the claim appears to be premised on a denial of the role of history and politics.

Such criticisms have an apparent 'obviousness' about them, and perhaps this has led to their being accepted on both sides of the Atlantic.[47] This appeal should be resisted. It is submitted the two Objections, properly understood, are incoherent and irrelevant respectively. This is brought out by the argument which follows. The same discussion also helps in understanding how the claim of this thesis must be understood, that consistency of principle can and must be found in corporate insolvency law. That position is set out in the following Section.

[46] Carlson, "Philosophy", p. 1389.
[47] See again Carlson, "Philosophy", p. 1389 and Finch, "Measures", p. 239.

Let us take the Psychological Objection first. Now it is undoubtedly possible that legislators and judges etc. would have had different moral views about even the basic insolvency principles they were legislating or deciding upon. Our task here, however, is to ask if it necessarily follows from that that the law itself reflects these possible inconsistencies. This could more illuminatingly be put as follows: what is the relationship between the states of mind of the law-makers as they engaged in law-making, and the law thus made?[48] The answer might seem to be clearest in the case of statutes, though similar considerations would apply, say, to the interpretation of case-law (discussed below). In reading a statute, it is said, one is reading the expression of the intentions of Parliament as to the law on the subjects addressed by that statute. The basic premise must therefore be that Acts of Parliament "should be construed according to the intent of the Parliament which passed the Act."[49]

Keeping this in mind, the question we posed above can be refined somewhat. We can now ask what the relationship is between the intentions of Parliament as expressed in, say, the Bankruptcy Act 1869, and the intentions of the individual legislators voting on that statute. The latter, of course, would presumably be infused with the divers moral attitudes undoubtedly at play. Someone moved by the Psychological Objection would have to give a particular answer to this question. For them, the reference to 'the intention of Parliament' must merely be "a theoretical construction, a compendious statement of the discrete intentions of particular actual people".[50] Parliamentary intention is nothing more than some sort of amalgam of the respective intentions of individual parliamentarians taken together. Only in this way could the Objection outlined above be sustained. Recall its claim, that the law (and for the illustrative purposes of this argument, statutes in particular) could not possibly enshrine a consistent set of moral principles, since the numerous legislators who had influenced it would not have been "driven by the same ethical impulse every time a legislative decision was made". If the *direct* and *constitutive* relationship implied here between the ethical impulses informing the intentions of the legislators, and the ethical impulses underlying the law, were somehow to be severed, the Psychological Objection would lose both its obviousness and its appeal. We would then be able to say that

[48] By far the best account, on which the following discussion draws, is found in R. Dworkin, *Law's Empire* (London, Fontana, 1986); see esp. Chs. 2 and 9. See also R. Dworkin, *Freedom's Law: The Moral Reading Of The American Constitution* (Oxford, OUP, 1996), and Dworkin, "The arduous virtue of fidelity: Originalism, Scalia, Tribe, and nerve" (1997) Fordham LR 1248, 1255.
[49] *Sussex Peerage Case* (1844) 11 Cl & Fin 85, 143; 8 ER 1034, 1057, *per* Tindal LCJ, who described this as "the only rule for the construction of Acts".
[50] Dworkin, *Law's Empire*, p. 315.

while the law-*makers* might differ as to their views about the basic principles underlying insolvency law, it would not follow that *the law itself* had to display similar inconsistency.

The argument so far does little more than uncover the assumptions underlying the Psychological Objection. But to accept it this far is in fact to accept that the Objection is incoherent. This can be brought out in the following way. Let us consider first whose individual intentions should count in constituting ‘Parliamentary intent’ even with respect to a single statute like the Bankruptcy Act 1869, and in what way. While it was a Bill before Parliament, some Members would have attended to its Readings more studiously than others. The intentions of the former would likely have been formed on the basis of a more complete and reflective view of the issues than those of the latter. Should they be given equal weight nevertheless? Some Members would have spoken during those readings while others would not. Some would have proposed amendments, some of which might eventually be reflected in the Act. How should their various intentions be combined into a composite? The Ministers responsible for steering the Bill through both Houses would obviously have taken a far greater interest in its preparation and progress, and might well have the best-formed intentions of all. Are their intentions to be regarded on par with those of the back-bencher who missed all the Committee work and the substantive part of the Readings, has little or no knowledge of the issues involved, and turned out for the final votes only at the insistence of the Whips? What is more, Parliaments later than the one which enacted a particular statute would obviously have had the constitutional right to amend or repeal it. It might be that a statute would have been unacceptable to the current Parliament in the way it was meant to be interpreted by most of its original legislators. But the judicial glosses put on its explicit text since then make it more palatable,[51] and so it is allowed to stand. Should the intentions of current Members who decide not to repeal the Act, though only on the understanding that the statute would be applied not as ‘originally legislated’ but as subsequently interpreted, also count in determining the meaning of the statute? And how do the intentions of those judges fit into the picture?

Nor would the most consequential of these problems be solved by adopting some arbitrarily simple ‘rule’ about who to count, and how. Suppose we stipulate that only the

[51] See e.g. *Dyson Holdings v Fox* [1976] QB 503: the Court of Appeal, in construing ‘family’ for the purposes of the Increase of Rent and Mortgage Interest (Restrictions) Act 1920, decided that the term included a long-standing relationship of co-habitation, even “though this clearly was not intended by

intentions of those voting for the Bankruptcy Act 1869 are to be taken into account in constructing Parliamentary intent, and that they should all count equally. However, suppose that once that Act had been passed, a problem came to light, one unquestionably within its ambit but not explicitly covered by its text. Imagine plausibly that it was then discovered that, amongst the 'authors' of the Act chosen using the above rule, there was disagreement about how the Act should be interpreted to deal with that problem. Some favoured an interpretation which would implement solution x, some others y, and still others z. In applying the Act, which solution should have been regarded as mandated by Parliamentary intent? Suppose the majority *of those who had voted in favour* of the Act preferred x. However, the groups favouring solutions y or z would, taken together, have favoured either y or z, but strongly opposed x. Further, if the problem now to be addressed had been brought to the attention of all the Members *before* they had voted on the Act, an *overall* majority would have supported solution y. Again, then, what should have been the content of the Parliamentary intent to be constructed out of the individual intentions of the legislators?[52]

These are formidable problems for that understanding of Parliamentary intent which feeds the Psychological Objection. But even if some magical solution could somehow be found for them, that still would not overcome the most serious flaw inherent therein, which concerns its neglect of the variety of mental states of each legislator. Notice the rough but important distinction between the legislators' *hopes* and their *expectations*.[53] Take the situation, not unheard of, where a Member disagrees with policy x, but votes for a statute incorporating it nevertheless because, say, he wishes thereby to be noticed favourably by the Whips. The statutory language is vague, however, and the Member fervently hopes that if the Act leads to litigation, a sensible court would strain to construe it so as to implement policy y instead of x, or at least to give the narrowest possible effect to policy x. At the same time, he believes most courts are unlikely to be sensible on this issue, and expects any litigation to be before one which would in fact be enthusiastic to apply x fully. Suppose several Members voting for the Bankruptcy Act 1869 were similarly divided as to their hopes and their expectations. It is clear a choice would have to have been made as to whether Parliamentary intent covered the hopes or the expectations of those law-makers, but no reasonable method of making it is available. Once

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Parliament in 1920"; see M.D.A. Freeman, "Positivism and statutory construction: An essay in the retrieval of democracy", in S. Guest, *Positivism Today* (Aldershot, Dartmouth, 1996), 11, at 15 and 21.

[52] See Dworkin, *Law's Empire*, pp. 312-37, from which these arguments derive.

[53] Dworkin, *Law's Empire*, pp. 321-4.

again, then, we are at a loss as to the meaning of the Act, since the 'Parliamentary intent' formula is indeterminate.

We seem to have reached an impasse. The only way the Psychological Objection can hold with respect to statutes is by making a direct constitutive link between the "ethical impulses' of individual legislators on the one hand, and those underlying the Act they vote into effect on the other. The problem, however, is that the Objection is its own *reductio ad absurdum*. It demonstrates not only that no consistent ethical impulse could underlie a statute, but also that *no possible intention* could ever be read out of it. In exactly the same way that the law-makers' moral views would differ as to the Bill they vote on, so would their knowledge of its contents, their interpretation of its ambit, their views as to how it should deal with problems not obviously covered by its language, their hopes and expectations concerning its effectiveness, etc. So not only does the statute not contain any consistent moral principles, it is devoid of any consistent meaning whatsoever. On the assumption that Acts of Parliament do have some meaning, then, the 'obviousness' noted above as explaining the appeal of the Objection disappears. Nor is the implausibility of the views enshrined in the Objection a new discovery. It is perhaps an appreciation of the problems summarised above that led courts, for example, to the conclusion that:

> Evidence that every member who voted for a measure put a certain construction upon it cannot effect the meaning which the court must place upon the statute, for it is the product, not of a number of individuals, but of an impersonal Parliament.[54]

Needless to say, almost all the arguments just rehearsed have direct parallels for any type of law-maker. For example, the Psychological Objection implies that since we would discover

[54] *Swart & Nicol v De Kock* (1951) 3 SA 589, 621, *per* Van der Heever JA, AD; cited by the authors of J. Bell and G. Engle, *Cross: Statutory Interpretation* (London, Butterworths, 1995) (3rd. ed.), 25, as "surely hold[ing] good for English law". For a somewhat similar point about the 'apparent' meaning of statutes, see *Inland Revenue Commissioners v Dowdall, O'Mahoney & Co. Ltd.* [1952] AC 401 (HL), 426, *per* Lord Radcliffe: "The beliefs or assumptions of those who frame Acts of Parliament cannot make the law." This has been quoted with approval in, e.g., *Kirkness (Inspector of Taxes) v Hudson & Co. Ltd.* [1955] AC 696 (HL), 714, *per* Viscount Simonds, and *Bettison and another v Langton and others* [2001] 2 WLR 1605 (HL), 1620G [62], *per* Lord Scott of Foscote. Also interesting is Goff LJ's judgment in *Pritchard v Briggs* [1980] 1 Ch 338, 398D-G. His Lordship stated that the framers of the Law of Property Act 1925, s. 186, "may have got it wrong" that a right of pre-emption is proprietary in nature: "They [the framers] merely assume it to be what I would hold it was not." Once again, then, the actual state of mind of those writing Acts of Parliament (and presumably, Parliament itself, which here voted s. 186, as drafted, into law) does not directly determine the content of the law.

different "ethical impulses" at play if we could glimpse into the minds of all the courts which sat in judgment in the cases which defined insolvency law over the ages, we have no hope of finding any consistency of moral principle in that law itself. Once again, however, evidence of the states of mind of all those judges would be no more than a jumble of psychological data, conflicting not only as to the moral views of each judge, but also the scope, ambit, content, and interpretation of their various judgments. If the way to understand *any* aspect of these judgments, and of using them to provide guidance for the future, was to attempt to construct some sort of composite of the judges' respective states of mind, then we would have little or no common law on insolvency (or indeed on any other subject) at all.[55]

It would be useful at this point to tackle briefly the Historical Objection. This, it is submitted, is based on a fundamental misunderstanding of the nature of our enterprise. While true to its premises, it is simply irrelevant to the point it seeks to rebut. It should readily be conceded that there would be numerous disparate historical causes of why insolvency law came to be the way it is. Moral impulses -- the thought that only *this* way of deciding a case, say, would do justice between the litigants -- would be one such type of cause, but they are unlikely to have been the only (or even the dominant) one. Some cases would have been, and are, decided the way they are simply because Counsel for one side happens to be more persuasive than that for the other, regardless of the merits of the dispute. Legislation, in its turn, is inevitably shaped by political compromise, and does not often enshrine the carefully worked out implications of a scheme of justice relevant to the subject being addressed. The legislative process is marked by intricate bargaining and the influence of various lobbying groups. The often delicate balance reached in order to secure a majority in both Houses might well create tension between different parts of the same statute. The principles underlying one set of sections may no longer cohere well with those embedded in another, once all the bargaining is done and a compromise reached. These problems would of course multiply as we gather within our explanatory ambit an increasing number of legislative acts. By the time we approach the historical creation of the *whole* of insolvency law (Acts, subordinate legislation, common law, etc.) viewed together as a unit, it might well turn out to be "based on entropy, anomie, conflict, and confusion, as well as the dictates of logic and reason."

[55] See Dworkin, "Law as interpretation" (1982) 60 Texas LR 527.

Or indeed that is what we would find, were we concerned to provide a "historical narrative or description" of insolvency law, if our aim were "to chronicle [this part of this] community's past from some neutral observer's point of view".[56] As applied to this thesis, the Historical Objection envisages its project as some kind of legal archaeology, a quest to uncover the artefacts buried in one part of society's legal history, a quest motivated by the hope that what was dug up would be the consistently egalitarian foundations of insolvency law. It then plausibly points out that the artefacts unearthed are as likely to be products of rhetoric and political horse-trading and compromise, even simple confusion or injustice, as of reason and morality. However, the project of this thesis is not the one the Historical Objection shows to be unrealistic. It is not an exercise in legal archaeology. Rather, the aim is to "*construct*[] a coherent vision of justice from [this] community's past actions", it is "to uncover[,] in that past[,] principles governing its actions in the present."[57] With this aim in mind, we seek here to "impose order over doctrine, not to discover order in the forces that created it."[58]

How this might be done is explained below, but the following comments serve as a useful bridge between the arguments in this Section, and those still to come. In discussing the *analogous* (not identical) issue of how to understand the purpose of an artefact, Daniel C. Dennett writes:

> the inventor is not the final arbiter of what an artifact is, or is for; the *users* decide that. The inventor is just another user, only circumstantially and defeasibly privileged in his knowledge of the functions and uses of his device. If others can find better uses for it, his intentions, clearheaded or muddled, are of *mere historical interest*. That is, it may indeed be an incontrovertible historical fact that a certain artifact was created by someone with a particular purpose very clearly represented -- both in his head, [] and in written 'specs' and blueprints, we may suppose -- but this historical fact, while it establishes something about how the artifact was intended at the outset, *may* shed no valuable light on the functions it can and does actually serve.[59]

5. Constructive interpretation

Here is the position taken in the argument which follows about how consistency of principle should be sought, and might be found, in corporate insolvency law. The thesis aims to provide an interpretation of this law more attractive than the others available. But this interpretation will not

[56] G. Postema, "Integrity: Justice in workclothes" (1997) 82 Iowa LR 821, 853.
[57] Postema, "Integrity", p. 853 (emphasis added). See also Dworkin, *Law's Empire*, pp. 227-8.
[58] Dworkin, *A Matter of Principle* (Oxford, OUP, 1986), 176.
[59] Dennett, "The interpretation of texts, people and other artifacts" (1990) 50 Philosophy and Phenomenological Research 177, 186 (original emphasis).

be one drawing on psychological data (even if any were available) about the various law-makers, legislative and judicial. The hopelessness of that sort of approach has already been exposed above. Nor will this be an historical account, concerned with tracing the causal antecedents of various bits of this law, or the various twists and turns in the legislative or judicial currents. That *by itself* would not be interesting if the aim is to construct a principled view of this branch of the law.[60] Instead, the account provided here is based on a *constructive* interpretation of insolvency law. This type of interpretation is about "imposing purpose on an object or practice in order to make of it the best possible example of the form or genre to which it is taken to belong."[61] In order to do so, the interpreter "proposes value for the [object of interpretation] by describing some scheme of interests or goals or principles [it] can be taken to serve or express or exemplify."[62] In the case of corporate insolvency law, it has been proposed above that at an abstract level, it is best seen as a scheme of co-operation to deal with peculiar insolvency issues, one which would be acceptable to all those affected by such issues, regarded as equals in the way described. The boundaries of the appropriate "genre" are drawn by the functional nature of insolvency law, and the value ascribed to it is that of enabling its subjects to co-operate as equals.

The reader might wonder why this variety of interpretation attempts to see its object as the *best* example of its genre. Is this perhaps the result of unjustified belief that the object is just *certain* to be the best of its kind? Will the attempt to see the object thus distort an appreciation of its 'true' nature? In fact, constructive interpretation is neither naive nor dogmatic, nor should it be misleading. Its 'assumption of optimality' (that the object is the best exemplar of the sort of thing it is) is merely a strategy of interpretation: "interpretation requires the invocation of optimality".[63] The interpreter seeks to understand the object by assuming that it serves a purpose, and by hypothesising what that purpose is. The optimality assumption is then adopted as a

[60] For the sake of completeness, it should be added that this thesis, while occasionally using evidence and arguments originally made in the context of the US Bankruptcy Code to inform its discussion of English law, is not meant to be a project in comparative law.
[61] Dworkin, *Law's Empire*, p. 52. This is made explicit in the text which follows.
[62] Dworkin, *Law's Empire*, p. 52. Dworkin's forceful arguments have made constructive interpretation part and parcel of legal discourse; in the English context, see e.g. Bell and Engle, *Cross: Statutory Interpretation*, Chs. 2-3; see also R. Allan, "Dworkin and Dicey: The rule of law as integrity" (1988) 8 OJLS 266. For the claim that Dworkin misrepresents certain aspects of 'British' law, see S. Lee, "Law's British Empire?" (1988) 8 OJLS 278.
[63] Dennett, "Interpretation", pp. 184 and 187-8. Dworkin has been the subject of friendly criticism for not clarifying sufficiently the points made in this paragraph; see e.g. Postema, "Integrity", p. 829.

default, that the object of interpretation wholly fulfils the purpose it is taken to serve.[64] This assumption allows the interpreter to construct theories about the nature of the object and make predictions, then to observe which of his predictions work and which fail.[65] His theories must be modified accordingly. The resulting interpretation is complex and rich, revealing not only the features it can successfully explain, but also those which are shown up as 'deviant'. On the basis of how much of the object is thus explained, and how attractive the explanation is, the interpretive community that the interpreter has sought to address can then either reject the interpretation as inadequate or inappropriate, or instead, can update its understanding of the nature of that object.

At least three points must be explained here. Note first of all the emphasis on *imposing* a purpose on the object of interpretation, here, insolvency law. This is very different from attempting to *discover* the purposes of the authors or creators of that law. The aim here is to "propose[] a way of seeing what is interpreted [] as if this were the product of a decision to pursue one set of themes or visions or purposes, one 'point' rather than another."[66] Second, however, the history of this body of law is by no means irrelevant, since it constrains and shapes the available interpretations. Remember that *any* type of interpretation has some creative element, even if trivial, since it seeks to explain or understand its object. It cannot thus be a mere replication or restatement or reproduction. As noted, an interpretation is constructive when it involves a particular type of creativity, i.e., when it posits some point or purpose which it claims is served by its object, then presents an account of how that object exemplifies that point. It remains nevertheless an interpretation *of* something, not an outright act of creation.[67] Put differently, it necessarily presupposes the existence of its object. In the case of insolvency law, which results from legislative acts existing in history, it follows that a constructive interpretation must 'fit' the product of those acts. It must explain them, be an interpretation *of* them. Any theory based on an 'interpretation' that failed to meet this requirement of 'fit' to an appropriate degree would be an exercise in wishful thinking, not a theory of our insolvency law at all.[68] So

[64] Consider the arbitrariness and complexity of assuming anything else, e.g. that 'the object of interpretation fulfils its purpose 90% of the time' (as a starting point, how do we know which features of it should be assumed to fulfil how much of their 'bit' of 'the' purpose?, etc.).
[65] In the context of legal interpretation, the predictions would 'work' by describing and explaining the relevant part of the law, or justifying it, or both; if they do not, then they 'fail'.
[66] Dworkin, *Law's Empire*, p. 59.
[67] See e.g. Dworkin, *Law's Empire*, pp. 231, 242, 255, etc.
[68] That this is the case is exploited in Chs. II and III below, as the final Section of this Chapter explains.

the history of this law shapes the process of interpretation by demanding that the interpretation be accountable to it in this way, that it be able to explain the present contours of the law.

Finally and importantly, however, no interpretation need fit *all* aspects of its *explananda*. This statement might appear surprising, but is actually very familiar from common law legal reasoning. One of its most common applications lies in ascertaining the *ratio decidendi* of a case.[69] The doctrine of precedent requires courts to pay due regard to the ratio of previous relevant decisions. The ratio of course is the legally authoritative determination of the court. But not everything the court says in its judgment forms part of the ratio. Notice three broad possibilities. First, some bits of the judgment are taken to be merely the opinions of the judges, persuasive because said by them in their judicial capacity, but not exercising the same "gravitational force" for subsequent courts and legal commentators as the ratio.[70] Second, some aspects of their judgment would have been regarded as crucial to their decision by the original judge, but might be read out of the ratio by subsequent courts. The original court might have considered the presence of facts A, B and C as determining some aspect of its decision, but a later court might decide the same decision was merited even though only facts B and C were present. Finally, a later court might pick out a fact D which was present in the previous case but not given importance there, and argue that the earlier decision would have been different in D's absence.

The point to note here is that the later court's 'identification' of the ratio of an earlier decision is an interpretation of that decision which fits some but not all of its explicit text. This can be characterised as an attempt to find some principle or set of principles which could, both, explain the result in that case, and which also cohere with the later court's sense of the 'point' of the relevant body of law.[71] Very much the same can be said of the process whereby a higher court reaches its decision after re-reading a line of cases, confirming some, re-interpreting others, and overruling a few. Again, the court's interpretation of this line of authority is based on seeing it as pursuing some set of purposes, and with that in mind, telling a story which, both, fits most (but

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[69] See e.g. the interesting (though resolutely non-theoretical) discussion in G. Williams, *Learning the Law* (London, Stevens & Sons, 1982), 68-79.
[70] For the quoted phrase, see R. Dworkin, *Taking Rights Seriously* (London, Duckworth, 1977), pp. 110-2.
[71] Williams, *Law*, p. 73, puts it this way: isolating the ratio is a matter "primarily [of] reading what the judge says in his judgment, but partly also [of] our knowledge of the law in general, and [of] our common sense and our feeling for what the law ought to be." It must be noted that the position taken here, following

not all) of that history, and which shows how it is a history of that bit of the law attempting to attain those purposes.[72]

We can now put these elements together. A constructive interpretation of insolvency law would seek to discover some set of principles which both fit most of the statutory and case law in this area, and which also justify this law, showing it to be normatively attractive in relation to what is taken to be the point of this law. As already noted, an abstract statement of that point, as seen in the following pages, is that it serves as a scheme of co-operation amongst all the relevant parties conceived of as equals in situations peculiar to corporate insolvency. It will be shown that this perspective, apart from demonstrating that this law is justified, also affords useful analysis of what it is and should be. However, to reiterate a point made before in this Chapter, we can also see why we should keep an open mind about whether, on some issues, the attempt to justify would fail, to be replaced instead by criticism. Like any interpretation, this one might reveal some parts of the law which do not fit within its justificatory and explanatory ambit. We would then have a good reason for condemning those as perverse in the way described above.[73] The other side of the coin is that some parts of this law criticised by others might turn out to be justified by the egalitarian principles identified as relevant here. That would provide grounds for asking that those criticisms be reconsidered.[74]

One final observation in this Section. The discussion here should have shown why the attributes of liberty, reasonableness and equality identified as crucial above, were described as

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Dworkin, is that constructive interpretation is about what the law *is*, not merely about what it *ought* to be. In fact, this dichotomy itself, as commonly understood, is thoroughly misleading.

[72] A particularly clear recent example is the House of Lords' decision in *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1993] AC 70, where a bare majority of their Lordships recognised a prima facie right of recovery based solely on payment of money pursuant to an *ultra vires* demand by a public authority. See in particular the comments of Lord Goff, at p. 166B-C: accepting the Society's plea to discard principles which disallowed recovery in such circumstances, and which "had come to be broadly accepted, at the level of the Court of Appeal", his Lordship engaged in a process of "reinterpretation [of this stream of authority] to reveal a different line of thought pointing to the conclusion that money paid to a public authority pursuant to an ultra vires demand should be repayable". See also Lord Browne-Wilkinson's near-identical comments at p. 196H. (Thanks to Look Chan Ho for drawing this case to the author's attention.) The broad claims reproduced in the text here are defended at length in Dworkin, *Law's Empire*, and in his other work referred to above. Consistent with these claims, see the current position in English law concerning statutory interpretation in, e.g., Bell and Engle, *Statutory Interpretation*, pp. 26-7, etc.

[73] Something similar results from the analysis of the *pari passu* principle in Chapter IV below.

[74] This is what is claimed in Chapter V to be the case with respect to the priority of secured credit.

constructive. The reason is of course that they are themselves claimed to be based on a constructive interpretation of the entirety of this society's political and legal culture

6. Some comments on the role of efficiency

So an egalitarian philosophy is employed in this thesis to inform its analysis of insolvency law. But the thesis also draws on another family of analytic tools, those offered by economics. The arguments in the following pages concern themselves with issues of 'efficiency'[75] as well as justice. This Section explains the notion of efficiency at play here, and its relationship with justice. The two conceptions of efficiency most frequently mentioned in the literature are the Pareto and the Kaldor-Hicks versions. It is however not always clear what those invoking the notion of 'efficiency' mean: "it is common knowledge among law and economics scholars that the oft-employed concept of 'social efficiency' is a highly equivocal term".[76] Nor is this only a problem with the practitioners of Law and Economics: 'full-time' economists are, if anything, even less explicit about their methodology.[77] The first task here will therefore be to disambiguate the two conceptions just mentioned. It will be argued that both are unhelpful to the present project, and that one is positively inconsistent with it. The Section then describes another conception, referred to as transaction cost efficiency. This, it is claimed, does not suffer from any of the problems identified here.

Pareto efficiency, named after the Italian economist credited with its invention, provides the usual starting point for discussion of this subject. A distribution of resources (or opportunities or entitlements) is Pareto optimal (or efficient) if any change would make at least one person worse off, judged by that person's own standards.[78] To understand what this means, suppose there are only two people (A and B) affected by a transaction which consists of taking an asset away from A and giving it to B. The change is Pareto superior if B compensates A fully

[75] Or 'social efficiency'; the two are synonymous here.
[76] Gary Lawson, "Efficiency and individualism" (1992) 42 Duke LJ 53.
[77] R. Posner, *Economic Analysis of Law* (5th. ed.) (New York, Aspen, 1998), pp. 14-5, has to resort to a deductive argument in attempting to understand the economist's notion of efficiency (as opposed to the ones common in Law and Economics): "The conditions for Pareto [efficiency] are almost never satisfied in the real world, yet economists talk quite a lot about efficiency; the operating definition of efficiency in economics [therefore] must not be Pareto superiority[;] nine times out of ten [an economist talking about efficiency] means Kaldor-Hicks efficient"!
[78] This is an accepted paraphrase of Vilfredo Pareto, *Manual of Political Economy* (translated by A. Schwier), (edited by A. Schwier and A. Page) (New York, A. M. Kelly, 1971), p. 261. See e.g. Posner, *Economic Analysis*, p. 14, and Lawson, "Efficiency", p. 85.

for that loss, and is still better off himself. Likewise, a change which affects numerous people is Pareto superior if all potential losers from the change have been fully compensated, and the gainers are still better off because of it. A distribution is Pareto optimal (or efficient) when all such mutually beneficial exchanges have been fully exhausted. Now clearly this notion has immediate and obvious appeal. "In a Pareto superior transaction, somebody gains and nobody loses. Who could possibly object?"[79] A transaction is Pareto efficient only if it would secure the unanimous consent of all those affected by it, and "Who can quarrel with unanimity as a criterion of social choice?"[80]

However appealing the notion of Pareto efficiency might seem, it is not very useful.[81] Hardly any transaction in the world -- perhaps none -- satisfies the criterion of Pareto superiority. Almost every transaction affects countless parties, at least some of whom are made worse off because of it. At the very least, almost any transaction changes the pattern of demand for the resource exchanged (by satisfying someone's demand for it). It thus affects the market price of that resource, thereby reducing the prices of identical or substitutory goods and adversely affecting the suppliers of those goods.[82] Further, given that few Pareto superior transactions can be made, it follows that almost any state of affairs is Pareto optimal: "What *is*, is Pareto optimal"![83] Not much guidance can be gained about the real world from a set of criteria which outlaws virtually every transaction, and which validates almost any distribution of resources.

Kaldor-Hicks efficiency, named after its British inventors, is often put forward as a more useful replacement.[84] That it is sometimes referred to as 'potential Pareto efficiency' provides a clue. Consider the simple two-party transaction again, where an asset is taken from A and given to B. The transaction is Kaldor-Hicks superior if B *could have* compensated A fully for the latter's loss and still be better off. The feature which makes this version of efficiency different

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[79] Lawson, "Efficiency", p. 85.
[80] Posner, *Economic Analysis*, p. 14.
[81] Nor does its 'appeal' have any substance, as explained below.
[82] Dworkin, "Is wealth a value?" (1980) 9 J. Legal Studies 191, 193; Posner, *Economic Analysis*, p. 14. The theoretical point is no less real even if the adverse effect is tiny in some circumstances.
[83] See e.g. G. Calabresi and P. Bobbit, *Tragic Choices* (New York, Norton, 1978), 83-7; Lawson, "Efficiency", p. 87, including the reference in fn. 91.
[84] See N. Kaldor, "Welfare propositions of economics and interpersonal comparisons of utility" (1939) 49 Econ. J. 549, and J. Hicks, "The foundations of welfare economics" (1939) 49 Econ. J. 696.

from the previous one is precisely that no *actual* compensation is required here, so long as the gains to the winners are larger than are the losses to the losers.[85]

This conception of efficiency suffers from serious problems, however.[86] First, recall the formula just given, that a transaction is Kaldor-Hicks efficient if the gains to those who 'win' from it are larger than the losses to the losers. Consider how those losses are to be reckoned. The only coherent measure available is the consent of each of the losers. So a transaction would be efficient only if the party losing out could have been fully compensated to its own satisfaction, while still leaving a surplus for the party benefiting from the transaction (call this the 'K-H surplus').[87] It follows, however, that if *any* person affected by a transaction objects very strongly to being deprived against his will of an asset or entitlement, so that a very high level of *ex post* compensation would have to be offered to redress his grievance at being treated thus, then the efficiency of the transaction becomes doubtful. Obviously, the greater the harm to the losing party, the higher the compensation required to remedy it, and so the greater the possibility that there is no K-H surplus.

> All it takes to make the universe of Kaldor-Hicks-efficient transactions an empty set is one person who sincerely cannot be bought -- that is, a person who values autonomy, either his own or that of others, so highly that no amount of after-the-fact compensation could possibly leave him as well off as he would have been[,] had the loss never been inflicted (without consent) in the first place.[88]

Again, transactions in the real world affect countless people. This is even truer of a rule or policy, potentially governing *multiple* transactions, that we might seek to test using the criterion of Kaldor-Hicks efficiency. This raises the probability that one of those affected by that rule or policy would be someone "who sincerely cannot be bought" in the sense specified above. Even if that is not the case, it is likely there would be little or no K-H surplus in many, perhaps most,

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[85] Posner, *Economic Analysis,* p. 14.

[86] Apart from those considered below, see also the discussion in L. Kornhauser, "Constrained optimization: Corporate law and the maximization of social welfare", in J. Kraus and S. Walt, *The Jurisprudential Foundations of Corporate and Commercial Law* (New York, CUP, 2000), 87, 98-110.

[87] Others possibilities, like those aggregating the utility of losers *as a group*, depend on the making of interpersonal comparisons of utility. Now, aggregation of this sort would be possible only if the utility of each member of the group of losers could be measured and put into the scales together. However, utility as employed in Law and Economics is derived from the satisfaction of preferences, and is thus an experiential state unique to the individual whose preferences have been satisfied. Interpersonal comparisons of the extent or intensity of this state are thus incoherent, as, therefore, are attempts to aggregate the utility of different individuals; see the insightful discussion in Lawson, "Efficiency", esp. pp. 66-71. For an excellent and comprehensive treatment of the broader questions on this point, see Dworkin, *Virtue,* Ch. 1.

instances, given the large number of adversely affected persons. So Kaldor-Hicks efficiency is scarcely more useful than the Pareto version.

Second, arguments based on Kaldor-Hicks efficiency violate the fundamental assumption of this thesis, that all relevant persons are to be regarded as equals. One embodiment of this moral equality is the maxim that they must be treated as ends, not as means.[89] However, reliance on Kaldor-Hicks efficiency to defend a rule or policy would imply that the mere fact of a gain for a large group of people justifies losses to a smaller one. It would follow that those losing out because of the rule or policy were being used merely as means towards the ends of others. Even great harm to them would be acceptable, as long as a sufficiently large number of others derived small individual benefits which, taken together, were even larger. To illustrate this objection, we can imagine a transaction that inflicts loss on A, such that £100 of compensation would be required to make him whole. The same transaction also, however, brings benefit to two hundred other people, each of whom would be willing to pay £1 for that benefit. The K-H surplus is then £100 (the gain of £200 minus the loss of £100), and so the transaction is efficient. The problem, however, is that, once the existence of the K-H surplus is established, *no compensation need actually be provided to A* for the requirements of Kaldor-Hicks efficiency to be satisfied. As noted, this is unacceptable in view of the particular moral underpinnings of the argument here.[90]

Finally, a problem common both to the Kaldor-Hicks and the Pareto versions of efficiency. On either conception, whether the transfer of an asset from X to Y is efficient depends on whether Y could compensate X for the loss and still be better off. However, Y's ability to compensate X depends (among other things) on the *prior* distribution of resources. Very simply put, a rich Y would be able to offer a larger payment to X for the transfer. What is more, note the dependence of both types of efficiency on the preferences of individuals for a resource or an entitlement. Efficiency is achieved when such a resource or entitlement is vested in the person who places the greatest value on it, thus satisfying the recipient's relevant preference. But a

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88 Lawson, "Efficiency", pp. 91-2, citing J. Coleman, *Markets, Morals and the Law* (Cambridge, CUP, 1988), 138.

89 For an insightful explanation of this well-known maxim, see Korsgaard, "Kant's formula of humanity", in *Kingdom*, Ch. 5, pp. 106-132.

90 Of course rules or policies might be justified even though they result in *some* losses to X and greater gains to Y. But the process of justification should not be consequentialist, moving from this fact to the conclusion that the rule or policy is thus justified. For such a rule or policy to be properly justified on egalitarian grounds, it would have to be shown that its selection resulted from a process which, at the very least, provided due and equal protection to certain fundamental interests of all the relevant parties.

person's preferences themselves are a function (*inter alia*) of his initial wealth and income. This is easier to understand if we remember that as defined in economics, wealth includes a person's native endowments, his skill at a sport or his possession of two healthy kidneys, etc.[91] So a physically weak person would have a greater preference for a legal entitlement to bodily integrity than someone stronger.[92] And a person might have a greater preference for leisure at one income level than at another.

It follows that "If income and wealth were distributed differently, the pattern of demands might also be different and efficiency would require a different deployment of our economic resources."[93] This shows also that simply because a transaction is efficient says nothing about its normative merits. Efficiency depends on the prior distribution of income and wealth amongst the parties, and that distribution may itself be unjust. If the initial distribution of resources is unjust, attaining an efficient allocation of those resources would be simply meaningless, since it would make that allocation no more desirable from the ethical point of view than if it were inefficient. So efficiency of either sort says nothing about the ultimate justifiability of any transaction, and thus, *a fortiori*, of any rule or policy.[94]

For all these reasons, we must conclude that efficiency *in itself* does not provide a goal that any area of the law should aim at. It creates no reason for the law to be one way rather than another. To say this, it should be noted, is to reject the dominant assumption in Law and Economics, that while not the only criterion for judging the ultimate normative acceptability of some aspect of the legal system, efficiency is still an "important [and] worthwhile" one.[95] But note the emphasised qualification, that efficiency does not 'in itself' provide any goals for the law. Here is how this is to be understood. For the purposes of this thesis, a distinction is drawn between what might be called *procedural* and *substantive goals* of the law. A substantive goal of a certain branch of the law (or indeed of the law as a whole) would be an end that it seeks to

[91] See e.g. G. Calabresi, "About Law and Economics: A letter to Ronald Dworkin" (1980) 8 Hofstra LR 553, 555 (referring to Dworkin, "Wealth", and Dworkin, "Why Efficiency?" (1980) 8 Hofstra LR 563). For a fuller discussion, see D. Johnsen, "Wealth *is* value" (1986) 15 J. Legal Studies 263, 268-270.
[92] See e.g. the classic, G. Calabresi and A.D. Melamed, "Property rules, liability rules, and inalienability: One view of the cathedral" (1972) 85 Harvard LR 1089.
[93] Posner, *Economic Analysis*, p. 15.
[94] This point is taken up again in Chapter II, in discussing whether the principles recommended by the Creditors' Bargain heuristic create normative appeal.
[95] See e.g. Posner, *Economic Analysis*, p. 13; B. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford, Clarendon, 1997), 15-6; R. Cooter and T. Ullen, *Law & Economics* (Reading, MA., Addison-Wesley, 2000); see pp. 12 and 43-44 (consistent with the comments made in the text here, but see below).

pursue. Taking corporate insolvency law as an example, the substantive goals of this law might be stated, at different levels of abstraction, as ‘To be just to all the relevant parties’, ‘To treat parties as equals’, ‘To provide a fair scheme of co-operation under the circumstances peculiar to insolvency’, ‘To show equal concern and respect for the interests of all those facing such circumstances’, etc. Substantive goals, then, are those which justify the existence of this part of the law by showing it in its best light, by demonstrating why it is worthwhile having it.

Procedural goals, on the other hand, are about *how* the law goes about attaining its substantive goals. For example, procedural goals would be concerned with the *methods* the law adopts to implement a fair scheme of co-operation in the circumstances of corporate insolvency. This perspective enables us to clarify the statement made above: efficiency can never be a *substantive* goal of the law. It can never by itself confer justification on any part of it. However, efficiency -- understood properly -- is quite indispensable as a procedural goal. Once a set of substantive goals has been exogenously specified (e.g. using a theory of justice), efficiency can be used to judge between various proposed schemes for implementing it.

Suppose we specify that a branch of the law should attain a set of substantive goals. Suppose also that there are two proposals about how to bring about these goals. Now it is obvious no proposal can be operationalized and implemented costlessly. Some resources will inevitably be consumed simply in putting in place any such proposal, and in maintaining it in operation. Remember also that most resources are scarce. So the more resources that are consumed in implementing a particular scheme, the fewer that will be available for other worthwhile objectives. It follows that if there are two methods of bringing about a certain goal in these circumstances, we must choose the method which is less costly to implement, other things being equal. Any other decision would amount to wasting resources, since the same objective could have been attained *and in addition*, a surplus would be available for application towards other valued goals. This waste is morally objectionable, then, to the extent that the attainment of those others goals is morally desirable.[96]

[96] A similar point is made by J. Grunebaum, *Private Ownership* (London, Routledge & Kegan Paul, 1987), p. 159.

This provides an understanding of the notion of efficiency employed here, which may be labelled *transaction cost efficiency*.[97] A method of implementing a set of substantive goals is efficient in this way when the resources it consumes in the process of implementation are lower than would be consumed by adopting any other feasible method of implementation. Put differently, a method is efficient, given a particular amount of resources dedicated towards implementation, when it can operationalize the set of substantive goals to a greater degree than would be possible for any other feasible method.[98] It is obvious that to attain transaction cost efficiency should be a (procedural) goal of every part of a morally defensible legal system. This is how efficiency analysis will be employed in the argument here, i.e., to determine whether the law attains its substantive goals in the cheapest feasible way.

One thing still remains to be done in this Section. We must understand the type of transaction costs (i.e. the costs inherent in implementing a set of substantive goals) relevant here. There are two broad (and overlapping) categories.[99] *Co-ordination costs* are the costs arising from the fact that there are limits on what people in the real world can foresee, and on their cognitive capacity for selecting the appropriate response to a set of circumstances presented to them. These costs also arise because there are informational asymmetries, e.g. information relevant to the common plans of both A and B is available only to the former, or is available to him to a greater degree than to the latter. An example from the corporate insolvency context is that of the co-ordination problems faced by the creditors of a company on the verge of insolvency.[100] The implication, given the aim of implementing any set of substantive goals requiring co-operation, is that some resources would have to be expended either ensuring that information is available to a fuller and more uniform degree to all the relevant actors, or that the adverse effects of this not being the case are remedied.

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[97] This draws on, but is not coterminous with, the insights provided by the branch of economics which goes by the same name; see the contributions to O. Williamson and S. Masten, *Transaction Cost Economics* (Aldershot, Edward Elgar, 1995). Specifically concerning the definition of efficiency, P. Milgrom and J. Roberts, *Economics, Organization & Management* (New Jersey, Prentice-Hall, 1992), 22-30, are particularly helpful.

[98] See, by analogy, Milgrom and Roberts, *Economics*, p. 24. See also Cooter and Ulen, *Law*, p. 4: the notion of efficiency they employ here also relates to the avoidance of waste, and is *procedural* in the sense defined here. Though they seem not to realise it, it is quite different from the *substantive* version they describe and adopt on pp. 12 and 43-4.

[99] The two categories are drawn from Milgrom and Roberts, *Economics*, pp. 29-30.

[100] It has been famously argued that insolvency law should be regarded (to use the terminology introduced above) as having as its sole substantive goal the alleviation of those problems; see e.g. T. Jackson *The Logic and Limits of Bankruptcy Law* (Cambridge, MA, Harvard Univ. Press, 1986). This issue is assessed at length in Chapters II and III below.

The second category of transaction costs is *motivation costs*. These arise because different actors have different incentives about how to behave in any situation, since they perceive their interests not to lie in the same direction. Again given the aim of implementing a set of substantive goals requiring co-operation, some resources would have to be expended aligning their interests in such a way that the actors would be encouraged to pursue those goals. In English corporate insolvency law, a good example is found in the wrongful trading provisions in section 214 of the Insolvency Act 1986, which seek to align the interests of managers of firms on the verge of insolvency with the interests of the firm's creditors.[101]

7. An overview of the thesis

The argument so far has concerned itself with the whole of corporate insolvency law. And the Authentic Consent Model (see below) to be put together in Chapter III is meant to provide a procedure for analysing and justifying this entire body of law. However, given the constraints of space, the ambitions of the remainder of this thesis are more limited. While the argument so far has been that consistency of principle must be sought, and might be found, in the entire corpus of insolvency law, the investigation of whether there is such consistency will be restricted to certain important aspects of the law governing the liquidation of insolvent companies.

Here is how this thesis is organised. Chapters II and III concern themselves with the principles that suspend ("stay") unsecured claims in a company's insolvency. There are two broad themes underlying the analysis in these chapters. First, that analysis attempts to unearth and illuminate the principles underlying the stay on unsecured claims. But second, it trades on the longevity and uncontroversial character of this feature of insolvency law, setting it up as a "paradigm"[102] or "provisional fixed point"[103] that any theory of insolvency law must explain and defend. Since the stay on unsecured claims has been so widely accepted and for so long, very persuasive reasons indeed would have to be brought to show it should no longer be part of insolvency law. Till such reasons are adduced, a theory claiming to be that of our insolvency law,

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[101] This is discussed in Chapter VI of this thesis. Note that in this thesis, unless otherwise specified,, 'firm', 'company', and 'corporation' are used interchangeably to refer to a non-charitable limited liability incorporated company.
[102] Dworkin, *Law's Empire*, pp. 72-3.
[103] *PL*, p 8.

but which does not explain and justify the principles underlying the stay, must be considered a failure. Or at least that is what Chapters II and III will claim.

Chapter II examines the Creditors' Bargain model of insolvency law. This well-known model asserts that the most prominent features of insolvency law are best seen as reflecting the notional agreement the creditors of a company themselves would strike if given the chance to bargain with each other before anyone lends anything. The perspective of the *ex ante* bargain is supposed to illuminate the deep structure of this law, and to confer justification on its rules by having reference to the virtue of autonomy. Chapter II asks if the model is consistent with its own premises, whether it can provide useful insight into insolvency law, and most importantly, whether it can generate normative appeal on egalitarian or indeed any other grounds. The principles underlying the stay on unsecured claims are used to demonstrate that the model has no explanatory or justificatory force. It seeks to rely on the self-interest of those subject to the stay to suggest they would consent to it. But it is based on nothing but creditors' hypothetical preferences, and provides no reason why these preferences should be considered binding. The model suggests no non-arbitrary time at which the determination of creditors' self-interest is to be made. Also, the point at which it asserts creditors would consent to the stay is such that creditors actually asked to bargain then would never come to any agreement. Or if they do, the agreement would be oppressive of weaker parties, would be strongly anti-egalitarian, and therefore would have no normative appeal. It follows that principles which can be argued for within the model have nothing to do with autonomy. Nor would they necessarily be efficient.

Chapter III develops an alternative model to analyse and justify insolvency law, referred to as the Authentic Consent Model (ACM). Consistent with the discussion above, its starting premise is that all (but only) those affected by insolvency law are to be given a choice in selecting the principles which would govern their rights, interests, and obligations. Once these parties have been identified, they are to be given equal weight in the selection process, since their legal status (whether they are employees, secured or unsecured creditors, etc.), wealth, cognitive abilities, and bargaining strength, all are morally irrelevant in framing rules of justice. The ACM operationalizes the constructive attributes described above by requiring all principles to be selected from its *choice position*. Here, all the parties are deprived of any knowledge of personal attributes, and must reason rationally. It is shown that parties in the choice position would in fact choose the principles laying down the automatic stay on unsecured claims. The Chapter argues that because of the construction of the choice position and the constructive attributes of the parties bargaining in it, the principles chosen are fair and just, and chosen in exercise of the parties' autonomy. As it happens, they are also efficient. The Chapter concludes by highlighting how the egalitarian character of the ACM distinguishes it from the Creditors' Bargain.

Chapters IV, V and VI deploy the new Model alongside of economic analysis to examine three of the most basic features of English corporate insolvency law. Chapter IV delves into the nature of the *pari passu* principle, which supposedly requires all unsecured claims of an insolvent company to be met proportionately from the insolvent's estate. The argument in that Chapter suggests that there is widespread misunderstanding about the role of this principle. The principle is claimed by commentators to be responsible for the orderliness of corporate liquidation, to explain and justify the collectivity of the liquidation regime and the rules providing for the avoidance (or more accurately, adjustment[104]) of certain types of transaction, and to ensure fairness to all of the insolvent's creditors. The central claim in the chapter, that none of these functions can properly be attributed to the principle, is illustrated by empirical evidence of how the estates of insolvent companies are in fact distributed, the statutory provisions which help put the principle in its proper place, and the case law said to support it. The ACM is deployed to demonstrate that the *pari passu* rule -- often called the 'equality' principle -- has little to do with 'real' equality. The Chapter shows, finally, what it claims is the actual role of 'formal' equality of the sort enshrined in the 'equality' principle.

Chapter V addresses one of the most controversial issues in the literature, about whether and how the priority accorded to the secured claims against an insolvent company can be justified. The arguments in the literature can broadly be construed in two ways. First and more obviously, they can be taken simply as contributing to the ongoing technical debate about the basis on which the priority of secured claims might be taken to be efficient. On this view, such arguments identify various such grounds (signalling, monitoring, control of creditor or debtor misbehaviour etc.), and suggest either that the priority of secured claim is efficient on some of these grounds, or that it has not been shown to be thus efficient. These arguments by themselves are of no direct interest to us here, since they seem to assume efficiency is a substantive goal of

[104] For an explanation, see Prof. Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet & Maxwell, 2001), p. 544.

the law of secured transactions. To that extent, they are inconsistent with the view taken here, that efficiency could not be a substantive goal.

Second, however, some of this debate might be understood as being about, not whether the principles providing for the priority of secured claims serve the substantive goal of efficiency, but about whether they accomplish the objective of (say) controlling debtor misbehaviour (one variety of motivation costs) only in a wasteful way, or worse, whether they allow for the exploitation of some types of parties by others. Now on *this* view, these arguments obviously have a direct relevance to the project of this thesis. Exploited parties have not been treated as equals. And a rational scheme of fair co-operation would not tolerate waste. Such arguments also cohere with the rather simplistic pre-theoretical intuition that secured creditors are 'obviously' treated better than unsecured ones, which is unfair to the latter. So Chapter V provides an analysis of the arguments construed in this second way. It uses economic theory and empirical data to find that these arguments are at best unproved, and more likely, false. It concludes by demonstrating that, taking into account the *actual* conditions under which security is demanded and offered, its priority over unsecured claims in the debtor's insolvency would in fact be part of a rational scheme of fair co-operation amongst equals.

Chapter VI considers the impact of insolvency on the obligations of the debtor's managers by examining the wrongful trading provisions of the Insolvency Act 1986 (section 214). It employs the tools of agency theory and the ACM to analyse the need for these provisions, their structure, role, and effect. It asks whether a scheme of fair co-operation about insolvency issues would include a section 214-type duty, and if so, why. The analysis reveals that the duty would not be equally relevant for all types of companies, and that the influence of the market for managerial labour ensures most section 214 actions are likely to be brought against directors of closely-held companies, and against shadow directors. The analysis utilises the insight that section 214 plays a role similar to security itself. An important aim of the Chapter is to challenge the Law and Economics proposition that to re-distribute the rights of parties in a corporate liquidation creates socially wasteful incentives. After arguing that s. 214 is re-distributive in the relevant manner, the incentives created by those provisions for the managers of both healthy and distressed companies are examined. It is suggested that these incentives are generally socially efficient. In the result, the provisions would be acceptable to all those affected by them, regarded as equals.

Chapter 7 concludes.

Chapter II: The Creditors' Bargain and the Collectivity of the Liquidation Regime

1. Introduction

When a company is rendered unable to pay its debts as they become due,[1] its unsecured creditors might find their ability individually to pursue their claims severely curtailed. In a compulsory winding up, the winding-up order automatically stays all proceedings against the company except by leave of the court.[2] Any disposition of the company's property between the winding-up petition and the order, any attachment, sequestration, distress or execution against its estate are void.[3] In a creditors' voluntary winding-up, the company's liquidator may apply for and receive a stay of any action by one of its creditors.[4] The winding-up order operates in favour of all those interested in the company's undertaking,[5] and the formal insolvency forum has a monopoly -- as against unsecured creditors (and the company's shareholders) -- over any proceedings against it. What is more, attempts to opt out of the mandatory collective forum -- and therefore from the effects of the stay -- are liable to be struck down as preferences.[6]

That a bankrupt's general creditors lose their ability individually to pursue their claims is one of the most well-established aspects of this area of the law. The very first formal attempt to deal with the problems associated with bankruptcy, "An Act Against Such Persons As Do Make Bankrupts", which was passed by Parliament in 1543,[7] provided for the bankrupt's assets to be distributed to his creditors in "a portion rate and rate like, according to the quantity of their debt".[8] The new procedure was initiated by a creditor making a written complaint to any three of the officials named in the statute, and crucially, "once initiated, barred other creditors from

[1] Insolvency Act 1986 (hereafter, "IA"), ss. 123(1), (2).
[2] IA, s. 130(2).
[3] IA, ss. 127, 128.
[4] IA, s. 112. For ease of exposition, this type of stay will also be referred to as the 'automatic' stay. This of course has no effect on the analysis.
[5] IA, s. 130(4).
[6] IA, s. 239; for the conditions which must be satisfied, see especially ss. 239(4), (5), and (6), and *Re MC Bacon (No. 2)* [1990] BCLC 325. For a detailed discussion of the points in this paragraph, see Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet & Maxwell, 2001), 330-41.
[7] 34 & 35 Hen. VIII, c. 4.
[8] *Ibid*., s. 1.

attempting to collect their debts for an unspecified time."[9] For corporate debtors, the history is somewhat more complicated because of the initial absence of limited liability and the possibility of a claim against the company's shareholders. But again, the same feature established itself at a significantly early stage.[10] Parliament in 1844 removed the need to obtain letters of patent from the Crown before a company could be set up.[11] In the same session, another statute -- dealing with the winding-up of companies and partnerships -- provided that "upon a company's failure a fiat in bankruptcy could issue and the [Bankruptcy] Court 'could proceed thereon in like Manner as against other Bankrupts'".[12] And by the time the Companies Act of 1862 passed into law,[13] it had become firmly established that when a company was involuntarily liquidated under court supervision, the presentation of the winding-up petition would cause all actions against it to be stayed.[14]

Contrast this with the freedom of action given to the general creditor of a solvent company. Without being concerned with the rest of the debtor company's affairs, or with the strategies of its other creditors, he can pursue any of a number of self-help and curial rights and remedies, should the company default on his individual debt.[15] Why deprive him of this freedom of action once the debtor company becomes unable to pay *multiple* debts as they become due? As already mentioned, this stay on individual actions by the general creditors of an insolvent company signals the switch from an individualistic to a collective regime. Collectivity has been a central and seemingly indispensable feature of that distinct body of law dealing with insolvency situations. Any attempt to analyse insolvency law which does not explain the deep structure of the collectivity rule must be considered a failure. Any attempt coherently to justify this branch of the law which fails to show this rule in a normatively attractive light constitutes no justification at all. The aim of this Chapter is to put to the test the best-established model in insolvency law.

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[9] V. Markham Lester, *Victorian Insolvency: Bankruptcy Imprisonment for Debt, and Company Winding-Up in Nineteenth-Century England* (Clarendon, Oxford, 1995), pp. 14-5. It must be emphasised that in this thesis, the *pari passu* principle is taken to be a rule of 'priority', i.e. one concerned with the order in which creditors are paid from the insolvent's estate. Issues of priority are analytically quite distinct from the automatic stay which deals with whether claimants have 'immunity' from having to participate in the collective liquidation regime. The immunity/priority distinction is discussed further in Chapter III.5, and explained in detail in Chapter IV.3.
[10] See generally, Lester, *Insolvency*, Ch. 6.
[11] 7 & 8 Vict., c. 110.
[12] Lester, *Insolvency*, p. 222, referring to 7 & 8 Vict., c. 111.
[13] 25 & 26 Vict., c. 90.
[14] Lester, *Insolvency*, p. 226.
[15] See generally, R. Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 1997) (2nd. ed.), pp. 4-5.

Can that model defend the existence of the automatic stay on unsecured claims when a firm enters the formal insolvency forum?

2. The Creditors' Bargain

There is no doubt that insolvency law scholarship was long dominated by the Creditors' Bargain heuristic. For almost two decades, insolvency scholars have either argued within its assumptions, or have proceeded by making it their first (and often primary) target. Though currently rather unfashionable, the model still constitutes the only sustained attempt at a principled analysis of the law governing bankrupt companies (and indeed individuals). Even those fundamentally opposed to the project of that model acknowledge that "the articulation of alternative points of view has not been nearly so coherent and well focused".[16] Attempting to make a virtue of these shortcomings, the Bargain's critics have sometimes claimed it is in fact *desirable* to have analyses which are "dirty, complex, elastic, interconnected", which can "neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision".[17] But one might think the whole purpose of analysing any area of the law is to understand why it contains certain principles, how it justifies having those principles, what policy goals it serves, and what decisions it would reach on questions as yet undecided. That such an explanation was simple and elegant rather than "dirty" and complex would be an added bonus. In view of the pre-eminence of the Bargain tradition, and of its claim to provide just such an explanation, this Chapter asks whether the analysis of the automatic stay given by those expounding that model is satisfactory.[18]

Within the Bargain tradition, Thomas Jackson stands out as the dominant figure. He is the progenitor of the model, and it is in his work (sometimes in collaboration with Douglas Baird and Robert Scott) that this model attains its complete and most refined form.[19] The aim of this

[16] E. Warren, "Bankruptcy policymaking in an imperfect world" (1993) 92 Michigan LR 336, 338. Warren is one of the best-known critics of the Bargain model.
[17] E. Warren, "Bankruptcy policy" (1987) 54 U. Chicago LR 775, 811.
[18] Chapter III addresses issues raised by some of the Bargain's leading critics, including Warren herself, K. Gross and D. Korobkin.
[19] Jackson, "Bankruptcy, non-bankruptcy entitlements, and the Creditors' Bargain" (1982) 91 Yale LJ 857; Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard Univ. Press, Cambridge, Mass., 1986); D. Baird and Jackson, "Corporate reorganizations and the treatment of diverse ownership interests: A comment on adequate protection of secured creditors in bankruptcy" (1984) 51 U. Chicago LR 97; Jackson and R. Scott, "On the nature of bankruptcy: An essay on bankruptcy sharing and the Creditors' Bargain" (1989) 75

Chapter is to examine and criticise the Creditors' Bargain, and for this purpose, Jackson's work will be taken as paradigmatic. However, it must be noted that *all* the criticisms made here of his work are equally applicable to all those who have written sympathetically within the Bargain tradition.[20]

Jackson asks us to imagine all those who would lend to a (or any) company coming together before any lending has taken place. Together, the prospective creditors seek to settle how their claims should be dealt with, should the company become insolvent at some stage after the loans are made. At this hypothetical meeting, the creditors-to-be come to realise that a multiple default by the debtor company would lead to a multi-party Prisoner's Dilemma if all of them continued to enjoy unrestricted freedom of action.[21] Under the (non-insolvency) individualistic debt-enforcement regime, claims are met roughly in the order in which they are brought. So, should it get into difficulties, there is a premium on racing for the company's assets, for the following reason. If the debtor's assets are insufficient to meet its liabilities,[22] then by definition not all of its creditors will be paid. Those who are quickest in pressing their claim would be paid in full; all others would get little or nothing. In order to ensure they were first at the finishing line, each creditor would have an incentive to expend resources monitoring the company's affairs, since the earlier they can discover it is in financial distress, the greater their chances of being paid. But most of this monitoring would be duplicative and wasteful. Regardless of the magnitude of this expenditure in the aggregate, the company's insolvency would deprive some claimants of some or all of what they are owed. What is more, individual debt-collection efforts would be haphazard, leading to the dismantling of the company's undertaking and the disposal of its assets piecemeal to satisfy claims as they arise. If the assets are more valuable together as a going concern, the loss of this 'going concern surplus' is suffered jointly by the creditors as a group (and by society).

At the hypothetical meeting, the company's creditors are also aware that some of them are risk averse. This means they prefer a lower but more certain return on their loan, to a higher but

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Virginia LR 155. See also Baird, "Loss distribution, forum shopping, and bankruptcy: A reply to Warren" (1987) 54 U. Chicago LR 775, 815.

[20] The present author must himself accept a degree of culpability! See Mokal, "An agency cost analysis of the wrongful trading provisions" [2000] CLJ 335.

[21] On the Prisoner's Dilemma, see e.g. E. Rasmusen, *Games and Information: An Introduction to Game Theory* (Blackwell, Cambridge, Mass., 1989) (2nd. ed.), pp 16-9.

[22] IA, s. 123(2).

more variable one.[23] This propels them to agree to participate in a Bargain which restricts their individual freedom of action, should the debtor become financially distressed. The individualistic regime is replaced by a collective one. The collective system responds to risk aversion by promising all similarly-placed creditors a lower but more certain return on their loans, and the need to waste resources on monitoring and the possibility of loss of the going concern surplus are both mitigated. Jackson suggests therefore that the stay on individual unsecured claims inherent in the collective insolvency regime should be seen as an off-the-rack (and therefore cheaper) version of the agreement creditors themselves would strike to govern their rights against the debtor company and each other, if given the chance to bargain *ex ante*, before they lend anything. They do not have this chance because the identity of those who would lend over the life-time of the debtor company and who would have claims outstanding when the company becomes insolvent, is uncertain *ex ante*, before *any* lending has taken place. So the Bargain model predicts what real-life creditors would agree to if they could meet with each other and if there were no transaction costs, and the automatic stay merely enforces that hypothetical agreement.[24]

What explanatory and justificatory force does this Creditors' Bargain model have? Does it really tell us anything useful about the automatic stay?[25] Jackson has claimed the model is "an application of the famous Rawlsian notion of bargaining in the 'original position' behind a 'veil of ignorance'".[26] But it is suggested here the Creditors' Bargain model is decidedly non-Rawlsian. It has certain distinctive features which contradict fundamental aspects of both the Rawlsian notions of the veil of ignorance and the original position. The Creditors' Bargain is instead a member of a family of 'contractarian' theories (so called because they derive their explanatory force from some sort of agreement) referred to in the political philosophy literature as 'mutual advantage' theories.[27] Specifically within the Law and Economics tradition, the

[23] For an introduction to the notion of risk aversion, see any textbook on intermediate microeconomics, e.g. R. S. Pindyck and D. L. Rubinfeld, *Microeconomics* (Prentice-Hall, New Jersey, 1998) (4 ed), Ch 5; on why it is reasonable to assume the existence of risk aversion, see p 155.
[24] This summarises the arguments in Jackson, *Bankruptcy*, Ch. 2.
[25] This focus of this Chapter should be contrasted with D. Carlson, "Philosophy in bankruptcy" (1987) 85 Michigan LR 1341, 1345-55. Carlson's concern is with Jackson's arguments in defence of the equal treatment of (some) creditors *within* the insolvency forum, i.e. about priority. This Chapter is about Jackson's explanation of the coercive collective forum itself, or in other words, about why unsecured creditors are denied immunity. Chapter IV shows how the two issues are quite separate.
[26] *Ibid*., p 17 fn. 22; see also pp. 236-7.
[27] Traces of 'justice as mutual advantage' can be found in varying degrees in, e.g., Hobbes and Hume. The leading contemporary proponent is D. Gauthier; see his *Morals by Agreement* (Clarendon, Oxford, 1986). To confirm that the Creditors' Bargain is a mutual advantage theory, compare Jackson, *Bankruptcy*, Ch. 2 and Jackson and Scott, "Nature", with Gauthier, *Morals*, Ch. 1.

Creditors' Bargain is an application of a model developed by Richard Posner a short while before Jackson first propounded the Bargain.[28] That the Creditors' Bargain is Posnerian and not Rawlsian has profound implications for Jackson's analysis. These are discussed below.

The normative appeal of the Creditors' Bargain is supposed to derive from two sources.[29] The first is the notion of consent (which explains the 'Bargain' terminology). The second is the *ex ante* standpoint from which creditors choose how their claims are to be dealt with in their debtor's winding-up (this is the Bargain model's version of the 'original position'). Put the two factors together and we are supposed to have in the model an ethically attractive justification for various aspects of insolvency law, and in particular, for the stay on unsecured claims in the formal liquidation forum. The argument in essence is this. No one should complain if the principles consented to by the relevant parties themselves, before these parties knew the eventual outcome of their transaction with the debtor, are applied to them now that the debtor is insolvent. Not to enforce these principles would in fact be to violate the parties' own autonomy.[30] It would violate their "freedom of choice", since it would mean overriding the choice the parties themselves would have made.[31]

This argument is examined in detail below. It is suggested here that the Creditors' Bargain fails to justify any aspect of insolvency law. The notion of consent it employs is hollow. The standpoint from which parties make their choice is incoherent and arbitrary, and confers no fairness on the choice made. The attempt to squeeze out legitimacy from the model fails at every level.

3. Fundamentals of the Creditors' Bargain

We must be very clear about the identity of the 'creditors' in the Creditors' Bargain. Everything which follows is premised on understanding who these people are. The two assumptions to be discussed here are central to the Bargain heuristic, and only these assumptions give meaning to it. Note first of all that in the Creditors' Bargain, the bargain is hypothetical, but the creditors are

[28] See Posner, "The ethical and political basis of the efficiency norm in common law adjudication" (1980) 8 Hofstra LR 487.
[29] D. Brudney, "Hypothetical consent and moral force" (1991) 10 Law and Philosophy 235, 235, concerning consent arguments generally in Law and Economics.
[30] Jackson and Scott, "Nature", p. 160; Posner, "Efficiency", pp. 489-497.
[31] Brudney, "Consent", p. 238, summarising one of the claims made for the argument from consent.

quite real.[32] The argument is that *actual* creditors in a (or any) real-life transaction, if allowed to bargain with each other before anybody has lent anything, would agree to the collective regime. "[The] hypothetical bargain analysis provides indirect evidence of what *real world parties* would, *in fact*, agree to."[33] So the hypothetical bargain is to be concluded by "actual people, deploying actual endowments of skill and energy and character, making choices under uncertainty".[34] This means participants in the Creditors' Bargain have the sort of attributes that creditors in real-life transactions have. The various parties who give consent in the Bargain lend either secured or unsecured,[35] are "systematically faster... or friendlier with Debtor" than others,[36] and are able to affect the (notional) bargaining process differently according to their "relative savvy and bargaining skills".[37] Let us call this the Real Parties premise.

These "real world parties" must together make a (hypothetical) choice of the governing insolvency principles. That choice is restricted only by the "natural ignorance" of the eventual outcome of their transactions with the debtor.[38] This last we call the Natural Ignorance premise. Importantly, creditors continue to have, and know they have, all the various attributes that make them different from each other at the time that the notional Bargain is supposed to be concluded. So for example:

> A central premise underlying this Creditors' Bargain conceptualization is that a system of [non-insolvency] law entitlements is already in place and that parties know [at the time that the Bargain is to be struck] what their priority positions will be so long as [non-insolvency] law continues to govern their rights.[39]

Jackson is more or less consistent as to the boundaries of the Natural Ignorance premise. The one lapse comes when, in discussing why the individual bankrupt's right to be discharged is non-waivable, Jackson implies individual parties, while able to anticipate the general "human tendency toward impulsive behavior", are unaware of how impulsive they themselves would be.[40] As already noted, however, Naturally Ignorant parties are aware of personal characteristics, and therefore presumably of how impulsive they usually are when taking important decisions,

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[32] See Gauthier, *Morals*, p. 9.
[33] Jackson and Scott, "Nature", p. 160 (emphasis added).
[34] Posner, "Efficiency", p. 499.
[35] Jackson, *Bankruptcy*, p. 59 fn. 80.
[36] *Ibid*., p. 15.
[37] *Ibid*., p. 30.
[38] Posner, "Efficiency", p. 499.
[39] Jackson and Scott, "Nature", p. 160; see also the references from Jackson, *Bankruptcy*, above.
[40] *Ibid*., pp. 236-7; I am grateful to Alison Clarke for bringing this passage to my attention.

personal or professional. Be that as it may, and guided by the principle of sympathy, let us ignore this inconsistency.

Note that in a way, Natural Ignorance is quite an unsurprising condition. It demands that before being asked (notionally) to consent to the automatic stay, creditors should be denied knowledge of what would happen to their particular debtor. They should not know if the latter would become insolvent while still indebted to them. They should not be aware of how well-positioned they would be in *this particular transaction* to win an individualistic race to the court in order to obtain a judgment and enforce it against the debtor's assets, if there is no collective insolvency regime and this debtor gets into difficulties. But as already noted, they should continue to be aware of who they are, of whether they are systematically faster than other creditors in this particular transaction, of whether they have inside knowledge of the debtor's business affairs by virtue of being one of its directors, etc. The creditors' ignorance is 'natural' because it is precisely the sort real creditors at some actual pre-transaction stage could be expected to be in, no more and no less.

Strangely, though, it might be (and has been) objected that to impose this condition on Jackson's model is to construct a man of straw which might eventually prove easier to knock down. It might be claimed that Natural Ignorance is too harsh a restriction to impose on the model, and can not be regarded as necessary to a faithful reading of it. In particular, what the creditors know about themselves in the *ex ante* position should be construed otherwise than by way of this condition.

The objection, which will be explained in more detail below, has been put to the present author a number of times, and appears to those making it to be very straight-forward indeed. In reality, it is a complex one, and can only be met through some understanding of the philosophical underpinnings of the Bargain model. Its significance will become increasingly apparent as the argument progresses, and it will decisively be shown to be untenable only towards the end of the next Chapter. But a start can be made in that direction now. Here are a couple of preliminary points.

Natural Ignorance requires creditors to know who they are, how good are their debt-collection skills, and how they are related to the debtor. Note first of all that this is the only form of restriction on the creditors' knowledge compatible with the actual text of Jackson's (and Scott's) argument. Any other reading simply ignores the repeated and emphatic reliance placed by its creators on this element of the model. Jackson's argument is replete with references to the knowledge the negotiating creditors have of their own abilities and characteristics.[41] There are also substantive internal reasons for saying he is thinking about actual people. The treatment of tort claimants is an example. Jackson has in mind a hypothetical agreement among real people who know they will lend to the company but do not know what will then happen to their debtor's business. Naturally therefore, he thinks real *involuntary* creditors could not be invited to participate in the notional Bargain, since they would not know at that time (*ex ante*) that they would later unexpectedly be forced to extend credit. It is for this reason that he says involuntary creditors "would not fairly be considered participants in a creditors' bargain."[42] Nor would it help to suggest all Jackson needs to change his position on this point is for him to ask what rule tort claimants would hypothetically pick before they knew the tort would be committed against them. As argued, this move would contradict Natural Ignorance, a fundamental element of the model. Only by keeping this in mind can we hope to understand statements of the following sort from expositors of the Bargain:

> [Whatever] the merits of the claim that society owes [tort] victims protection[,] this protection does not derive from the consensual arrangements that would underlie any ex ante Creditors' Bargain. Distributions to nonconsensual claimants are *conceptually different* from those that would be agreed to in any bargain in which individual self-interest was a central feature.[43]

Turning now to the other premise of the model, it should be equally clear that given the nature of the Creditors' Bargain, Jackson *must be* concerned with Real Parties. In its justificatory role, the Bargain is supposed to legitimate real-life coercion against real-life creditors (they are deprived of their freedom of action). Suppose such an actual creditor C who is well-poised to win an individualistic race for the insolvent's assets, finds he has been deprived of this advantage by the automatic stay. How would Jackson justify this to him?[44] Suppose the Creditors' Bargain is not based on what actual people would have done, and Jackson runs through its arguments to C. C's response would surely be along these lines: "So you say the imaginary participants in an

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[41] See again Jackson and Scott, "Nature", p 160 and Jackson *Bankruptcy*, pp 59 fn 80, 15 and 30, etc. See also Posner, "Efficiency", p 499. These examples are merely illustrative, not exhaustive.
[42] Jackson and Scott, "Nature", p. 177
[43] *Ibid*., p. 178 (emphasis added).
[44] At the individual or institutional level; see Section 4(d), below.

imaginary agreement would have given imaginary consent to the stay. Fine, those imaginary people must be held to their imaginary choices. How precisely does that justify depriving *me* of my advantageous position?" [45] To avoid C's retorting thus, Jackson has to say the stay would have been consented to, not by some non-existent persons, but by C himself *ex ante*. Only then can he justify coercing the non-fictional C into giving up his favourable position.[46]

In any case, it would not take matters any further to say the Creditors' Bargain is based on the choices of fictional creatures. Someone might claim the Bargain focuses on the consent of fictional 'agents' or 'representatives' of different types of creditor. Put differently, the claim would be that the model describes the agreement of some archetypal 'bank-', 'employee-', 'director-', and 'trade creditors', etc. Now remember that the Bargain is supposed to be a hypothetical one, and no transaction costs are involved. We must ask why the model still needs to resort to the agreement of fictional creatures. If it can prove that *actual* creditors would agree to the stay if they could bargain together without incurring transaction costs, any argument that fictional 'representative' creditors would do the same is superfluous and simply pointless. But suppose the Creditors' Bargain must appeal to the consent of fictional creatures because it can *not* prove actual creditors themselves would have agreed to the automatic stay. Jackson must now explain how fictional creatures *with all the relevant attributes of actual creditors* would come to a different decision. And if these fictional creatures *do not* have all the relevant attributes of actual creditors, then how do their supposed decisions justify coercion against actual creditors who are different in those relevant respects?[47] Again, the only answer available within the framework of the Creditors' Bargain is that while it concerns hypothetical choices, those choice would have been made by Real Parties in any (or all) actual transactions.[48]

4. Consent

This element of the model is the first source of its normative appeal. The fact that one has agreed to accept a particular obligation, or to the application to his situation of a certain policy, is a good

[45] It is suggested the sort of reply one would ideally need to C's question is sketched out in the next Chapter. But that is not Jackson's reply. What is more, given Natural Ignorance, it could not be his reply.
[46] It is clear this is what Jackson is in fact trying to achieve; see e.g.. Jackson and Scott, "Nature", p. 160.
[47] The same applies *mutatis mutandis* to the analytic role of the Creditors' Bargain, discussed in Section 6, below. If the only thing the Bargain can explain is how the automatic stay serves the interests of fictional people who do not bear sufficient resemblance to real-life creditors, then it provides little help in understanding the real world.
[48] To similar effect, see Brudney, "Consent", p. 242.

moral reason for enforcing that obligation against him or applying that policy to him. If actual consent is unobtainable because impractical, then it is argued "implied" consent may be relied on to the same effect:

> If there is no reliable mechanism for eliciting express consent, it follows, not that we must abandon the principle of consent, but rather that we should look for implied consent as by trying to answer the hypothetical question whether, if transaction costs were zero, the affected parties would have agreed to the institution [or policy].[49]

Consent of some description by the creditors to the collective liquidation regime is an important element in the Creditors' Bargain. The acceptability of a stay on individual actions is often referred to the court of creditor consent:

> Assume that each party can watch out for its own interest, and let us see whether... there are reasons to think that these people [the creditors] would favor a set of restrictions on their own behavior.[50]

It has rightly been noted that "Despite enormous appeal on its face, consent is among the most troubled and troubling notions in all of political philosophy".[51] Its use in the Bargain model must therefore be subjected to studious attention. This Section seeks to determine what sort of consent is at issue, the nature of the propositions being consented to, and the role self-interest plays in determining whether consent has been given.

a. Mere preferences

Consider first how crucial it is to determine the nature of the propositions being consented to. Suppose a choice is to be made between Rules P and Q. P lays down that in a company's winding-up, unsecured creditors are barred from pursuing individual actions independently of the collective winding-up regime. Q, on the other hand, is the rule that there is no stay on individual collection efforts. X Ltd. is a weak, over-stretched trade creditor. It anticipates it would be unable to spend much on monitoring its debtor and racing for its assets, should the debtor become financially distressed. X also expects there to be other, better-resourced creditors who would beat it in any such race. X is asked to indicate as a preference which rule it wants, and chooses P. Later, X makes a succession of profitable deals, and finds plenty of resources at its disposal to

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[49] Posner, "Efficiency", p. 494.
[50] Jackson, *Bankruptcy*, p. 13. There are numerous such examples; see, e.g.., *ibid*. pp. 15 ("Would the creditors agree in advance to [such] a system?"), 17 fn. 22, etc.
[51] R. Hardin, "The morality of Law and Economics" (1992) 11 Law and Philosophy 331, 361.

expend on monitoring any prospective debtors. It now states it wishes to change its choice, opting -- as could be expected -- for Rule Q. Should X be allowed to resile from its *actual* consent? Note that if this question is answered in the affirmative, then the similar question premised on X's *implied* consent must *a fortiori* be answered in the affirmative. If actual consent in such circumstances does not bind, nor would any variety of implied consent.

So, is the switch from P to Q condemnable, because morally suspect in some way? This depends on the sort of choice X was asked to make. If what was required of it was a mere preference, then there is nothing objectionable in changing one's preferences in line with one's self-interest. It would be perfectly permissible, indeed more accurate, to say X prefers Rule P till time t, and Rule Q thereafter. Time t of course is the moment at which X transforms from a struggling weakling into a commercial heavyweight. It would be another matter if X was asked to pick what it regarded as the fair or just rule (or even the most economically efficient one). The switch from P to Q would then smack of hypocrisy.[52]

Now all of Jackson's arguments from consent are put in terms of Creditors' preferences. Jackson does not suggest the automatic stay would be agreed to by actual creditors selecting fair or efficient principles, but rather that it would be preferred to any alternative by parties motivated by nothing but self-interest.[53] Jackson does not so much as hint anywhere in his work that the creditors are to be asked anything but simply, what they prefer. The background is that the Creditors' Bargain is an economic model, and micro-economics itself is based on individuals revealing preferences. The argument often is that despite the fact that individuals are doing no more than expressing preferences in the market, the result (given conditions of complete markets, sufficient competition, information and resource flows, etc.) is an overall tendency towards efficient equilibrium, which is taken to be a desirable state of affairs. Individuals are not *deliberately* making efficient choices (or "fair" ones, whatever that might mean in this context).

So as an economic model, the Creditors' Bargain is based on preferences.[54] But mere preferences are not binding. So for example there would be nothing morally condemnable for

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[52] A similar argument is considered by Brudney, "Consent", pp. 239-40.

[53] For a similar observation, see D. Korobkin, "Rehabilitating values: a jurisprudence of bankruptcy" (1991) 91 Columbia LR 717, 738.

[54] The possible difference (irrelevant here) between the economist's notion of 'preference', and that employed by the Creditors' Bargain is that the former is concerned only with the actual choice made, but

weak creditor C to say at the time that he extends the loan that he prefers the principles laying down the automatic stay, but upon discovering he was particularly well-positioned to grab the now-insolvent debtor's assets in a particular transaction, to state truthfully that his preference is now for the individualistic regime. Such preferences are motivated by nothing but self-interest, and there is no reason in the Creditors' Bargain why they should not shift with that self-interest. Someone might wish to reply that the choice before time t would have encouraged legitimate expectations about how future transactions would be dealt with, so it should be held binding. But this reply misses the point. The order of choices is arbitrary and could be reversed (a rich creditor which had chosen the individualistic regime before t is newly-impoverished and now wishes to choose the collective one). In that case, the Bargain model should insist the reified choice is the one in favour of the individualistic regime, hence providing no support for our collective system. Or it might be stipulated that the choice made after t should only affect transactions taking place at later times t2, t3, etc. Since there would then be no retroactivity, there could be no confounded expectations, and the automatic stay could be abandoned thenceforth for the free-for-all system.

Now of course a legal system can not allow its insolvency rules to change in line with the whims of one or other creditor. To say that, though, is not to support but to condemn the Creditors' Bargain. There is nothing in that model itself which weaves together non-binding preferences into binding rules. In the example above, the model can not explain why X Ltd.'s preference for the collective regime overrides its later preference for the individualistic regime (or indeed *vice versa*). So the model provides no justification for the coercion inherent in the collective regime. Nor can Jackson get away by saying the preferences he is concerned with are "implied", not real. If one's real choices do not bind, why should choices one never actually made? Crucially, there are no substantive or procedural constraints in the model to ensure the rules picked (actually or "impliedly") ought to be considered binding.

b. Varieties of consent

Still, let us give the Creditors' Bargain the benefit of the doubt. Perhaps the *ex ante* position of the model, to be discussed later, provides a unique morally privileged time, so that even preferences revealed then would be binding. So let us put this objection aside for the moment.

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the latter might also take into account what the actor thinks and says about his actual choice. See Gauthier, *Morals*, pp. 26-38 for more detail.

Let us distinguish between different types of “implied” consent.[55] Consider the paradigm of two parties freely entering into a contract of sale (say). The terms of the contract reflect the rights and obligations *expressly* consented to by them. Suppose now that the price was settled in US dollars, but the contract is silent as to the currency in which payment is to be made. The judge discovers that both parties contemplated payment in pounds sterling. For the sake of simplicity, let us suppose the buyer’s manager authorised the buyer’s bank to make the payment from its sterling account, and the seller’s finance director similarly informed the seller’s bank to expect a deposit in pounds sterling. The judge has discovered a real ‘state of mind’, an actual but un-stated common understanding between the parties as to the mode of payment. That payment was to be made in pounds sterling has been consented to by the parties, though the consent was *unexpressed*. Be that as it may, the unexpressed consent provides a good reason by itself for the term to be enforced against the contractors.

Suppose now that there is no evidence of the parties instructing their banks as to the mode of payment. But suppose evidence is adduced that in that industry, for that product, in that region, it is universal practice for the price to be determined in dollars, but for payment to be made in British pounds. Given these facts, the judge would have a reason to require the contractors to make and accept payment in sterling on the basis of *reconstructed* consent. The ‘term’ being enforced has been reconstructed with reference to what the reasonable person in the parties’ position would have agreed to. Note that the content of such consent is conventional, being determined by asking what normal people in similar (geographical, cultural, commercial) circumstances would expect. Also, this sort of consent can only arise because the parties have participated in an institution, here, the commercial community they operate in. The obligation accepted or rights conferred in this way flow from this participation. They have no normative significance independent of such participation. Finally, such rights and obligations are contingent on there being no stronger countervailing factors:

> Obligations generated by reconstructed consent are only prima facie and not ‘all things considered’ obligations. They can be overridden by other considerations.[56]

[55] R. Dworkin, “Why efficiency?” (1980) 8 Hofstra LR 563, 577, and Brudney, “Consent”, pp. 263-8. See also, Daniel Farber, “Economic efficiency and the ex ante perspective”, in Jody Kraus and Steven Wilt, *The Jurisprudential Foundations of Corporate and Commercial Law* (Cambridge, Cambridge University Press, 2000), 54.
[56] Brudney, “Consent”, p. 267.

So, is the "implied" consent appealed to by the Creditors' Bargain express, unexpressed, or reconstructed consent? Recall that the Bargain seeks to justify the institutions and principles of insolvency law, and does so by reference to the *ex ante* consent of the parties subject to the coercion inherent in this law. It is clear creditors in a (or any) transaction have provided no actual consent, express or unexpressed, to being thus bound. Because the identity of all those who would eventually lend to the company (voluntarily or involuntarily, as by being the victim of a tort committed by it) is unknown before *any* lending has taken place, it would be difficult to expect them to have given express consent. Nor would it be helpful to imagine that creditors have unexpressly consented to the collective regime by "taking a silent vow to that effect each morning before breakfast."[57] At the very least, the model provides no empirical evidence in support of any such assumption.

Reliance on reconstructed consent is equally unhelpful. For one thing, to employ this notion in justifying an institution is problematic. It has been noted that reconstructed consent is conventional, and that it is premised on the existence of an institution. In the example considered above, parties are bound by the payment-in-sterling rule because they are members of a particular commercial community, and because a reasonable member of that community would expect the payment-in-sterling rule to be applied in that situation. The consent to that rule is said to arise only because the community already exists, and because its practices are considered legitimate enough to be allowed to be adopted by its members (or whose legitimacy is being demonstrated elsewhere).[58] To attempt to justify the existence of the community itself, or of some of its practices, by referring to consent which is deemed to arise precisely because the community and its practices exist, is to commit oneself to a vicious circularity. Further, reconstructed consent is only a prima facie reason for holding someone to a particular course of action, and must be displaced if a stronger opposing reason dictates a different result. Specifically in the example above, actual evidence that parties intended the payment to be in US dollars, would override any attempt to "reconstruct" a contrary "consent" (unless that actual intention itself is unacceptable for some independent reason). Suppose an unsecured creditor X extracts a covenant from debtor D at the time the loan agreement is concluded that in D's winding-up, X would not be bound by the automatic stay on enforcement action by unsecured creditors. X has not then consented to the stay in fact; indeed, he has explicitly rejected it by procuring the covenant. It is not helpful to

[57] As Dworkin, "Efficiency", p. 578, rather flippantly remarks in the context of tort liability.

justify the continued applicability of the stay by invoking X's "reconstructed" consent to it. It might still be possible to argue, of course, that it is reasonable to strike down the X-D covenant purporting to grant X immunity from the automatic stay for independent reasons. It might therefore be said X should be held to have agreed to what is reasonable. But then the notion of consent is doing no work at all. It has dropped out of the picture, and appeal is being made directly to whatever factors make the mandatory automatic stay reasonable. For all these reasons, then, the Creditors' Bargain could not be relying on reconstructed consent.[59]

This brings us nicely to *counterfactual* consent. The label itself suggests that if X is said to have given counterfactual consent to a policy P, he has in fact not consented to P. "[A] counterfactual consent is not some pale form of consent. It is no consent at all."[60] What is actually being said is that X's "consent" is a fiction, and that policy P ought to be applied to him for reasons which have nothing to do with whether he has consented to it. Consent in this sort of argument is merely the facade behind which the real work is done. One must then examine the arguments given for saying X *would* consent to P. P stands or falls on the strength of those arguments.[61]

What sort of reasons might one adduce to argue that X has given counterfactual consent to a proposition or policy? Consider first the most obvious. It might be argued that if X had been asked to consent in advance to policy P, he would have done so. It is therefore fair later to apply P to him, even though he did not in fact consent. P can then said to be justified because of X's counterfactual consent. Note that this argument takes us no further at all. We must still ask why X would have consented if consulted *ex ante*, and the response determines whether it is fair now to insist that counterfactual consent was given. Consider what may be called the Belated Offer argument:

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[58] For a similar observation, see Alan Schwartz, "Karl Llewellyn and the origins of contract theory", in Kraus and Wilt, *Foundations*, 12, 34.
[59] There is a somewhat similar argument that in English law, actual intention is required to signal participation in the institution of contract. But once there is evidence of such an intention, the *content* of the contractual obligation is determined by the 'objective' approach to intention, or in the terminology adopted here, by what parties have given reconstructed consent to. See A. de Moor, "Intention in the law of contract: Elusive or illusory?" (1990) 106 LQR 632.
[60] Dworkin, "Efficiency", p. 578.
[61] This is not to suggest counterfactual consent has no role to play in normative argument. The next Chapter sketches out a model in which hypothetical consent under carefully-specified conditions is argued to confer justification on the principles thus consented to.

> Suppose I did not know the value of my painting on Monday; if you had offered me \$100 for it then, I would have accepted. On Tuesday I discovered it was valuable. You cannot argue that it would be fair for the courts to make me sell it to you for \$100 on Wednesday. It may be my good fortune that you did not ask me on Monday; but that does not justify coercion against me later."[62]

So a mistake -- and fraud and duress etc. -- are bad reasons for saying since X would have consented *ex ante* to a proposition, he should now be held to the content of that proposition. What *good* reasons might there be for attributing counterfactual consent to X? Here is a plausible answer. Policy P is in X's interest. So it is reasonable to claim X would consent to it. This form of argument is common to much of Law and Economics where reference is made to consent.[63] This form of argument is also clearly at the heart of the Bargain model. Recall the discussion at the beginning of this Chapter. Since the collective insolvency regime characterised by the automatic stay is so clearly in the common interest of the creditors, it might seem only reasonable to conclude they would consent to it, if asked in advance.

Let us investigate the link between self-interest and counterfactual consent by considering what we might call the Indirect Lottery argument. Suppose Y, a benevolent member of X's community, picks out X's name at random from a phone book,[64] and buys a lottery ticket on his behalf. Before the purchase, Y tries to contact X to obtain his consent. He writes to him, leaves messages for him by telephone and electronic mail, and visits his home to seek his consent in person. But as it happens, he is unable to get in touch with X. There is an added complication. We want to make X's interest a real issue. Now if X were buying the ticket himself, preferred risk, and the lottery was fair, the pleasure of taking the chance would increase his utility and buying the ticket would be in his interest.[65] But here, since X is not aware the ticket has been bought, he derives no pleasure from taking the chance, and gets no benefit from a fair lottery. So let us specify that the lottery is biased, offering (say) a one in a million chance of winning £100m, and the ticket costs £10. It might now be in X's interest to buy that ticket.[66] It is in his interest even for Y to buy that ticket for him, and let us suppose he accepts later he would have

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[62] R. Dworkin, "The original position", in N. Daniels (ed.), *Reading Rawls: Critical Studies on Rawls' 'A Theory of Justice'* (Stanford Univ. Press, Stanford, 1989), 16, 19.
[63] See e.g. Posner, "Efficiency", p. 492, and the references therein cited.
[64] Under 'X', of course.
[65] Being risk loving, X would prefer a one in a million chance of winning £10m, over having that £10 in his pocket, even though the expected return in both cases is £10 (£10m divided by 1 million, and £10).
[66] The expected return from the lottery is now 100 (100m divided by 1 million), and even ignoring the effect of risk preference, this exceeds the value of £10 (still 10). The word "might" is employed in the text to indicate the possibility that X might have a more valuable use of *that* £10 in mind.

consented to the purchase if Y had actually been successful in contacting him. He was not asked, and the ticket loses. Y now demands X pays him £10, the price of the ticket. Is there any reason for forcing X to comply?[67]

We should notice that the notion of self-interest as employed in the Indirect Lottery argument is rather confused. Two ambiguities must be removed if we are to make progress. The first concerns the *time* at which self-interest is to be ascertained, and is easy to resolve. The second concerns the *level* at which a justification must be provided. This will need to be explained.

c. Time for the determination of self-interest

The easier one first. In what sense was the purchase of the ticket by Y in X's interest? It certainly was not in X's *actual* interest by the time X discovered the ticket had been bought, i.e. after the lottery had already taken place and that ticket had lost. The purchase was in X's *antecedent* interest, though, i.e., before the lottery had taken place.[68] This point can be made as a function of the state of current knowledge rather than in terms of time. Y's purchase of the ticket on X's behalf increased X's expected utility when it was not known X would lose. It decreases his utility when it becomes known he has lost. So it is crucial in any argument from interest to specify precisely when (temporally or as a function of knowledge) the calculation of that interest is to be made.[69]

d. Level at which self-interest is to be reckoned

Now for the more complicated ambiguity. Let us grant that Y's purchase of the ticket on X's behalf was in X's antecedent best interest. It still seems counter-intuitive to force X to pay Y. Antecedent interest does not seem to justify the coercion. Just because X would consent to the purchase when it took place seems to provide no reason to impute counterfactual consent to him *ex post*. "The point of course is that unless you choose, you haven't chosen. Hypothetical consent of this kind binds nothing."[70]

[67] Brudney, "Consent", pp. 238-9, considers a similar example.
[68] Dworkin, "Position", p. 20, introduces this distinction.
[69] Dworkin, "Efficiency", pp. 580-1.
[70] Brudney, "Consent", p. 239.

So should we condemn the Creditors' Bargain because it relies on antecedent self-interest, when the Indirect Lottery argument shows such self-interest does not justify later coercion? It is suggested the Creditors' Bargain should *not* be condemned merely for this reason. The impasse is not complete. The claim from antecedent interest must be modified and restricted, but it should not be abandoned.

To get over the hurdle created by the Indirect Lottery argument, we must recognise a quite crucial distinction. A court decision (say) might be justified in two ways. We might claim the decision itself is based on a moral principle, or that it directly serves the ends of justice or fairness, howsoever defined. This is an *individual-level* justification. Or we might say the decision is justified not because it enshrines some desirable moral precept, but simply because it upholds a policy, and that it is the policy which can be justified on moral grounds. This is an *institutional-level* justification.[71] It is easy to see the two types of justification are distinct. Suppose someone is convicted for driving on the wrong side of the road. To keep the example clear, suppose no other factors (e.g. immediate danger to others) are involved. It is then difficult to justify the conviction by referring directly to any moral principles. It is easy, though, to say the conviction is justified because it serves the morally desirable policy of co-ordinating traffic and creating safer driving conditions in general.[72] This is not to imply that no court decisions can be justified at the individual level, merely that some decisions are only derivatively moral in the way described.

This distinction is especially relevant to arguments from consent. It is one thing to say consent can be invoked to justify an institution, rule, or policy, and quite another to claim consent directly provides a justification for every part of that institution, or every instance of that policy's or rule's application.

> A consent theorist can be an institutionalist, insisting on the creation of institutions or procedures to which we are then bound without insisting on consent to every action taken under those institutions.[73]

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[71] A slightly different version of this distinction is found in Hardin, "Morality", p. 349. Dworkin, *Taking Rights Seriously* (London, Duckworth, 1978), 9, distinguishes in a similar way between those acts wrong in themselves, and others wrong just because the law forbids them.
[72] Hardin, "Morality", p. 351.
[73] *Ibid*., p. 361.

Armed with this distinction, we can see that the role of antecedent self-interest in imputing counterfactual consent now becomes somewhat clearer. An institution or policy *might* be justified because it is in the antecedent self-interest of everyone affected, even though particular transactions under that institution or policy would be difficult to justify by referring to the antecedent self-interest of the individual concerned:

> If we have to justify everything to every involved individual on the spot in each case, society will not go... [We] may justify the system overall in particular moral terms and still be unable to justify results in specific cases in those same moral terms. The specific results will be justifiable only derivatively and contingently from the justification for the larger system.[74]

Look again at the Indirect Lottery argument. X can not be forced to pay Y on the basis that it increased X's expected utility for Y to buy him a lottery ticket without consulting him. X's antecedent self-interest confers no individual-level legitimacy on Y's action. But consider an institutional-level equivalent. In this, the Compulsory Insurance argument, X (who here is risk averse) retires from work after making a lifetime's payments into the National Insurance fund (which, in X's home jurisdiction, is similar but not identical to that in England). To create symmetry with the example considered above, assume that X (incredibly) never found out such contributions were being deducted from his salary etc. The National Insurance scheme, though well-known, is very complicated, and this means many reasonable people do not understand how it is funded. X now points out he never needed to (and never did) make a single claim against the Fund, and that he never actually consented to the compulsory National Insurance scheme. He concedes that the scheme might have been in his antecedent best interest, and that, if asked as a young man with uncertain employment prospects, he would have consented to the scheme. But he recites the Indirect Lottery argument to show that antecedent self-interest provides no justification for the scheme, and that he should be repaid the sum of contributions plus interest. But surely (and only) if antecedent self-interest justifies the institution, X has no right to demand a crude, direct justification in his individual case. Forcing him to make the contributions is not counter-intuitive in the way that forcing X to pay Y £10 would be in the Indirect Lottery argument.[75]

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[74] *Ibid*., pp. 366-7.

[75] X is not alone in his confusion. Brudney, who came up with a version of what has here been called the Indirect Lottery argument, suffers in the same way because of his inability to make the leap to the institutional level. See "Consent", p. 239, despite his attempts to include both policies, and individual transactions in the argument.

In a similar way, an unsecured creditor C might be told his collection efforts against his insolvent debtor are to be stayed because that stay is in his antecedent self-interest, even though he was particularly well-poised to start the race for the debtor's assets on this particular occasion, and could have beaten everyone else to the High Court. But recall that it matters *when* one's self-interest is determined. What is in one's interest at time t1 might not be so at time t2. Or to put it differently, one's self-interest is a function of knowledge (among other things) of one's own attributes. The automatic stay might be in C's interest when it is not known (to C himself or objectively) whether C would turn out to be a well-resourced, lightening-quick collector of debts, or a poor, over-stretched one. But the stay might not be in his interest once it is known C is the former.

So we move to the next Section with a list of questions. The Creditors' Bargain seems to rely on counterfactual consent based on antecedent self-interest to justify the stay on unsecured creditors pursuing individual collection strategies. Exactly when is the determination of interest to be made? And why is that time privileged, so that counterfactual consent given then would confer legitimacy on the stay? And what sort of choice is made? If the choice of the rule imposing the stay is a mere preference, why is that binding? If the preference is motivated solely by self-interest, why are the parties not allowed to change their preferences in line with their self-interest?

5. The normative appeal of the ex ante *position*

The Bargain's *ex ante* position is the second source of its normative appeal. The Bargain is to be concluded before any lending has taken place, and the parties are uncertain how they would fare under any regime picked to govern the situation, should their debtor become financially distressed. How does this confer justification on the choices then made? The answer is not clear. Here is one suggestion. Being unaware of the eventual contingencies they themselves would then face, the parties can not bias the selection process so as to produce principles favouring them at the expense of others. Uncertainty leads to a sort of fairness. On this view, uncertainty is crucial in generating normative appeal in the Creditors' Bargain, so it is important to be clear about the nature of the limitation on the parties' knowledge. Recall that the Bargain is to be concluded by Real Parties, the very individuals who extend credit in real life. At the time that the Bargain is concluded, they are in Natural Ignorance. This means they are not aware of how their transactions with the debtor will turn out. They can not foresee whether the latter would become insolvent or not, nor do they know how well-positioned they would be to race for that particular debtor's assets, should there be no collective insolvency regime characterised by the stay on unsecured claims. But they do know who they are, and what characteristics they have (wealth, social position, cognitive abilities, bargaining strength and skills, relationship with the debtor, etc.).[76]

With these fundamental elements of the Creditors' Bargain fixed firmly in mind, let us return to Jackson's attempt to justify the automatic stay. Natural Ignorance is an important feature of the *ex ante* position, then, and it is from this position that creditors, these "real world parties", must make a binding choice whether to accept the stay on unsecured claims in the debtor company's insolvency. Since no actual choice has been made, we must ask whether a counterfactual choice propelled by self-interest would be made. The *ex ante* position presumably models the requirement that the choice must be in the antecedent interest of the parties. So we can answer one of the questions we ended the previous Section with. When must the determination of self-interest be made? In the *ex ante* position, when all the prospective creditors meet up "before extending credit".[77] And in deciding what serves their interests the best, what are the creditors contrasting with the collective liquidation regime? The comparison must be with the state of affairs if there were no such regime.[78]

Does the fact that the *counterfactual* choice is to be made in this particular *ex ante* position confer any justification on the principles chosen? It is difficult to see how it could. Note first of all that the *ex ante* position based on Natural Ignorance provides no non-arbitrary, morally privileged point in time at which the determination of parties' interest can be made. Recall the Belated Offer argument discussed above. Before X discovered his painting was valuable, he would have chosen to sell it to Y for a pittance. Recall also that self-interest is a function of knowledge. That X's *ex ante* self-interest, in a state of Natural Ignorance, dictates sale of the

[76] See Section 3, above.
[77] Jackson, *Bankruptcy*, p. 17 fn. 22; see also p. 30: "[Imagine] that we met with each other and with the debtor before making the loans". But the argument which follows does not turn on the fact that the antecedent self-interest of all the parties is to be determined at the same instant in time. This is discussed below.
[78] *Ibid*., p. 15: "Consider what the creditors would get if there were no bankruptcy system... Without a collective system..."

painting for $100 seems to provide no reason for forcing him to transfer the painting to Y for that amount despite discovering the painting is actually worth $100,000.

It might be objected that this argument turns on the existence of a mistake, and while creditors in the *ex ante* position are uncertain how their transactions with the debtor will turn out, no mistake can be attributed to them. Now this is not strictly speaking a permissible objection within the model. Real Parties in Natural Ignorance might well be mistaken about the precise nature of some aspect of the transaction. Still, let us modify the example. X now owns shares in a company, and if asked, he would sell these shares to Y for £100, their market value today. Y never asks, and the value of the shares jumps to £100,000 the next day.[79] Again, there seems little reason to force X to do what was in his self-interest in (natural) ignorance of how things would turn out.

It might now be objected the argument here has fallen into the individual-level/institutional-level confusion. The examples above demonstrate that a decision based on calculations of antecedent interest under Natural Ignorance provide no justification to individual transactions. But a policy based on such calculations might be justified at the institutional level. Let us examine this suggestion with reference to the stay on unsecured claims itself.

Consider C Ltd., a creditor. Of the first ten loans it makes, five have to be collected through court proceedings. Three of these debtors go into insolvent liquidation. C is young, its employees are still learning to work together, and its finance director is inexperienced in ordinary (non-insolvency) debt-collections procedures. If asked before extending credit whether the automatic stay on unsecured claims was in its self-interest, C would have replied in the affirmative all five times. Of its next ten debtors, there are again court proceedings against five debtors and three of these again end up in insolvent liquidation. C's employees are now proficient and well-coordinated, and its finance director can count on them to ensure claims will be filed, and judgments obtained and executed speedily. If now asked before making each of the bad loans, C would calculate that the automatic stay was in fact not in its self-interest, since it could do far better under the individualistic non-insolvency regime. Now the Real Parties premise requires "actual people, deploying actual endowments of skill" to make the calculation of self-interest. So we must ask C whether it finds the stay acceptable. But what is the correct *ex*

[79] Admittedly rather incredible, except in the hey-day of the 'Dot.coms'.

ante position from which this calculation is to be made by C? Is it at the very beginning, when C has just started in the business of lending? Or after its tenth loan, or its tenth bad loan? It matters immensely when the calculation is made, but the *ex ante* position as defined by Natural Ignorance provides no answers.[80]

But if we can not decide when to ascertain creditors' self-interest, we can not decide whether they would consent to the automatic stay. Remove counterfactual consent, and nothing is left. The whole edifice comes tumbling down. The Creditors' Bargain justifies nothing.

The resolute defender of Jackson's model might still object. The argument sketched out above misunderstands the notion of the *ex ante* position, it might be said. The focus should not be on one creditor over a series of transactions, but rather on all the creditors in a (or any) transaction. Judged *ex ante*, before any loans are made, it would be in the parties' own interest to accept the stay on unsecured claims.

This version of the notion of the *ex ante* position actually makes things a bit worse. Let us take C Ltd. as it is after having made twenty loans and having dealt with the consequences, a consummate collector of debts, lining up to extend credit for the twenty-first time. Let us also consider E, F and G, highly-skilled computer engineers who work for the debtor-to-be at a time when there are plenty of such engineers in the job market, and who have never worked for an employer which became insolvent. They of course will become creditors for back pay and accrued holiday remuneration, etc. Before any lending takes place, C's finance director meets with E, F and G to make a binding choice as to what should happen, should their debtor become insolvent. It is suggested here that no agreement can take place. The Natural Ignorance premise allows parties to be aware of their own attributes, to know one of them is "systematically faster" than others. Under these conditions, C would insist on a free-for-all system, while E, F and G, knowing they can never compete, would hold out for the stay on all claims.

This game can be played any number of times, with different parties making decisions on the basis of their own ability to collect debt, and on their assessment of their particular competitors' ability in each transaction. Since the parties know they differ in their debt-collection skills and their ability to influence the debtor, no agreement would be reached. Parties with a

[80] Dworkin, "Efficiency", pp. 580-1, considers a similar argument in the context of tort law.

better than even chance of winning the race to grab the debtor's assets would simply have no reason to give up that chance and participate in the collective regime.[81] What is more, parties are merely expressing preferences based on self-interest, and nothing in the Creditors' Bargain leads us to believe they should not be allowed to alter their preferences from transaction to transaction. Not only will agreement between unequal creditors not be reached in a particular transaction, then, it will *never* be reached in the *ex ante* position to any transaction. Interestingly, Jackson has to concede this:

> A... troublesome feature of the analysis is that a collective system seems to require a homogeneous pool of creditors. If C1, for example, were a more astute observer of D's behavior, or had closer relations with D, C1 might know ahead of time that she had a better than even chance of winning any race against C2, and hence would be unwilling to enter into a collective proceeding agreement in which she would share equally with C2.[82]

So no counterfactual agreement can ever be attributed to the creditors unless they are (nearly) identical. Jackson in fact is forced on several occasions to make the assumption that creditors are identical.[83] But that is to contradict the fundamentals of his model, that Real Parties in Natural Ignorance would have given consent to the stay on unsecured claims. This "feature" of his analysis is "troublesome" precisely because Jackson knows creditors are homogeneous neither in his model nor in the real world. His model is and has to be built on the Real Parties premise. Real creditors are not homogeneous. But the model cannot justify the automatic stay without assuming creditors are homogeneous. This in effect makes the model self-contradictory, and this flaw is fatal. What is more, the assumption of creditor homogeneity renders Jackson's conclusion merely tautological: creditors stipulated to have equal debt-collection skills would agree to a system which equalised differing debt-collection skills.[84]

But let us be charitable. Suppose we assume an agreement (laying down *some* rule) has been attained in the (or some) *ex ante* position. Does counterfactual consent under the circumstances of the Creditors' Bargain create some moral legitimacy for the propositions consented to? Grant for the moment that the agreement is socially efficient.[85] But surely we can also ask whether it is *just*. Note that this is a query at the institutional level. The Creditors'

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[81] This point has also been made by Carlson, "Philosophy", p. 1349.
[82] Jackson, "Entitlements", pp. 863-4; see also *Bankruptcy*, p. 15.
[83] *Ibid*. But Jackson then suggests this assumption "may" not matter to the conclusion. His attempts to claw back what he has given away here are discussed below.
[84] Carlson, "Philosophy", p. 1348.
[85] In fact, as we shall see, it is not.

Bargain is supposed to justify the rules that will govern unsecured claims in the debtor's insolvency, whether or not decisions reached in applying those rules themselves seem fair. So creditors of different bargaining strength, banks who will lend unsecured, trade creditors weak and strong, share-owning directors who will also lend to the debtor, and employees, all are supposed to gather before any lending takes place to reach an agreement. Natural Ignorance allows them knowledge of the degree of leverage they will respectively have on the debtor's decisions, and the bargaining takes place in the shadow of this knowledge.[86]

Presumably, all the creditors, driven by self-interest, will want the rules chosen to preserve as many of their pre-insolvency relative advantages as possible, and to dilute the relative advantages of others as much as possible. *Ex hypothesi*, agreement will be reached, so there must be some give and take. This give and take presumably involves allowing the rules to reflect one's pre-agreement leverage over the debtor to a lesser degree, so long as others similarly give up their own leverage. This suggests creditors who have little pre-agreement leverage have little to offer the others, and little bargaining power in the negotiation.[87] Some employees whose services could be regarded as fungible, and trade creditors in a highly competitive industry fall into this category. Banks, directors, the Crown, strong trade creditors and highly-trained employees with scarce skills can influence the debtor to a greater degree, and therefore can collect on their debts more effectively. In addition, certain creditors -- banks again, the Crown and trade creditors -- are repeat players, with accumulated expertise in collecting debt. Others -- most employees, for example -- will have no such experience. Again, this provides for different bargaining strengths.

Since the less influential have little leverage they can give up, it is less likely the eventual agreement will reflect much of their interests. The rules chosen in the *ex ante* position will be biased towards the interests of the strong. Very weak creditors, who derive bargaining strength

[86] For discussion of a similar problem, see the example of a rich and a poor man bargaining over a pot of gold in A. Gibbard, "Constructing justice" (1991) 3 Philosophy and Public Affairs 264, 275.
[87] The notion of bargaining power employed draws on, but does not replicate, that employed by J. Elster, *The Cement of Society* (New York, CUP, 1989), esp. pp. 74-94. In Elster's terminology, bargaining power is derived from an actor's *outside options* (roughly, the actor's fall-back position if the bargaining were to fail), *inside options* (their position and resources while the bargaining continues), *time preferences* (the more impatient the actor is to reach an agreement, the weaker its bargaining power), and *risk aversion* (the more it wishes to avoid the unpredictability which might result from there be no agreement, the less bargaining power it has). In hypothetical bargaining of the sort discussed here (and in the next Chapter), it is difficult to give meaning to the inside options of the parties, and bargaining power is taken to be affected more by their outside options, i.e. what their position would be if they cannot agree on principles to govern

only from the possibility of joining a negotiating coalition, and from the fact that they must participate in any final agreement and can hold it up, might find their interests are virtually unprotected by the rules chosen.[88]

So, does an agreement concluded in Jackson's *ex ante* position have any moral appeal? Is it just in any way? It is suggested here that it is not. The Creditors' Bargain allows the strong to bring their real-life advantages to the bargaining table. By the same stroke, it *requires* the weak to be burdened by their real-life disadvantages in the negotiations. The resulting rules are shaped so as to allow the very strong completely to overwhelm the very weak. But these rules are not *just* rules. "Justice is normally thought of not as ceasing to be relevant in conditions of extreme inequality in power but, rather, as being especially relevant in such conditions."[89] Just rules must be laid down precisely because individuals in the real world are strong, weak, or helpless, and because it is not fair for the strong to be allowed to exploit the weak. Justice redresses bargaining advantages, but the Creditors' Bargain merely reflects them. Where justice would require protection of the weaknesses of others, then, the Creditors' Bargain mandates their exploitation. It should be clear the Creditors' Bargain is "not an alternative account of justice, but rather an alternative to justice."[90]

It would be fruitful here to pull together the various strands of discussion in this Section. The Creditors' Bargain depends on the argument that it would be in the antecedent self-interest of actual creditors to accept the stay. It was pointed out that self-interest is a function of time, or what is the same thing, of knowledge. What is in C's self-interest depends on what is known about C, and about C's competitors in a particular transaction. It does not matter whether one is thinking about C making a real calculation of his self-interest, or whether one is making a calculation on his behalf and attributing it to him counterfactually. One must equally specify

insolvency situations, so that pre-insolvency debt-collection laws continue to apply. Elster suggests that (even) in real-life bargaining, outside options play a major role; see e.g. pp. 78-9.

[88] This paragraph draws on Gauthier, *Morals by Agreement* (Oxford, Clarendon, 1986), Ch. 5. It develops Gauthier's insight that in a bargain between rational self-interested parties, Party X may not claim any part of the pay-off enjoyed by Party Y in the "initial bargaining position" (which here is the non-insolvency debt-collection system), but only some part of the "co-operative surplus". So for example, bank-creditors would attempt to retain at least as much as they could get for themselves without a collective system. If they could not, they would still wish to minimise the amount they would have to give up. (On this last point, the position taken here departs from Gauthier's, since here we imagine a bargain even though there is no co-operative surplus from the bank's perspective.)

[89] B. Barry, *Theories of Justice* (Univ. California Press, Berkeley, 1989), 163.

when that calculation is made, or is to be made. One must also say why one has chosen *that* instant in time, or *that* state of knowledge, to determine C's interest. Why should choices made *then* be binding, so that a contrary choice made earlier, or one made later, would not prevail instead? If the answer is that the applicable rules are simply to be chosen before each creditor lends, then it was argued (and Jackson seems to agree) that the collective regime would not be acceptable to creditors who know they are different. It was also argued any choice of rules made in the *ex ante* position is likely to be exploitative and has no normative attraction.

Note also that it would not help matters to say that since the Creditors' Bargain is based on counterfactual consent, that consent can be "sought" at different times from different parties. In other words, the suggestion would be that one could select a different state of knowledge at which to ascertain the self-interest of different creditors. If the times at which each creditor's interest were to be determined were chosen judiciously, one might be able to say even unequal creditors would agree to the stay. But of course this merely multiplies the problems. One must now state why one is picking that particular point in time for each creditor. What makes each of those instants morally privileged, so that each choice then made would be binding? An answer not available to Jackson is that these times are selected so as to rig the model to get the results he wants. That methodology would be morally unjustifiable and internally incoherent.

Finally in this Section, a word about the claim (noted above) that constructs similar to the Creditors' Bargain generate principles justified because they express the relevant parties' autonomy.[91] The argument above should have demonstrated that, at least on the best-known conception of autonomy, this claim does not hold. For Kant, autonomy is to be contrasted with heteronomy. People act heteronomously if they act in accordance with principles determined by their social position or natural endowments, or if they allow such principles to be determined by the things they happen to want at any particular time. They act autonomously, on the other hand, by expressing their nature as free and equal rational beings, and by not allowing the principles of their actions to depend on social or natural contingencies. Nor do they allow the choice of such principles to be biased by their conceptions of the good. Autonomy lies in being independent from the contingencies of nature and society, but the Creditors' Bargain is the product of

[90] This paraphrases W. Kymlicka, *Contemporary Political Philosophy* (Clarendon, Oxford, 1990), p. 131, writing about mutual advantage theories in general.
[91] Jackson and Scott, "Nature", p. 160; Posner, "Efficiency", pp. 489-97.

precisely these contingencies. It should be obvious the Creditors' Bargain has nothing to do with autonomy. It in fact *ensures* the parties act heteronomously.[92]

6. The Creditors' Bargain as description

We can see the Bargain model provides no justification for the automatic stay on unsecured claims. A set of rules which can be argued for within it does not, for that reason alone, acquire any moral appeal. Still, the model should not be abandoned just yet. Perhaps we are asking too much of it. Perhaps Jackson did not set out to *justify* (any of) insolvency law. It could be that the Creditors' Bargain heuristic is "merely" an analytic device. Its role would then be to help us understand how insolvency law can be seen as fulfilling certain functions. These could include attaining efficiency by increasing social utility, or the aggregate utility of all the participants of this institution.[93] Or the model might be meant to show how a complex process, the selection of insolvency law principles, can be rendered more manageable by reducing it to a problem of rational individual choice.[94] Some commentators have certainly seen this as its primary functions.[95] We focus in this Section, then, not on the normative but the positive role of the Bargain.

For the Creditors' Bargain to yield useful analysis of the insolvency regime, it would have to predict the distinctive features of that regime. Put differently, we should be able to muster the tools provided by the model, and construct the rules laying down (say) the automatic stay on unsecured claims. That such claims should be suspended should emerge as a prediction of the model. The Creditors' Bargain can not hope to analyse insolvency law if it does not first produce predictions which "fit" that law.

Recall the discussion above concerning the Real Parties and the Natural Ignorance premises. Jackson argues the automatic stay emerges naturally from the model based on these

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[92] This paragraph draws closely on Rawls' discussion of the Kantian interpretation of his original position. See *A Theory of Justice* (Harvard Univ. Press, Cambridge, Mass., 1971) (hereafter, "*Theory*"), pp. 251-7.
[93] The argument concerning efficiency is tackled on its own terms here. However, it would be pertinent to recall the reasons for rejecting altogether the notion of efficiency as generally employed in Law and Economics; see Chapter I.6, above.
[94] This description of the role of an analytic device is from Daniels, "Introduction", in Daniels, *Rawls*, p. xxxix.
[95] R. Scott, "Through bankruptcy with the Creditors' Bargain heuristic" (1986) 53 U. Chicago LR 690, 693-4.

conditions. It is suggested here that he is wrong. We can already see why. The way in which he is wrong depends on an element of the model already considered. *Must* the parties reach an agreement? If not, stronger creditors would not give up non-insolvency advantages to participate in a collective regime, unless they are assured superior rights within that regime. Nothing in Jackson's model argues for that result.[96] So his model predicts there will be no collectivisation, and that non-insolvency debt-collection law would continue to apply even when there is a multiple default.

If, on the other hand and as seems more sensible, the model begins with the assumption that agreement has been reached, the answer is rather less clear. If the question were of nearly identical creditors, we could perhaps expect them to settle on the rule which would prevent them all equally from pursuing individual strategies. To this extent, Jackson's model fits reality well, and perhaps for this reason, as noted above, he sometimes assumes that all creditors are identical. But this contradicts the very building blocks of his theory, and amounts to nothing less than rigging the problem so as to obtain the desired solution. As noted, Jackson admits that this "feature" of his analysis is "troublesome".

But Jackson then tentatively suggests the assumption of creditor identity "*may* not matter to the actual conclusion".[97] You could introduce varied creditors into the model and still find that it predicts they would settle on the automatic stay binding on all in the debtor's insolvency. But the reasons he provides for this assertion are either unconvincing or illegitimate. Let us consider why Jackson thinks even dissimilar creditors would still bargain for the automatic stay. First, he suggests "Participation in or monitoring against the race [for the insolvent's assets in a non-collective system] would be costly for *all* creditors".[98] That might be so, but some creditors are likely to have a huge relative advantage in these activities compared to others. Repeat players will be better off here than one-off transactors, to take the obvious example, because they have more accumulated skills in keeping informed of the debtor's business prospects, and because of economies of scale, can do so more cheaply. And better-resourced creditors will be better able to position themselves for the race, than those under financial constraints. Ensuring one is first at the finishing line, though expensive, might be worthwhile especially if the costs can be passed on

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[96] In fact, he supports the *pari passu* principle for unsecured creditors; see *Bankruptcy*, pp. 30-1.
[97] *Bankruptcy*, p. 15 fn. 18 (emphasis added). Carlson also notes this point, but then fails to engage with Jackson's defence of this statement; see "Philosophy", pp. 1349-50.
[98] *Ibid*.

by the beneficiaries of these activities, to less experienced, less well-off creditors. This happens when the former are paid in full (including debt-enforcement costs) from the insolvent's estate, while the latter get little or nothing.

Jackson also suggests "there will be residual elements of uncertainty of relative ranking that could be eliminated to the benefit of all creditors".[99] The obvious response would be to point out that certain types of creditor do not need the automatic stay to eliminate this risk. They could do so more effectively than others, for example, by diversifying their portfolio of loans. A creditor of this type would balance the expected costs of being ranked somewhat lower in some transactions, by the expected benefits of being ranked higher in others. What is more, the creditors best able to diversify (notably, repeat players) are precisely the sort best placed to monitor the debtor and race for its assets. Note therefore that this refutation of both of Jackson's arguments has cumulative force. The two factors he suggests make the assumption of creditor identity irrelevant actually demonstrate how indispensable the assumption is if his model is to produce the prediction that unsecured creditors would all agree to the collective regime.

It was noted above that Jackson's reasons for suggesting the assumption that all creditors are identical may not matter, are unconvincing or illegitimate. The paragraphs above considered the unconvincing reasons. Now for the illegitimate ones. In response to the suggestion that residual uncertainty of relative rankings could be eliminated through diversification, Jackson retorts that "diversification is a response to risk-aversion, not to the more general point that use of individualistic remedies leads to a *collectively undesirable* race."[100] But this observation is meaningless within his model. Actual creditors bargaining *ex ante* and motivated by their self-interest do not care about the implications of their actions for the *collective* weal. The question is not whether the collective regime and the automatic stay are in the collective interest of the creditors as a group -- of course they are -- but whether they are in the *individual* interests of creditors able to diversify. Jackson provides no reason for thinking such creditors would accept the automatic stay.[101]

[99] *Ibid*.
[100] Jackson, "Entitlements", p. 863 (emphasis added).
[101] To similar effect, see D. Korobkin, "Contractarianism and the normative foundations of bankruptcy law" (1993) 71 Texas LR 541, 562.

Finally, Jackson hints elliptically that "there would be distinct advantages to a legal rule that presumed equality in the position of all creditors with similar legal entitlements, instead of delving into a case-by-case examination of factors such as 'knowledge' [of] or 'friendliness' [with the debtor]."[102] If one ignores the implicit violation of the Real Parties premise and follows the solitary clue to where Jackson promises to explain this comment,[103] one finds an appeal to practical considerations. Instead of trying to accommodate the immense possible diversity of all the creditors in all the insolvency proceedings a legal regime would be expected to regulate, it would be sensible and reasonable to create rules only roughly based on the particular attributes of various types of creditor. The automatic stay would be a good practical response, clumping all roughly similar claims together as 'unsecured', and suspending them equally.[104]

Perhaps. But again, this is to abdicate from the claim that the *Creditors' Bargain* can explain the automatic stay. Such practical considerations about the difficulties of creating a flexible legal system and ensuring its viability would of course have no relevance for the creditors bargaining *ex ante* in a (or any) transaction. Again, Jackson has to concede this. The appeal to practical considerations just mentioned is made from the perspective, not of the creditors bargaining *ex ante*, but of a "legal decision maker".[105] Something of an open admission, then, that one must resort to considerations extraneous to the Creditors' Bargain model to explain the stay. There is also another problem. We should notice the circularity. In its descriptive role, the Creditors' Bargain claims the legislator has enacted whatever would have been agreed to by creditors bargaining *ex ante*. Since getting creditors to reach such an agreement in real life is impractical, the Bargain model predicts what they would have agreed to. But at this point, instead of predicting what the *creditors* would have agreed to, the model simply makes a guess at what it regards the *legislator* would do if he were looking for a convenient solution. So the explanation the model offers here is that the legislator has done what he would have done!

So the Bargain heuristic, applied faithfully and in full view of the implications of its premises, predicts either that unequal creditors would be unable to reach any agreement, or else would agree to a system reflecting to a great degree the strengths and weaknesses of their

[102] *Bankruptcy*, p. 15 fn. 18.
[103] "See Chapter 2." *Ibid*.
[104] *Ibid*., pp. 30-1, including fn. 18. This reconstruction of what Jackson possibly has in mind makes only a weak claim to accuracy. Jackson is far too imprecise in indicating where his views on the subject are to be found. See the footnote above.
[105] *Ibid*.

“actual” bargaining power. The collective regime, defined by the stay on all unsecured claims, can not be squeezed out of this model. If the model can not predict and describe the stay, it can not be used to analyse it either.

A last word in this Section. Note what must be the unkindest cut of all. As discussed at the beginning of this Chapter, the automatic stay supposedly serves the goal of economic efficiency by preserving the going concern surplus and minimising wasteful monitoring and administrative costs. In the terms introduced in Chapter I.6, it minimises the co-ordination costs which would exist if the creditors were required to pursue individual strategies in their debtor’s insolvency. If this is correct, as seems likely, then in its failure to predict and explain the automatic stay, the Creditors’ Bargain must forfeit any claim to being the analytical arbiter of the efficiency of this central part of insolvency law. Jackson’s model is not even efficient!

7. Conclusion

It has been argued the Creditors’ Bargain has neither descriptive nor moral force. It fails on the first count because it relies on a confused and ultimately meaningless notion of consent. It suggests that driven by self-interest, all creditors would accept the automatic stay on unsecured claims in their debtor’s insolvency, if only they could be consulted before lending anything. But the interests of the creditors are a function of the time at which they are calculated, and of what is then known about the world. The Bargain model specifies no non-arbitrary point at which this calculation could be made and as a result is quite indeterminate. Further, it relies on nothing but creditors’ preferences, and suggests no reason why those preferences ought to be considered binding. Creditors actually asked *ex ante* to choose an insolvency regime would either be unable to reach agreement, or would pick a system designed to reflect their pre-insolvency advantages. In any case, any agreement made under the circumstances of the Bargain model would likely be exploitative and oppressive of weaker parties, and would have no justificatory force.

Recall from the first Section above that the automatic stay on unsecured claims is the most distinctive and well-established part of all of insolvency law. Since the Bargain model can not even predict (and therefore can not explain or justify) the collective regime defined by the stay, it can have little use in analysing any of insolvency law. But despite the fact that Jackson is ultimately unsuccessful in explaining the automatic stay, there are valuable lessons to be learnt from his failure. The insights gained from examining the Bargain model – and rejecting it – are useful in any attempt to do better. The next Chapter represents a modest start in that direction.

Chapter III: The Authentic Consent Model -- Justifying the Collective Liquidation Regime

It will be argued in this Chapter that insolvency law, and in particular the automatic stay on unsecured claims, *can* be justified by asking what all the parties concerned would agree to, if given the chance to bargain under suitable conditions. The consent relied on here is again hypothetical consent. Here, though, the consent is not of "real world parties", nor are the parties allowed to deploy "actual endowments of skill and energy" in the bargaining process, nor are they in Natural Ignorance. Rather, hypothetical consent is given by all the relevant parties, conceived of as free, reasonable, and hence equal, under conditions which will be referred to as *Dramatic Ignorance*. As such, this model is based on "authentic consent", the consent of the "true and genuine person".[1] Another way of putting the same point is to say that this Chapter constructs a thought experiment to analyse and provide justification for the principles underlying the automatic stay. This thought experiment is based on asking what the relevant parties would agree to, if given the chance to bargain under the appropriate conditions about how their claims should be dealt with, should their corporate debtor become insolvent.

So the model developed here is again contractarian. Specifically, it is Rawlsian, and draws on notions famously elaborated by John Rawls in *A Theory of Justice*,[2] and restated and modified in *Political Liberalism*.[3] It was noted above that Jackson also claims his Creditors' Bargain is an application of Rawls' methodology. But it will become apparent as the argument progresses that "It is hard to exaggerate the difference between these two versions of contractarianism."[4] The Creditors' Bargain is a "mutual advantage theory". The Authentic Consent Model (ACM) is based on "justice as reciprocity". The differences between these, teased out throughout this Chapter, are finally crystallised in Section 6. Note also that this Chapter is not the first manifestation of the desire to counter Jackson's attempt wrongly to claim Rawls as his own. Donald Korobkin constructed a self-consciously Rawlsian alternative to the Creditors' Bargain in

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[1] Dworkin, "Why efficiency?" (1980) 8 Hofstra LR 563, 575, who warns the term "authentic consent" can be "misleading".
[2] Cambridge, Mass: Harvard Univ. Press, 1971 (hereafter '*Theory*').
[3] New York: Columbia Univ. Press, 1996 (hereafter, following Rawls' own preferred abbreviation '*PL*'; see *PL*, p xxxvii).
[4] W. Kymlicka, *Contemporary Political Philosophy* (Oxford: Clarendon, 1990), p 128, contrasting Rawls' approach with 'mutual advantage' theories.

1993.[5] The present work sets off in the same direction, and follows a similar route. But while the impulse which drives both Korobkin's essay and this Chapter is the same, the two encapsulate radically disparate visions of the role of insolvency law, and reach very different results. The points of disagreement will become apparent very shortly.[6]

1. The plot

This model builds on the view of corporate insolvency law laid out in Chapter I.2, above. To reiterate, this part of the 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 seen as laying down the fair terms of co-operation among all the parties affected by these peculiar circumstances. The parties themselves are considered free, reasonable, and equal, and as fully co-operating members of society. In this model, insolvency law provides the guidelines for how the institutions within its province are to realise the values of liberty and equality. The model specifies a point of view from which these principles can be seen as more appropriate than any others to the idea of the parties conceived in this way (this is the model's *choice position*).[7] The following Sections consider the model's conception of the person, and the point of view from which the principles to be proposed in this model are to be judged. Here, the province of insolvency law is mapped out. Once again, this discussion should be read in view of the notion of co-operation described in Chapter I.2, above, as being relevant to the circumstances of corporate insolvency. It will be seen that elements discussed there and in other portions of Chapter I surface again in different guises in subsequent Sections below, reinforcing and illuminating what has gone before.

One could perhaps be forgiven the assumption that to assert that corporate insolvency law should be seen as dealing with issues peculiar to corporate insolvency, is to assert something trivial and banal. And yet this Section must defend this proposition, so controversial is this issue in insolvency scholarship.[8] In particular, it might be objected that the role of insolvency law as

[5] "Contractarianism and the normative foundations of bankruptcy law" (1993) 71 Texas LR 541.
[6] On Korobkin's work, see also Mary Newborn, "The new Rawlsian theory of bankruptcy ethics" (1994) 16 Cardozo LR 111.
[7] *PL*, Lecture 1; see esp. pp 3-5.
[8] On this point, for a statement of the position most similar to that adopted in this thesis, and which will be explained in this Chapter, see G.E. Brunstad, Jr., "Bankruptcy and the problems of economic futility: A theory on the unique role of bankruptcy law" (2000) 55 Business Lawyer 499.

conceived of in this thesis is unacceptably narrow. Some commentators see insolvency law as capable of effectively doing a lot more. Whether it be the under-representation of employees in corporate decision-making, the supposed insensitivity of boards of directors to broad social concerns, or the tendency of capitalist competition often to expose people to hardship, these commentators argue that the solution lies in amending insolvency law in particular ways, and applying it in a certain manner. However, it will be argued here that such an approach undermines what must be a fundamental goal of every reasonable legal system: that like cases be treated alike. The fact is that the ambit of corporate insolvency law is necessarily limited. To overlook this in selecting principles of insolvency law would be to ensure the law as a whole treated similarly-placed individuals differently for wholly arbitrary reasons. In other words, it would not be treating them as equals.

Take Korobkin, who advocates a view of insolvency law which, it is submitted, is defective precisely for this reason. He regards insolvency law as a response "to the problem of financial distress".[9] He argues that a corporation, like a household, is a focal point of social interaction for mutual advantage. "In diverse ways, persons invest in the corporation and, in turn, become 'invested' in it as a source of financial and personal fulfilment."[10] Such investments are not made only by shareholders, creditors, employees and directors, but also by the company's "customers, the friends or family of those who work for the corporation, and the citizens of communities directly affected by its operation."[11] In fact, "the problem of financial distress affects virtually all persons in society to some degree".[12] When struck down by financial distress, the corporation -- this pivotal, almost organic social institution with its widespread and deep-rooted ties with everyone in society -- suffers "a crisis in 'collective autonomy'... [losing] the capacity to regulate itself according to collectively chosen, mutually constructive ends."[13] All the economic, personal, and social ties constructed around its existence are suddenly in jeopardy.

Insolvency law must be seen as a response to these circumstances, addressing the "failure of collective autonomy" and "supplying the reflective capacity that the enterprise [now] lacks."[14] Insolvency law is not merely (or even primarily) a more efficient collective debt-enforcement

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[9] Korobkin, "Foundations", p 546.
[10] *Ibid*.
[11] *Ibid*.
[12] *Ibid*., p 554.
[13] *Ibid*., p 548.
[14] *Ibid*., p 548.

mechanism. It must do much more. It must "address the concerns of the employee who fears the loss of employment", for example.[15] It must pay heed to the plight of "an employee who [entered] the corporation without skills or training and is thus viewed by her supervisors as especially dispensable."[16] It must even seek to provide representation at some level to "affected members of the community at large" and their "diverse political, moral, and personal values."[17] And if, in achieving these aims, insolvency law must violate the pre-insolvency rights of those with direct financial concerns in the company, then so be it.[18] With the whole edifice of society seemingly teetering on the brink, and with so many interests to protect and ideals to serve, who would object to the Chancery judge carrying out some redistribution of wealth from the company's creditors, to other groups in society?[19]

It is suggested this expansive benevolence is arbitrary and misguided. Korobkin's grand, imperialistic vision of insolvency law results from a rather simple error. Somewhere along the way, he stops asking himself: What makes insolvency law *special*?

Consider Companies A, B, C, and D. A, B, and D each operates a manufacturing plant in an identical small community. C operates two such plants in two such communities. Each of these plants is the main employer in the area, the main focus for beneficial social interaction of the sort described by Korobkin. Imagine these small communities having a similar, relatively high rate of unemployment, so that workers in these plants are likely also to be supporting out-of-work family members. Numerous small traders are dependent on each plant, supplying raw material, selling food to the plant's employees, transporting the plant's product and clearing its waste. Suppose also that each community is governed by the same legal system, which is identical to that in England, except in one respect. Insolvency law in this jurisdiction incorporates and reflects all of Korobkin's concerns in a way recommended in his essay.

Imagine now that there is a similar serious downturn in the industries in which A, B, and C operate. All three companies (along with thousands of others) are beset by financial distress. A

[15] *Ibid*., p 555.
[16] *Ibid*., p 558.
[17] *Ibid*., p 570.
[18] *Ibid*., pp 550-1.
[19] This observation mirrors Baird, "A world without bankruptcy" (1987) 50 Law and Contemporary Problems 173, 185: "Requiring those with rights against a firm's assets to take account of the interests of the workers is tantamount to giving the workers rights to the firm's assets."

Ltd. is hit particularly hard, and being the worst prepared, is forced into insolvent liquidation. C Ltd. responds by deciding to focus on its core competence. It sells off one of its plants to E Ltd., and concentrates on the other. Both business units recover and become profitable. B Ltd. meets the challenge by rationalising its operations and downsizing. Dozens of employees "who [entered] the corporation without skills or training and [are] thus viewed by [their] supervisors as especially dispensable" are fired. B too survives the crisis. D Ltd. has not been affected by financial distress at all. It was set up by X fifty years ago, who has run it since as a friendly, only semi-professional enterprise, not worrying too much about turning a big profit. At around the time A, B, and C are going through the pangs of financial distress, X dies. X has no family, and no buyer can be found for the factory, so it is boarded up. The heart is ripped out of the community. People lose their jobs, and other businesses in the community dependent on D become insolvent.

The purpose of sketching out this scenario at some length is to show that Korobkin's analytical chain, made up of financial distress, corporate insolvency, and undesirable social costs, breaks down at *each* of its links. A Ltd. initiates a formal insolvency proceeding, and those associated with it enjoy the (dubious) benefits of Korobkin's luxurious insolvency regime. Arguably, they do not lose their jobs and social interaction, and are given the opportunity to reconcile their diverse social, political and personal values, to the detriment of A Ltd.'s creditors.[20] The problem is that the provisions of Korobkin's *insolvency* regime apply only to *insolvent* companies, that is, those unable to pay their debts as they become due, or whose liabilities exceed their assets.[21] But what about B Ltd.? It suffers financial distress but never

[20] This, at least on one plausible view, is partly what happens in proceedings governed by Chapter 11 of the US Bankruptcy Code, which Korobkin supports both in the article under discussion and elsewhere. See e.g. G. Triantis, "Financial slack policy and the law of secured transactions" (2000) 29 J. Legal Studies 35, 67-8: "Bankruptcy scholars have long criticized the bias of bankruptcy judges in favor of continuing operations of debtor firms [in Ch. 11 proceedings]. The courts often accept overly optimistic projections of value creation or give weight to the interests of specific constituencies (particularly employees or customers). The bias is clearly manifest in the reluctance of judges to terminate Chapter 11 cases or convert them into Chapter 7 liquidations, their hesitation to appoint trustees or examiners, and their inclination to extend the debtor's exclusive right to propose a plan beyond the statutory 120-day period..." This thesis takes no position on the desirability as such of particular features of Chapter 11.

[21] IA, s 123. It is very important to note that in fact, this argument is broader: B, C and D never invoke *any* special procedure designed to deal with companies in 'financial distress', and remain subject only to general company, employment, and social security laws etc. So this argument applies with equal force to any Korobkinian changes either to liquidation or to so-called 'rescue' regimes (the latter may only be available in a firm's insolvency; alternatively, they might be invokable without the need to demonstrate insolvency). The real contrast is between 'ordinary' law which deals with companies throughout their existence, and special provisions which may be invoked only when a firm is in crisis.

becomes insolvent, and so those associated with it never get the protection of Korobkin's insolvency regime. Yet its most vulnerable employees suffer the ravages Korobkin must think are exclusive to insolvency situations. If Korobkin does not think so, then why does he discriminate between A's and B's workers? Why under his regime are the former "better off" than the latter, when the two groups are subject in exactly the same way to their employers' financial distress? Similarly, the communities woven around A Ltd. and D Ltd. are threatened in exactly the same way, even though D is not the victim of financial distress. Since D never becomes subject to insolvency law, it never enjoys the benefits of Korobkin's vision. Korobkin wants to give the community in which A operates additional rights, but seems unmoved by the identical plight of D's community. His model creates a discrepancy in the treatment of people who are going through exactly the same problems. Again, Korobkin must believe the community affected by A's insolvency is more worthy of protection than that devastated by D's closure, but he provides no reason for taking that position.

Note how Korobkin constructs his analytical chain. The way he approaches his task virtually ensures confusion. He identifies financial distress with undesirable social effects, while the D-A comparison shows the latter can exist without the former, and C's case demonstrates financial distress is not always accompanied by those undesirable social effects. (C Ltd.'s example also shows that even in financial distress situations, a less intrusive legal system might in fact allow the harmful effects of financial distress to be mitigated.) He then makes the unstated assumption that all firms in financial distress enter a formal insolvency forum, when the cases of B and C indicate this is untrue.[22] What is more, by not asking "What makes insolvency law special?" at this point, he fails to notice that *precisely* the same problems exist whether or not a firm enters the insolvency forum, even whether or not it is in financial distress. Korobkin therefore seeks to address non-insolvency issues through insolvency law. The recipe for arbitrariness is complete.

The point ought by now to be clear. Korobkin pursues goals through insolvency law which -- if considered desirable -- ought to be pursued by the general (non-insolvency) law. If workers deserve protection against dismissal even though they are judged superfluous to their employer's plans, then this policy should be implemented generally, not merely restricted to that minority of workers whose employer becomes subject to insolvency law.[23] 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. Korobkin claims his model produces principles which are "fair", which have "real normative force".[24] Unconstrained arbitrariness of the sort found in his model is not a hallmark of fairness, nor does it commend itself as a normative principle.[25]

It has been urged in response that "there is no reason why issues arising in insolvency should be governed by rules or agreements formulated without regard to insolvency".[26] But with respect, while the sentiment thus expressed is sound,[27] its invocation here misses the point completely. Simply because an issue can "arise in insolvency" does not by itself mean it should be dealt with by insolvency law. Consider an analogy. That a murder has taken place in a vehicle

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[22] See also Brunstad, "Economic futility", p. 505: "Of course, not all forms of financial distress lead to bankruptcy or justify the suspension of conventional rules of law in favor of a specialized system of bankruptcy regulation" (footnotes omitted).

[23] Anyone suggesting special protection for displaced employees of *insolvent* businesses would have to face the fact that twelve times as many businesses close down without defaulting on their debt obligations (and therefore without invoking any formal insolvency procedure) as those which do become unable to pay multiple debts; see Bank of England, *Finance for Small Firms: A Sixth Report* (January 1999), p. 22 including fn. 24, citing D. Storey, "Firm size and performance", in Acs and Audretsch (eds.), *The Economics of Small Firms* (Kluwer, London, 1990). So proposals of the sort made by Korobkin, which are meant to protect (say) employees but which apply only to employees of insolvent businesses, would leave upto 90% of their target population unprotected. This objection holds for all the other groups Korobkin wishes to 'protect'.

[24] Korobkin, "Foundations", p 571.

[25] This discussion applies equally to arguments similar to Korobkin's, made by Warren "Bankruptcy policy" (1987) 54 Univ. Chicago LR 775 (argues that the role of insolvency law is to (re-)distribute losses associated with business failure; however, the sort of losses Warren is concerned with can and do accrue to the same types of parties without their becoming subject to *insolvency* law at all), and Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (New Haven: Yale Univ. Press, 1997) (argues that insolvency law must protect 'community interests'; again, though, such community interests can be and are threatened in an identical way without insolvency law being implicated). A similar argument is mentioned by Finch, "The measures of insolvency law" (1997) 17 OJLS 227, 234: "[I]nsolvency [law] does and should recognize the interests of parties who lack formal legal rights in the pre-insolvency scenario not least because parties with formal legal rights never bear the complete costs of a business failure" [footnote omitted]. Again, Finch fails to recognise that such "costs" can fall on parties without legal rights even when the business in question shuts down without ever becoming subject to insolvency law. To avoid arbitrariness, Finch (and Warren and Gross) should be making such an argument in the context of general company law (or indeed that of employment or social security law). As Brunstad rightly observes as part of a different line of argument, "if a problem is not uniquely insolvency driven, it is probably best left to some other method of resolution [rather than to insolvency law]"; "Economic futility", p. 532.

[26] Finch, "Measures", p 237. Finch attributes this 'response' (and the one discussed next) to "communitarians".

[27] See Chapter IV, below.

on a public highway rather than in a house (say) should not make a difference to the law which applies to the situation. This despite the fact that the "issue has arisen" against the background of the regulation of traffic on the roads, and that the law of murder is "formulated without regard" to that background. Similarly, the issues of workers losing their jobs, of communities being devastated when businesses close down, of tax authorities losing revenue, all can and do arise without the company in question ever becoming subject to insolvency law. Exactly the same issues exist whether or not the relevant legal entity is able to pay off all its debts. Insolvency is here an irrelevant part of the factual background, analogous to the number of times the letter 'a' occurs in the name of the insolvent's managing director. The law as a whole should not make distinctions based on the former any more than it does the latter.

It has also been argued that "it is perfectly proper to advert to [concerns about the protection of jobs, communities, etc.] in *both* pre-insolvency and insolvency law."[28] With respect, this again misses the point. If the law deals with *identical* issues in the *same* way regardless of whether the company in question is insolvent (as it should), then *insolvency law* is not playing any role at all.[29] The fact that the vehicles owned by a company must obey traffic rules regardless of whether the company is in the process of being liquidated, does not make the traffic code part of insolvency law when it is applied to vehicles in fact owned by insolvent companies! One would have thought the point was a simple one. To classify a part of the law as the road traffic code is to classify it functionally, that is, on the basis that it deals with issues specifically associated with the regulation of traffic on the roads. Similarly, to classify another part of the law as insolvency law is to classify it on the functional basis that it deals with issues specifically associated with corporate insolvency. The desire on part of some insolvency law scholars to claim for their subject the greatest jurisdiction they can might be understandable, but it is also pointless and ultimately (because of the potential for arbitrariness) harmful.

The ACM developed here focuses, then, on what makes insolvency law *special*. It provides and validates principles to govern *insolvency* issues, those "unique difficulties that arise only in the context of an insolvent debtor's inability to satisfy [its] obligations as they come due."[30] It

[28] Finch, "Measures", p. 237 (emphasis in the original).
[29] And of course if the issues are *not* identical and one arises only in insolvency, then we would not be violating the prescription that insolvency law should only deal with issues peculiar to insolvency.
[30] Brunstad, "Economic futility", p. 505 (footnote omitted). Brunstad provides five categories of such difficulties relevant here: (i) the insolvent's incentives to discriminate between its creditors, (ii) its incentives to make gratuitous transfers of its assets, (iii) the incentives of the insolvent's creditors to incur

accepts that not all insolvent firms will come to be governed by those principles, since not all such firms would invoke a formal insolvency proceeding or otherwise become subject to insolvency law. No part of the law has full control over its province. Not all crimes are punished, nor all torts compensated, nor all breaches of contract remedied. So this model makes no claims to omnicompetence on behalf of insolvency law. At the same time, it provides a standpoint from which to judge any proposal suggested as a candidate for an insolvency law principle. Any proposal which passes the tests set by this model can be regarded as just, and as an appropriate principle of that law.

2. The cast

It has been mentioned that the ACM is contractarian, based on the hypothetical consent of the relevant parties. This Section sets out the criterion by which parties are to be admitted to the notional choice position, and therefore, hypothetically to be allowed to give their consent to -- or to withhold it from -- any proposed principle.[31] It should be noted that the aim of this Chapter is (*inter alia*) to provide the broad test which can identify these parties. It sets out and defends the principles which (it is contended) ought to be applied to determine whether a particular party should be given a say in the selection of fair insolvency law norms. The Chapter does not itself seek to make a comprehensive identification of all such individuals (or indeed groups).

> The ACM is based on the fundamental idea that:
>
> it is fair to require people to submit to procedures and institutions only if, given the opportunity, they could in some sense have agreed in advance on principles to which they must submit.[32]

People must be consulted on the choice of governing principles because they would later have to submit to those principles. The *only* reason why their participation must be sought in the bargaining process is because their rights, interests, and obligations will be affected by these principles. But this means those who do not have to submit to those principles should have no

wasteful monitoring and collection costs, (iv) the insolvent's incentives to undertake overly risky projects, and (v) the need to reconcile the heterogeneous rights and risk preferences of the insolvent's creditors. By contrast, this thesis aims, not to provide any such closed list of peculiar insolvency issues, but rather, to produce an analytic framework within which to judge *any* proposal that a principle be added to (or be recognised as part of) insolvency law. This is explained in the following Section.

[31] This is subject to the parties' being equal. That and the criterion discussed here together constitute the sufficient conditions for admission.

say in their selection. Suppose a set of principles does not affect the rights, interests, or obligations of X at all. In that situation, it is difficult to see why X ought to be consulted on how W, Y and Z -- all of whom are affected by that set of principles -- should be expected to behave. In the ACM, insolvency law is regarded as dealing only with insolvency issues. It follows that only parties affected by insolvency issues are to be allowed a say in the choice of principles to govern such situations.[33] Crucially, though, note that the question "who is affected by insolvency issues?" is to be answered broadly. There is no restriction, for example, that only those with direct financial concerns in the insolvent company are to be taken as affected by corporate insolvency. This should make it clear the ACM rejects the narrow concerns of the Creditors' Bargain, which restricts participation in the *ex ante* agreement to those who have contracted for legal rights to the debtor's assets once insolvency has occurred.[34] So shareholders are not included in Jackson's model,[35] nor on one view are non-consensual creditors like the debtor's tort victims.[36]

The ACM welcomes any proposal that a certain principle be admitted into insolvency law, and judges that proposal by asking the central question: What makes insolvency law special? *Any* party -- no matter how remote it might prima facie seem to be from insolvency issues -- can argue that its interests are affected by those issues in a way special to corporate insolvency. There might be issues peculiar to insolvency situations which affect parties other than creditors. Insolvency law must have principles to govern such issues when they arise, and in selecting those principles, all those affected must be given a say. To take just one example, the wrongful trading provisions of the Insolvency Act 1986[37] lay down principles dealing with a manifestation of the old agency problem in the peculiar circumstances of corporate insolvency. The provisions affect the rights, interests, and obligations of managers and shareholders, as well as creditors. In deciding whether the wrongful trading provisions can be justified, the ACM therefore allows participation to shareholders and managers, as well as creditors.

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[32] T. Nagel, "Rawls on justice", in N. Daniels (ed.), *Reading Rawls: Critical Studies on Rawls' 'A Theory of Justice'* (Stanford: Stanford Univ. Press, 1989), 1, at p 4.

[33] See also Finch, "Measures", pp 238-9. The position of those who are not faced with peculiar insolvency *issues*, but who are affected nevertheless by insolvency *law*, is dealt with in Section 4(b), below.

[34] Jackson *Bankruptcy*, pp 32-3; Jackson and R. Scott, "On the nature of bankruptcy: An essay on bankruptcy sharing and the creditors' bargain" (1989) 75 Virginia LR 155, 160-2, but see pp 194-6.

[35] Jackson, "Bankruptcy", p 868 fn 52.

[36] Jackson and Scott, "Nature", p 177.

[37] Section 214.

So the model extends participation to parties other than creditors because it focuses on what makes insolvency law special. For the same reason, it rejects exorbitant claims of the sort exemplified by Korobkin:

> [The] problem of financial distress affects virtually all persons in society... As a result, all persons in society should have representation in the choice of [insolvency law] principles.[38]

As already argued, issues related to financial distress which are not peculiar to corporate insolvency are to be settled so as to prevent the creation of arbitrary distinctions between those faced with exactly the same circumstances, based on whether they become subject to insolvency law. If employees, members of the broader community, or their friends and family are affected by financial distress in a way that they would be whether or not the debtor becomes insolvent, then the choice of principles governing their circumstances must be made in models justifying employment, general company, or social security law. As conceived of here, insolvency law is not hegemonistic, nor does it exhaust opportunities for doing good.[39]

3. The characters

It was argued in Chapter II, above, that actual parties in real-life transactions have varying bargaining power, negotiating skills, cognitive abilities, financial muscle, and clout with the debtor. These are the "real world parties" of the Creditors' Bargain, and while such real-life transactions might be fair against the background of just principles, the selection of the principles themselves can not be allowed to reflect these differences.[40] Principles formulated merely to reflect such differences, and not concerned with protecting the weak against exploitation

[38] Korobkin, "Foundations", p 554.

[39] Incidentally, this also counters criticism of the sort levelled against Korobkin by Finch, "Measures", p 235, that "principles of insolvency law designed by a veiled and highly inclusive group are liable to be so protective of so many interests, and as a result so uncertain, that the effects on the cost of credit would be catastrophic." The ACM certainly does not face this problem. Those invited to participate in the choice position here are all parties affected by corporate insolvency in a *unique* way. The interests to be protected are interests either threatened only in the debtor's insolvency, or threatened by it in a manner peculiar to insolvency. The categories of such interests are unlikely to be wide. In fact, Finch's criticism is unfair even to Korobkin, who himself seems to recognise his approach is hopelessly wide and attempts to respond. After framing what is supposedly the foundational principle of his model, the so-called "principle of inclusion" which opens the door to "virtually all persons in society", he goes on effectively to deny this principle *any* significance at all; see "Foundations", pp 574-5, esp. fn 162, p 581, etc.

[40] A contract between X and Y might be fair, even though X is immensely rich and Y immensely poor. But a necessary (though perhaps not sufficient) condition for it to be so is that the law giving effect to the contract does not accord certain privileges to X on account of his wealth which are not given to Y, nor apply disabilities to Y on account of his poverty which do not apply to X.

resulting from the differences, would not be just. The ACM claims to be able to pronounce on the justice of insolvency law principles. It can not therefore be based on the consent of Real Parties.

So in order to specify the *fair* conditions under which the relevant parties might give consent, the ACM incorporates the notion of equality described in Chapter I.3, above. In view of that discussion, the ACM regards all those affected by issues peculiar to insolvency as endowed with the moral power to form and revise a conception of their own good (hence, as *free*), and also with the moral power to be moved by considerations of reciprocity (hence, as *reasonable*). It follows that the parties must be regarded as *equal*, so that each has a right to have their interests accorded equal care and respect in the choice of insolvency law principles. This starts the process of transforming the actual people who will eventually find themselves governed by insolvency law principles -- the cast -- into parties capable of giving authentic consent to those principles -- the characters. This process will be completed in the next Section.[41]

In addition to being regarded as possessing these constructive attributes, the ACM also takes the relevant parties to be motivated by self-interest in proposing, considering, and accepting or rejecting principles of justice to govern insolvency situations. It could be argued that in a certain way, this too is a constructive attribute, something citizens as legislators are expected to have in this society:

> In a democratic culture we expect, and indeed want, citizens to care about their basic liberties and opportunities in order to develop and exercise their moral powers and to pursue their conceptions of the good. We think they show a lack of self-respect and weakness of character in not doing so.[42]

The ACM takes a more tentative view of the role of self-interest. It refuses to elevate this supposed characteristic of the parties to the same normative level as liberty, equality, and reasonableness. This is because, unlike Rawls, we are not concerned with 'self-interest' in securing for oneself the fundamental rights that any decent society must accord to its citizens. Instead, our focus is on self-interest in a commercial context, where (as explained below) the parties desire to secure for themselves some proportion of the insolvent's assets. So the ACM's assumption, that parties are driven (*inter alia*) by self-interest, is weaker and more contingent. The assumption is not normative at all: the model does not assume citizens *ought* to be motivated

[41] Members of the cast are really 'in character' only once on stage.
[42] *Ibid*., pp 76-7.

by self-interest. (Note the contrast with the three constructive attributes discussed above.) Rather, the assumption is positive, that citizens *are in fact* thus motivated. This means that if the *actual* parties -- to whom the principles chosen using the model are to be applied -- are not self-interested, then the principles will be defective to that extent.[43]

Having said that, a word in defence of the assumption. Suppose the principles chosen using the model thus constructed secure certain rights to certain parties, on the assumption that being self-interested, they would want those rights. Suppose though that the parties turn out not to be self-interested in those respects, or to that extent. It would presumably be a rather simple matter for them to forego the protection or advantages afforded to them by those rights. In any case, it would be simpler than the situation of parties who are in reality motivated by self-interest, and who are trying to claim advantages not afforded to them by principles chosen by a model based on the assumption of their being altruistic. It is better for you to have and to be free to give away, than for you to want but not have. In making the assumption that parties are self-interested, the ACM errs on the side of caution.[44]

4. The stage

This Section defines and describes the choice position. It is in this position that parties affected by insolvency circumstances are to debate and consent to the principles which will govern those circumstances. Recall from Chapter II, above, that while accepting the possibility that institutions might be justified because they serve the antecedent interests of all those subject to their writ, we rejected the Creditors' Bargain because it provided no non-arbitrary point at which calculations of antecedent self-interest could be made. In the ACM, the choice position provides the non-arbitrary, morally privileged standpoint from which parties are to make calculations of antecedent self-interest. The normative attraction of the principles chosen stems from the constructive attributes of those making the choice, and features of the construction of the choice position itself. In this position, parties are rational and Dramatically Ignorant. In order to define the choice position, these constituents of its construction are discussed in turn.

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[43] Barry, *Theories of Justice* (Univ. California Press, Berkeley, 1989), p 338, in the context of Rawls' assumption in *Theory* that people in the original position care about the welfare of their descendants.

[44] For a similar idea, see the comment by Rawls about liberty and the 'primary goods' (discussed below) in *Theory*, p 143.

a. Rationality

Parties in the choice position are required to reason rationally. Let us take a person who has the ability to select and pursue his own aims and interests. "The rational applies to how these ends and interests are adopted and affirmed, as well as to how they are given priority."[45] In selecting the means with which to attain those objectives, rationality implies the ability to be guided by such principles as: "to adopt the most effective means to ends". Rational persons can also weigh up how the final ends they are choosing contribute towards furthering their conception of the good, and how they cohere with each other.[46]

One implication of the requirement that parties in the choice situation be rational should be noted. Transaction cost efficiency springs naturally from this assumption.[47] If X wants to attain objective O, and can choose between Methods A and B, both of which ensure he will attain O, then rationality requires him to choose whichever method is cost-effective. If A costs him £100 and B costs him £110, then *ceteris paribus*, he must choose A.

[45] *Ibid*., p 50.
[46] *Ibid*., pp 50-1.
[47] On this, see Ch. I.6, above. For a similar methodology, see Swygert and Yanes, "A unified theory of justice: The integration of fairness into efficiency" (1998) 73 Washington LR 249; see also Joseph Beatty, "The rationality of the 'original position': A defense" (1983) 93 Ethics 484.

b. Dramatic Ignorance

The notion of Natural Ignorance and its role in the Creditors' Bargain have been discussed above. Natural Ignorance allows parties to know who they are, what attributes they have, and what they value. It only precludes knowledge of how a particular transaction would turn out for these Real Parties. 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."[48] But Jackson's *ex ante* position happily reflects that arbitrariness. The previous Chapter concluded by suggesting that without more, there is no moral force in choices made by naturally ignorant parties.

Contrast that notion of uncertainty with Dramatic Ignorance. The astute reader would have gathered by now the significance of the adjective. Performed drama involves the enactment of an often fictional situation by people playing often fictional characters. But despite being "made up", good drama involves interaction in recognisable (even if unfamiliar) contexts between characters with recognisable attributes. It speaks to the concerns of its real-life audience, offering insight into familiar everyday reality. Drama is often "dramatic" in another way. It focuses on and exaggerates certain elements of that reality, perhaps forcing a reassessment of their significance.

The ACM is somewhat similar. Its aim is to analyse and justify the principles of insolvency law. To this end, it gathers together all the parties affected by those issues which, on the best arguments, could be regarded as unique to insolvency. It then imbues them with the constructive attributes it claims democratic society expects of its citizens as legislators. To revert to the simple drama analogy, the cast are now "made up" and ready to walk out of the wings onto the stage. Once there, they will solemnly act out the roles allotted to them, choosing the principles of justice governing corporate insolvency. But once on stage, they would also have cast off their personalities and characteristics, assuming instead their dramatic personae. In the terminology employed here, they would be in a state of Dramatic Ignorance.

In Dramatic Ignorance, parties are stripped of knowledge of their own attributes, circumstances, social positions, degree of risk aversion, and conceptions of the good. It also excludes knowledge of one's "native endowments", strength, intelligence, and bargaining savvy.[49] It prevents the parties knowing whether they will be faster in collecting debts, or friendlier with the debtor, or particularly badly hit by the debtor's insolvency. This is the "obscuring" role of Dramatic Ignorance.

Note also that insolvency *law* does not simply affect those actually faced with peculiar insolvency *issues*. It also has an impact on others who might *potentially* be affected by such issues. Parties often conduct their dealings with an eye on numerous contingencies, not all of which materialise during the course of their transactions. This is certainly true of insolvency. It is also the case that parties bargain in the shadow of the law. They make plans, demand rights, and accept liabilities, all in anticipation of how they will be treated, should insolvency law affect any part of their dealings. So in selecting principles of insolvency law, the interests of such parties -- i.e. those who must plan their affairs because they might face issues peculiar to insolvency, but who actually turn out not to be thus affected -- must also be protected. To safeguard these interest, parties in Dramatic Ignorance are deprived of knowledge about whether the debtor in question will in fact become insolvent. Since they do not know whether they would actually have to deal with insolvency issues, or only potentially so, they would choose principles which pay equal regard to the set of interests associated with each of those affected by insolvency law.

Second, Dramatic Ignorance ensures that what is essential to the "true and genuine person" is left behind. Here is how this is achieved. Note first of all that the choice position is "a case of pure procedural justice." This means there are no external criteria, independent of those specified by the ACM, by which the fairness or justice of the chosen principles can be judged. Because the affected parties themselves, "symmetrically situated" in the choice position,[50] are to choose principles, the choice is taken to be that of principles for free and equal citizens. This also indicates how the choice position models the parties' liberty, equality, and reasonableness. That citizens affected by insolvency issues are to be regarded as *free* is modelled by the rationality of the parties in the choice position.[51] In this position, parties anticipate the various conceptions of the good they might turn out to have, and are able rationally to provide the means for enabling any such conception to be pursued through their choice of insolvency principles. That the choice position is a case of pure procedural justice models the citizens' rational autonomy. They are

[48] *Theory*, p 141.
[49] *Ibid*., p 25.
[50] *Ibid*., p 24.
[51] *PL*, p 104.

bound by nothing except what they themselves would specify as free and equal persons.[52] That citizens are *equal* is modelled by the choice position placing all the parties symmetrically. As long as one has the capacity to form a conception of the good, and the capacity to be moved by considerations of reciprocity, one is admitted to the choice position, and there has equal influence on the choice of principles.[53] The symmetry of the choice position also models citizens' *reasonableness*, and Dramatic Ignorance means the parties do not know who they will turn out to be and what would be their conception of the good. This ensures the principles are impartially chosen and fulfil the requirements of reciprocity.[54]

Parties in this state, while not omniscient, are also regarded as having all the knowledge they need to reach decisions on insolvency issues, including knowledge of social, economic, and political theory. They also have access to all the relevant empirical data then available. (More accurately, of course, the parties have all the knowledge materially and intellectually accessible to the person expounding the ACM.) That the parties are suitably knowledgeable, and that they are free, equal and reasonable, is ensured through the "exaggerating" role of Dramatic Ignorance.

c. The choice position

It is time to deal with three objections made to the construction of the choice position. Each of these objections is ultimately spurious, and in arguing against them, it is submitted that one ends up with a richer appreciation of the fundamental ideas in which the ACM is grounded.[55]

i. The claims of the unproductive

The first objection is to Dramatic Ignorance. It was pointed out in Chapter II, above, that the Creditors' Bargain is based on a contractarian model developed by Richard Posner. Jackson takes

[52] *Ibid*., p 72.
[53] *Ibid*., pp 79, 305.
[54] *Ibid*., pp 104, 305-6.
[55] One quite hopeless ground for criticism can be dismissed straight away. Carlson, "Philosophy", p 1344, describes theories based on conditions similar to Dramatic Ignorance as "ineffective" because "One cannot really fathom a time when people are so disembodied from their histories that they have no idea whether they are more likely to be investment bankers or widows." This sort of criticism has force against any attempt to rescue the Creditors' Bargain by depriving all creditors of knowledge of who they are in the *ex ante* position. But against the ACM, this objection would be bizarre and entirely beside the point. Dramatic Ignorance is based on *moral* considerations, as explained in the text, and is not supposed to be a description of some actual 'historical' state, amnesic or amnestic. This issue is taken up again in Section 6, below.

from Posner the ingredients which go into the construction of the Creditors' Bargain. A very important one of these is Natural Ignorance. Parties in the Creditors' Bargain know who they are and what they want, but not how their transactions with the debtor are going to turn out. Posner gives two reasons for preferring Natural Ignorance to what here has been called Dramatic Ignorance.[56] The more interesting objection concerns the sort of claims the parties in Dramatic Ignorance must take into account. Since parties do not know their own attributes, they do not know whether they would turn out to be talented and hardworking, or lazy and unproductive. Given this factor, Posner claims any choice position based on Dramatic (rather than Natural) Ignorance "opens the door to the claims of the unproductive." In order to look after their interests if they do turn out to be unproductive, the parties would have to ensure the rules chosen in the choice position gave as much importance to the claims of lazy and unproductive people, as those of diligent and productive ones. "[T]he choices of the unproductive are weighted equally with those of the productive." The result is objectionable, concludes Posner, because it "obscures the important moral distinction... between capacity to enjoy and capacity to produce for others".[57] While productive people have both, unproductive ones only have the former.

This objection reveals rather nicely the extent of Posner's misunderstanding of a true Rawlsian choice position of the sort sketched out here. Note first of all that Posner seems to think parties in that position, like the parties in the *ex ante* position of the Creditors' Bargain, are doing no more than expressing preferences. Since these preferences are shaped by nothing but one's whims and self-interest, parties can express any preference without restriction. But of course this is wrong. Because of the construction of the choice position, parties must act reasonably. Here, they are not merely expressing preferences, they are selecting principles of justice. In order to do that, they must propose principles others can reasonably accept.[58] Further, "in selecting principles of justice the parties must... take into account the consequences of those principles being mutually recognised and how this affects citizens' conceptions of themselves and their motivation to act from those principles."[59] Parties are also rational. They realise that (given

[56] The first deals with the preference functions of those regarded as being in Dramatic Ignorance. Rawls deals with this problem by stipulating people in this state want certain 'primary goods' no matter what else they want, and the model developed here makes the same assumption about the insolvent's assets. This is discussed below.
[57] Posner, "Efficiency", pp 498-9.
[58] *PL*, p xliv.
[59] *Ibid*., p 104.

Posner's assumptions) unproductive people can only be sustained through the efforts and work of productive people.

Two conclusions follow. First, if there are too many unproductive people in any society, not enough would be produced to sustain everyone and that society would collapse. In order to ensure this does not happen, the principles chosen to govern everyone equally would be likely to discourage rampant un-productivity. And second, citizens in actual society are constructively regarded as fully co-operating members of society. Co-operation is based on reciprocity, and on not making demands against others which one would be unwilling (though able) to meet oneself. For some people to require others to work so as to sustain them while not reciprocating in kind is to make an exploitative demand. Reasonable persons do not make exploitative demands. And it undermines citizens' motivation to uphold principles if they regard them as exploitative. So exploitative demands would not be enshrined in the principles of justice selected in the choice position. Put the two factors together and it should be clear Posner is wrong in thinking the claims of the unproductive would be given equal weight to those of the productive.[60]

Note also that in the specific corporate insolvency context, the assumption of rationality itself rules out paying heed to the claims of the unproductive. Companies are created to attain certain ends. "[People] usually become involved with companies with the intention of improving their economic position. [So they would want] to have their affairs governed by rules which are designed to foster efficient outcomes."[61] Within the limits set by society (for example through environmental standards, laws on labour rights, product liability and misrepresentation etc.), then, companies must maximise profits for their shareholders (or otherwise maximise shareholder value).[62] Rational parties do not tolerate knowing un-productivity in ventures such as these, since un-productivity is the antithesis of the very reason why companies exist. And if the claims of the unproductive will not be tolerated in the company's solvency, there seems little reason why they should be in its insolvency. Even in the very unlikely case where someone

[60] It should be clear the argument is based on the assumption that "unproductive" people are capable of being productive but choose not to be. As for people who are unproductive simply because they are unable to work (due to disability, etc.), parties selecting general, society-wide principles (not just those applicable in corporate insolvency situations) *would* anticipate they might turn out to suffer from such incapacity, and would choose principles accordingly. Such principles might lead to a welfare state of some description. Discussion of this is obviously beyond the scope of this thesis.
[61] B. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Clarendon, 1997), pp 305-6.

creates a company in order to avoid having to work hard, that person's claims against the company are at an end once it is insolvent. The company's assets belong to the creditors,[63] who are unlikely to want to indulge his desire for leisure in deciding what they should do with those assets. Rational parties anticipate all this while deciding which principles to choose. Because of rationality and reasonableness, then, Posner's objection to Dramatic Ignorance turns out to be quite spurious.

Now for the other two objections. Recall that by the time the relevant parties reach the choice position, they have been rendered (dramatically) ignorant of any knowledge of personal attributes or conceptions of the good. By virtue of being symmetrically situated in the choice position, the parties can not choose other than to protect their equality:

> The right of each[] to be treated equally without regard to [their] person or character or tastes is enforced by the fact that no one else can secure a better position by virtue of being different in any such respect.[64]

Parties seek to further their self-interest in choosing the principles to govern insolvency situations, but "The state of ignorance in the [choice] position is so shaped that the antecedent interest of everyone must lie [] in the same solution."[65]

This ensures agreement. But (it might be asked) since all the parties have no knowledge of who they are, of what they value, or of their own advantage, how are they to decide which principles would better serve their self-interest? And since all parties are equal in all respects, in what meaningful sense can they be said to have *agreed* to a particular set of principles?

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[62] *Piercy v S Mills & Co* [1920] Ch 77; *Hogg v Cramphorn Ltd* [1967] Ch 254; *Bamford v Bamford* [1970] Ch 212; *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62; see also *Rackham v Peek Foods Ltd* [1990] BCLC 895 and *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626.

[63] For the purposes of this thesis, this should be taken to mean no more than that, under the general law, creditors have priority over shareholders in having their claims met from the firm's resources, and that insolvency law needs a reason to depart from this position. See further *Kinsela v Russell Kinsela Property Ltd (in liq)* (1986) 4 NSWLR 722, 730, per Street CJ; quoted with approval by Dillon LJ in *West Mercia Safetywear Ltd (in liq) v Dodd and another* [1988] BCLC 250, 252-3; G. Morse (principal ed.), *Palmer's Company Law* (London: Sweet & Maxwell, 1992) (25th ed), para. 8.506, and the authorities therein cited; see also Insolvency Act 1986, s 214, and the discussion on Ch. VI, below; finally and in the US context, see Brunstad, "Economic futility", p. 555, including the sources cited in fns. 210-11: "the law recognizes that, upon the occasion of a debtor's insolvency, creditors become equitable 'owners' of the assets of the debtor".

[64] Dworkin, "Position", p 49.

[65] *Ibid*.

ii. What do the parties aim for?

Let us deal with the first objection, which is the easier of the two. If the choice situation were designed to settle principles of justice for all aspects of society, then the lack of knowledge by the parties of their own conception of the good might pose serious problems. The parties in Dramatic Ignorance know they have a capacity to have, develop, and revise some such conception. Once out of Dramatic Ignorance, they will discover what they value. But before that point, how do they decide what set of principles best protects and furthers interests they do not then know they have? One popular response is to stipulate parties want certain "primary goods". These are "all-purpose means normally needed for...pursuing conceptions of the good with widely different contents."[66] In the general society-wide context, the primary goods are defined to include basic rights and liberties like "freedom of movement, free choice of occupation protected by fair equality of opportunity..., income and wealth" etc. So parties judge the proposed principles on the basis of how effectively they ensure a distribution of primary goods which would serve the sort of conceptions of the good they might turn out to have.[67]

It is tempting to follow these general theories in stipulating a fairly abstract primary good the parties faced with the peculiar circumstances of insolvency are regarded as desiring in the choice position, no matter what their conception of the good. For example, Korobkin asserts parties in the choice situation are to be regarded as desiring "the best possible position to influence the actions and decisions of the financially distressed corporation".[68] The ACM resists the urge to remove too far from the context and actual circumstances of corporate insolvency the stipulated choice of what all parties are presumed to want. In society generally, citizens pursue a myriad of objectives, aims, goals and desires. They have immensely varied conceptions of what makes life worth living. In choosing principles of justice to regulate all of society, it is right to regard them as wanting fairly abstract rights of the sort mentioned above, because only such abstract rights would serve the pursuit of most conceptions of the good.

But in insolvency circumstances, the "primary good" all relevant parties, no matter what their conception of the good must in the final analysis want, is the insolvent's assets. Parties in the choice situation know, after all, that by definition it is the fact of these assets being insufficient to meet the debtor's liabilities, which gives rise to all situations peculiar to

[66] *PL*, pp 75-6.
[67] *Ibid*.

insolvency. Tort victims, secured and unsecured creditors, and shareholders, all want to ensure the insolvent's assets are used so as to benefit them. Employees who claim their jobs should be protected in a situation somehow peculiar to corporate insolvency are claiming precisely the same right. They wish the firm's assets to be deployed so as to ensure they will continue to enjoy the benefits associated with those assets being thus deployed. This would include having a workplace they have invested in and value, their fruitful association with work-mates, and of course their salaries, wages and bonuses. Directors who become subject to wrongful trading claims have similarly deployed the insolvent's assets to their own ends, rather than in trying to minimise harm to the company's creditors. Members of a community who claim to be affected by peculiar insolvency circumstances again want the firm's assets to be deployed so as to provide them all the benefits they claim they would lose because of insolvency.

Parties in the choice position know, then, that no matter what their conception of the good turns out to be, and no matter how they turn out to be related to the insolvent firm, what they would want is the insolvent's assets. They therefore judge the acceptability of all proposed principles by reference to how they ensure the parties would have access to those assets, no matter who they turn out to be.

iii. The absence of "bargaining"?

This deals with the objection that parties might have nothing to aim for while Dramatically Ignorant and in the choice position. The final objection is more theoretical and perhaps more fundamental. It claims the fact that parties are in effect rendered identical by being deprived of all knowledge of what makes them different, means the choice situation has been transformed from an hypothetical agreement between parties, to a decision of one (any) of them as to which principles to choose. Whole refutations of theories based on conditions similar to Dramatic Ignorance and the choice position have been based on this objection.[69] So it must be considered carefully.

The choice situation is argued to produce fair principles because of the nature of the parties bargaining in it. Its fairness can be said to arise, *inter alia*, from the fact that it rejects

[68] "Foundations", p 571.
[69] See e.g. Barry, *Impartiality*, pp 58-9.

principles "no rational person bargaining with others on a footing of equality could agree to".[70] But it is objected that the choice position "does not have any room for bargaining with others -- on a footing of equality or any other footing." This is because "There can be no bargaining among people who, even though they have conflicting ends, do not know what those ends are. The whole idea of bargaining therefore becomes inapplicable and the choice of principles reduces to a choice by anyone in the [choice] position picked at random."[71]

The implications of this "shift from collective agreement to individual computation" are not merely formal or stylistic.[72] Since there is no bargaining in any meaningful sense, there can be no claim the choice position generates principles fair because they protect the interests of each of the parties. What is more, the choice position then commits what might be called "the ambiguous sin of ignoring the difference between people."[73] Its construction ensures the only relevant calculation made within it would be that "of a single individual who is attempting to maximize the prospects of all the people he might turn out to be" once he is removed from the state of Dramatic Ignorance.[74]

This objection is best dealt with by looking at it in game-theoretic terms. The objection amounts to saying that because of the identical constraints imposed by Dramatic Ignorance on the knowledge of all the parties in the choice position, the choice position is transformed from a game-theoretic to a decision-theoretic situation. A bargain would be a case of *strategic* choice, such that "the actor takes his behaviour to be but one variable among others, so that his choice must be responsive to his expectations of others' choices, while their choices are similarly responsive to their expectations." But, runs the objection, Dramatic Ignorance turns this into a case of *parametric* choice, in which "the actor takes his behaviour to be the sole variable in a fixed environment [and] regards himself as the sole centre of action."[75] All the ills mentioned then follow. To meet this objection, it would have to be shown that in the choice position, and even given the constraints of Dramatic Ignorance, the problem of selecting insolvency law principles remains a game. This would be done by demonstrating that the multiplicity of parties

[70] *Ibid*., p 58, quoting H L. A. Hart.
[71] *Ibid*.
[72] *Ibid*.
[73] Dworkin, "Efficiency", p. 583 (footnote omitted).
[74] Barry, *Impartiality*, p 59.
[75] Gauthier, *Morals*, p 21.

has significance, that there is strategic interaction between the parties in the choice situation, free and equal though they are.[76]

To see the problem thus is to solve it.[77] The construction of the choice position ensures all parties have identical information and action sets (the latter is the range of options available to them). This helps predict how all would reason by considering how any one of them would reason. But this does not reduce a game (or bargain) to a mere decision. To hold otherwise is to confuse symmetrical games with decision problems.[78] The most famous paradigm in game theory illustrates this.

The Prisoner's Dilemma[79] involves two identical individuals A and B, both suspects in a crime, being interrogated in adjoining police cells. Each has identical information, and faces an identical set of choices. Each knows that if both of them confess, each would be sentenced to eight years (say). If both deny any involvement in the crime, they get a year each for lesser offences. But if one "defects" by confessing while the other holds out, the defector is pardoned and walks off a free man, while the other is sentenced to ten years. Now because both "players" have identical information and action sets, the reasoning of both can be predicted by looking at the reasoning of either one.[80] But of course it matters immensely to the outcome that there are two parties. Each party would behave differently if they were the only one in that predicament and did not have to worry about the decisions of the other.[81] There is strategic interaction, then, even though parties are identically situated. The situation does not change if Player A suffers from temporary amnesia and can not recall whether he is A or B, nor if both A and B are thus afflicted. It continues to matter that there are two of them, not one.

This insight is equally applicable to the choice position. The parties are symmetrically situated, and because of Dramatic Ignorance, must reason in a similar way to attain the same end. But again, it *matters* that there are multiple parties, each of whose choices affects others. Recall

[76] See A. Laden, "Games, fairness, and Rawls' *A Theory of Justice*" (1991) 3 Philosophy and Public Affairs 189, 209.
[77] This strategy of organising ideas differently in order to find solutions obscured by the old organisation is in fact Rawls'; see *PL*, p 9.
[78] Laden, "Games", p 210.
[79] See e.g. E. Rasmusen, *Games and Information: An Introduction to Game Theory* (Blackwell, Cambridge, Mass., 1989) (2nd. ed.), pp 16-9.
[80] Both ought to hold out, but in fact, if rational and unable to co-operate, both will confess. Confession is the dominant strategy for both.

again how the ACM determines whose consent should be sought in deciding on insolvency law principles. Everyone who is affected by a proposed principle meant to govern a peculiar insolvency situation is given representation.[82] Put differently, to decide who should be present in the choice position is to decide whose interests must be protected there. Parties in the choice position do not know who they will turn out to be in real life, but they do know it will only be one of those whose rights and obligations are being determined by them.[83] So the identity of those represented in the choice position determines the nature of the strategic interaction between the parties there. By circumscribing the interests being protected, it determines what their choices are and how these affect themselves and each other, whoever they turn out to be. So it matters that the ACM is based on a *bargain*, not a simple decision.

It might be useful to put the argument in a different way. A bargain *per se* could be thought of as protecting the participants by giving all of them the ability to hold out till their interests are taken into account.[84] There can be no such holding-out under Dramatic Ignorance, since parties deprived of the knowledge of factors which make them different from each other would not know what to hold out for. This has been taken to mean the advantages associated with the ability to hold out -- the ability to demand one's interests be given consideration before any agreement is concluded -- would be lost. But the argument above demonstrates this is wrong. Democratic Ignorance removes not just the ability, but also the *need* to hold out. Outside the choice position, one would refuse to conclude an agreement because one's concerns had not been addressed. But in the choice position as defined by Dramatic Ignorance, *each* person's concerns are given *equal* weight by *every* participant in the bargain, since each participant has an equal chance as against each other participant of discovering that a (any) particular set of interests is in fact their own. What is more, (keeping in mind the comparison with the Prisoner's Dilemma) each participant must take into account the existence of the sets of interests associated with each other participant in the bargain. Not only does Dramatic Ignorance not remove the necessity of doing that, it also ensures all parties would still come to an agreement.

[81] Holding out would now be the best course of action, *ceteris paribus*.
[82] This is subject to the discussion above about those who are affected by insolvency law without being affected by a peculiar insolvency issue.
[83] Only for this reason do they -- acting out of self-interest -- choose impartially by according equal protection to the sets of interests typically associated with all such parties.
[84] This still does not guarantee the interests of all the parties would receive equal consideration; see Ch. II.5, above.

And in any case, once the parties are returned to real society, and find out who they are, the principles chosen in the choice position are to be justified *to them as real people* by pointing out that they themselves, encouraged to decide fairly in their own antecedent self-interest, would choose *these* principles. It should be obvious that it is mistaken to insist -- because each party has identical information and action sets, and because they therefore reason in a similar way -- that there is no significance to the presence of multiple parties, or no strategic interaction between these parties. The objections based on this mistake must be rejected.[85]

It should be clear by now why the principles chosen in the choice position produce normative force and are to be considered binding. The choice position is based on conditions as to the nature of the parties, and on their state of knowledge "that we do in fact accept [as normatively attractive]. Or if we do not, then perhaps we can be persuaded to do so by philosophical reflection." Each element of the choice position can be supported from within the political and legal culture of this society.[86] Any party affected by a peculiar insolvency situation can enter the choice position at any time by imposing on its own reasoning the constraints which define the choice position, and by acknowledging that binding principles of law must be of general application, not merely suitable for a particular transaction.[87] It can then ask whether it accepts the principles binding it as fair. The choice position is "a device of representation [and] serves as a means of public reflection and self-clarification. It helps us work out what we *now* think, once we are able to take a clear and uncluttered view of what justice requires when society is conceived as a scheme of cooperation between free and equal citizens".[88]

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[85] One moral of this argument is that one should not be misled, to conclusions which do not follow, by comments of the following sort from Rawls, *Theory,* p 139: "[T]he parties have no basis for bargaining in the usual sense".

[86] *Theory*, pp 21-2.

[87] Relatedly, such principles must be supported by what Thomas Scanlon has called "generic reasons". These reasons are "based [not] on the particular aims, preferences, and other characteristics of specific individuals [but rather,] on commonly available information about what people have reason to want. [They] are reasons [] that people have in virtue of their situation, characterized in general terms, and such things as their aims and capabilities and the conditions in which they are placed"; see *What We Owe to Each Other* (Cambridge, Mass., Harvard UP, 1998), 204-5.

[88] *PL*, p 26; emphasis added to indicate a standpoint in actual society, free of the artificial constraints of Dramatic Ignorance.

5. The performance

It has been pointed out that the stay on individual actions by unsecured creditors has been a part of bankruptcy and insolvency law, as it were, from the day that there has been such a law. The collective regime defined by the stay is the most central and unchallenged aspect of the process of winding up companies. The stay on unsecured claims is a “provisional fixed point”, then. That it should exist and be part of insolvency law is one of our “settled convictions” about this area of the law.[89] We feel confident, and can agree, that independent action by the unsecured creditors of an insolvent should be stayed, whether or not we agree on any other aspect of the insolvency regime. Very persuasive reasons indeed would have to be produced to convince us the stay should no longer be part of insolvency law. Till such reasons are forthcoming, any explanatory theory about the insolvency regime should be able to account for the stay. If it does not, it can not claim to be an account of *this* regime. We condemned the Creditors’ Bargain precisely because it fails this test. Does the ACM do any better?

It is suggested the very reasons which led to the failure of the Bargain heuristic descriptively to account for the automatic stay, must also compel the conclusion that the ACM succeeds. The Real Parties premise of the Creditors’ Bargain meant unequal parties would either not accept a stay at all, or would accept a rule which reflected the inequality in their debt-collection and bargaining skills. And the lack of any specific *ex ante* point at which the counterfactual agreement was to be concluded meant that the self-interest of the parties, which drove the agreement, would be different depending on when (temporally or as a function of the parties’ knowledge of personal attributes) it was ascertained. It was noted that Jackson’s strategy for dealing with these issues -- the assumption that all (“real”) creditors are identical -- gave the game away by violating every single condition of his model (“real world parties”, “actual endowments”, “natural ignorance”).

The ACM is very different. It first ascertains who should be included among the parties who would be asked to accept or reject the automatic stay. It does this by asking whose rights and prospects are affected by the automatic stay in a way peculiar to the circumstances of corporate insolvency. These parties include all the insolvent’s shareholders, and all its unsecured creditors, consensual, non-consensual, adjusting and non-adjusting. The collective regime defined by the automatic stay compulsorily deprives these parties of the ability to proceed against the debtor company in a way unique to insolvency. The discussion in Sections 1 and 2 above shows it remains to be demonstrated that any other party is thus affected by the automatic stay. In addition, for the shareholders, insolvency proceedings might confirm at law what might already be the case in fact, that there being insufficient assets to pay off creditors, they (the shareholders) are no longer the residual claimants to the company's assets. Again, this is unique to insolvency situations.

These parties are then stripped of any knowledge of personal attributes and put in a state of Dramatic Ignorance. Since the parties do not know who they will turn out to be once the state of Dramatic Ignorance is removed, they must equally take into account the interests of all the actual people they might find themselves to be.

In the choice position, the parties realise that the insolvency of the debtor leads to a common pool problem in the way described in Chapter II, above. Adopting the terminology introduced in Chapter I.6, above, the parties recognise the existence of co-ordination costs for the creditors of an insolvent firm. All the creditors would have to expend resources monitoring the debtor and racing for its assets, and the race might lead to a value-destroying breaking up of the debtor's business. The parties in the choice position also anticipate at least some real-life creditors would be risk averse. The utility of such creditors would be increased by assuring them a lower but more certain return on their loans than would be the case under the individualistic non-insolvency regime. The automatic stay minimises these co-ordination costs in a way mutually beneficial to all the creditors as a group.

Parties would also realise that shareholders (who by definition have agreed to postpone their claims to those of the company's creditors if there is doubt about the company's solvency) would benefit from maximising the value of the collective pool of the company's assets. Those assets might be sold off together as a going concern if that is how they are most valuable. Alternatively, they might be disposed of piecemeal. Whatever the case, a procedure which can review all the possibilities and settle on the optimal result would be more likely to ensure shareholders receive any potential surplus from the sale. In addition, parties in the choice position would also deduce that a collective liquidation regime minimises the uncertainty inherent in any individualistic post-insolvency regime about the creditors' respective positions in

[89] *Ibid*., p 8.

the queue for the debtor's assets.[90] This would be reflected in the interest charged by adjusting creditors on their loans during the company's solvency. Since the company would have to pay less on financing its debts, more would be available for disbursement to the shareholders. Realising this, a party in the choice position would be willing to accept the automatic stay even though they might turn out to be a shareholder of the company rather than a creditor.

Note another very important consideration for the parties in the choice position. They anticipate that they might turn out to be a creditor particularly vulnerable to, and badly affected by, the debtor's insolvency. Certain employee-creditors arguably are an example, since they are usually dependent solely on their salaries, might be unable to diversify by working for more than one employer, and might be unable quickly to find work on losing their job. It might be possible, in the choice position, to make an argument that such creditors deserve more protection in the insolvency forum than a well-diversified bank-creditor, say. But the parties in the choice position accept a distinction that will be referred to as that between *immunity* and *priority*. It might be that employee-creditors deserve priority over bank-creditors in being paid out of the insolvent's estate for the reasons mentioned. But that is a separate question from whether employee-creditors should be immune from having to give up individual debt-collection rights and being forced to participate in the collective regime characterised by the automatic stay. Even if employee claims should be met before bank claims, it would be in the collective interest of employees and banks alike to maximise the pool of assets from which all these claims would be met, in *whatever* order.[91] The question of how the insolvent's assets should be *distributed* can be and often is a different question from how they should be *deployed*.[92]

Parties also anticipate some of them would turn out to be (or to have their relevant interests represented in the real world by) creditors of the sort who are not benefited by the automatic stay in most individual transactions. This would be the case with creditors who are repeat players, are well-diversified, and have the resources to position themselves advantageously for the individualistic race for the insolvent's assets.[93] But in the choice position, the principles laying down the automatic stay would still be chosen. Parties of course do not

[90] Jay Westbrook, "The globalisation of insolvency reform" [1999] New Zealand LR 401, 406-7.
[91] Compare IA, ss. 175 and 386, and Sch. 6. But note that the employee-creditor example is merely illustrative. No position is taken in this Chapter on the priority of employee claims in corporate insolvency.
[92] Carlson, "Philosophy", p 1352, makes a similar point. For a qualification, see Ch. VI, below. The argument is taken up again in the next Chapter.
[93] See Chapter II, above.

know who they will turn out to be. They might turn out to be (or be represented by) the type of creditor who could do better in the individualistic race, but they might not. Faced with this uncertainty, the parties would put themselves in the position of both sorts of creditor. They would ask what their prospects would be under the collective regime marked by the stay. This regime enhances the value of the pool of assets available collectively to all creditors. So to grant any type of creditor immunity from having to participate in this regime is to impose costs on all the creditors as a group. But this is not decisive for the parties. Suppose the collective regime would threaten the vital interests of a creditor of type X. Parties anticipate they might turn out to be a creditor of this type. So they would not risk leaving such vital interests unprotected simply because that enhances the pool of assets available to all.

All the parties in the choice position together might accept a smaller pool of assets, then, and tolerate the existence of some co-ordination costs, if the only alternative is to destroy completely the prospects of one type of creditor. Each party has some incentive to agree to this, because each party has an equal chance (as against each other party) of turning out to be such a creditor. If the automatic stay does turn out to threaten some type of creditor in this way, the parties would contemplate giving that creditor immunity from it. But in fact, the type of creditor who could do better without a stay is precisely the sort best able to cope with the effects of the stay if it is imposed. Well-financed repeat players can anticipate the effects of the stay on their own prospects, and can adjust their lending terms or their interest rates accordingly. They are also likely to be well-diversified. Other types of creditor who have influence over the debtor even though they are not repeat players (e.g. directors who have lent to their company) ought to be well-informed about the debtor’s prospects, can control the debtor’s actions, and can still adjust the terms of their loans. In either case, the automatic stay does not threaten any of their vital interests. And again, it would still be possible for any party to make an argument that, within the collective regime, some types of creditor should be given priority over other types.

It is important to be clear about the differences between the reasoning of the parties in the choice position, and of the creditors in Jackson’s *ex ante* position. In the latter, creditors who can do well under the individualistic debt-collection regime would want that regime. They do not care about the size of the *common* pool of assets. As long as they are paid, they do not mind if their activities have an adverse effect on others. For repeat players, the accumulated expertise of collecting debt and the associated economies of scale are tools to be used to seek the best position for the individualistic race. Diversification is the way of ensuring even if one does not win a particular race, the harm thus done can be remedied by winning other races. In this way, these creditors can pass on the costs of their race for the insolvent's assets to all the other creditors, and being motivated only by self-interest, would indeed do so.

For the parties in the choice position, on the other hand, there are no "others" to whom these costs can be passed. All the parties equally must take them into account. The stay seems to protect the interests of parties (especially one-off transactors) who as a group simply would not have any chance of competing against repeat players in the individualistic race, and (for non-consensual creditors) might have had little control over the terms of the loan. And the parties in the choice position know that the creditors worst affected by the automatic stay (creditors who are not risk averse in any particular transaction because they are repeat players, and those having insider knowledge of the company's prospects, etc.) have the ability to diversify and to adjust interest rates and other terms of the loan to compensate for the effects of the stay. This assures them such creditors would not suffer harm to their vital interests if they are indeed subjected to the collective regime.

So in the choice position, and reinforced by understanding the priority/immunity distinction, all the parties would select the automatic stay on unsecured claims.[94]

6. The denouement

It is time to note the implications and consolidate the results. The ACM is a descriptive and analytic device. By focusing on insolvency law as a scheme of fair co-operation in insolvency situations, it helps illuminate the deep structure of the automatic stay. It shows how all the relevant parties, motivated by antecedent self-interest and considerations of reciprocity, would consent to the collective regime defined by the stay. And importantly, it also indicates focusing

[94] Carlson, "Philosophy", p 1354, claims that "Contractarianism is based upon a deep pessimism about whether the theorist can justify to himself or others what is good or bad in this world. This pessimism often leads the theorist to acquiesce to whatever other people want." It should be pointed out that this Section of the Chapter constitutes a refutation of Carlson's claim. The contractarianism of the ACM is driven by the recognition of the necessity for seeking justification for the institutions of insolvency law. And it is based on the cautious optimism that such a justification can be found. What is more, as demonstrated by the argument in this Section, the model does not abdicate from the duty to reason about "what is good or bad". Rather than accepting "whatever other people want", it seeks to put forward a view about what would be acceptable to citizens conceived of in a particular way.

on the stay in isolation provides an incomplete picture. Arguably, parties in the choice position might find the automatic stay in their interest if they turn out to be a particular type of creditor only if such creditors are assured a certain priority within the collective insolvency regime.

The ACM is also a justificatory device. It sees all parties as free and equal, reasonable and rational. By removing factors which are morally irrelevant in proposing and accepting principles of justice, the model ensures the principles chosen are fair and just. As a result, the principles recommended by the ACM can be seen as having been consented to by "true and genuine" persons. They are justified because they can be regarded as having been chosen in exercise of the full political autonomy of all those they will govern:

> [Full] autonomy is realized by citizens when they act from principles of justice that specify the fair terms of cooperation they would give to themselves when fairly represented as free and equal persons.[95]

Finally, and as promised, a word to the sceptic who is tempted to make the innocent claim that the ACM is just another form of the Creditors' Bargain. It might be said the "only" difference between the two is that the former employs Dramatic Ignorance. The Creditors' Bargain is unsuccessful because it seeks to ascertain the counterfactual consent of creditors who are aware at that time of who they are. This ensures either that no agreement would be reached, or if reached would be exploitative and oppressive of weaker parties. But the solution is straightforward. Simply deprive the creditors of the Creditors' Bargain of any knowledge of who they are, and at a stroke, one solves all the problems which beset that model. Someone who does take this view might wonder why the intelligent people who have been writing in the Creditors' Bargain tradition for the last two decades have not thought of this simple move before! Why for example does Jackson base the bargain model on Real Parties in Natural Ignorance? This means he is forced to assume later that all ("real") creditors are homogeneous, and then has to go to torturous lengths to argue even non-homogeneous creditors would accept the automatic stay.[96] Surely a simpler way would have been to stipulate that all creditors are to be rendered homogenous by being deprived of any knowledge of personal attributes at the time that their consent is notionally sought. But neither Jackson nor any other expositor of the Bargain has done that.

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[95] *PL*, p 77.

[96] See Chapter II, above.

The answer, of course, is that the move is not simple at all. What divides the Creditors' Bargain and the ACM is not a narrow slit consisting of dissimilar types of uncertainty (the two versions of Ignorance). It is a wide chasm of profound philosophical differences. This can be made clear in the following way. Suppose S, a scholar sympathetic to the Creditors' Bargain, suggests the Bargain model should drop Natural Ignorance in favour of Dramatic Ignorance. So the notional consent of creditors should be sought after stripping them of any knowledge of what sort of creditor they are (voluntary or involuntary, bank or employee, etc.). How would S justify this move? Let us assist by suggesting four possible ways. First, the move from Natural to Dramatic Ignorance might be supported by saying this is the only way for the Creditors' Bargain to predict the automatic stay on unsecured claims. But surely this just begs the question. *If* the move is *nothing more* than the rigging of the model to attain the desired result, it is intellectually dishonest. What is required is a *justification*, and the need to save an otherwise failing theory is not an attractive justification.

Second, S might simply decline our demand for a justification for the Natural to Dramatic move. He might reply, for example, that it is just convenient to base the Creditors' Bargain on Dramatic Ignorance. But real creditors are unlikely ever to be unaware of who they are and of their conceptions of the good.[97] As already mentioned, they are entitled to ask why the notional choices of non-existent creatures who seem so different from them should have any significance for them. Why should real creditors accept as fair or binding rules supposedly chosen by creatures who are figments of S's imagination? S has no response.

He might now claim all he is concerned with is the Bargain model's ability to predict and explain the collective liquidation regime. Making the assumption that creditors are unaware of personal attributes at the time their consent is sought allows him to do that, and he might state that he feels no obligation to *justify* that regime to those subject to it. Now of course the refusal to justify laws to those governed by them is rather repugnant to democratic societies, and might lose the Creditors' Bargain some support. Laws must be legitimate, not just imposed. But even in the claim that S can predict and explain the automatic stay, he would be only half-right, half of the time. By arbitrarily adopting Dramatic Ignorance, his model would certainly have acquired the power to *predict* the automatic stay. But it still can not *explain* it. S's position now can be

[97] This is where Carlson's comments, "Philosophy", p 1344, concerning widows and investment bankers, noted *supra*, are relevant.

compared to that of a young child who has learnt to predict that by pressing a switch on a torch light, she can produce a beam of light. But the child can not assign any meaning to the fact of pressing the switch. She can not explain the role of the internal wiring, the batteries, the bulb, the plastic case, the reflectors, etc. And if pressing the switch no longer works because the batteries run out, or the bulb fails, or water seeps through the case and short-circuits the wiring, the child would be at a loss to suggest anything useful. Such would be the case with S. He could baldly state that by using Dramatic Ignorance, one could predict that insolvency law would stay all unsecured claims. But he can not assign any meaning to the use of these strange Dramatically Ignorant creatures, seemingly so different from real-life creditors. Nor can he employ the principles which justify use of Dramatic Ignorance to criticise the liquidation system or suggest reform, should circumstances change and the system is no longer appropriate. But surely we are entitled to expect more illumination from insolvency law scholars than we do from the child with the torch.

Finally, though, S might produce a more satisfactory response. He might reply that it is *right* and *proper* for those selecting binding rules to be required to do so impartially, and that Dramatic Ignorance achieves precisely that. This would be a good justification, and the beginning of the process which leads to the ACM. But in saying that, S would also decisively have rejected the Creditors' Bargain. His suggestion now is based on the idea that each person matters equally. This needs to be given substance. The ACM accomplishes that by regarding as equal all those who have the moral capacity to form and revise a conception of the good, and the moral capacity to be moved by considerations of reciprocity. These two moral powers are accepted as logically prior to the hypothetical contract, and are essential to qualify for participation in it. The choice position as defined by Dramatic Ignorance is appropriate because it gives substance to the idea of moral equality, and by extension, to the right of all moral equals to equal care and concern in the selection of binding principles.

But these notions are profoundly alien to the Creditors' Bargain. As a mutual advantage theory, the model sees "justice" as an extension of brute rational choice.[98] Its aim is to prove one could manufacture the principles supporting the insolvency regime by appealing to nothing but rational self-interest. So the bargain is based on nothing but preferences, and these are shaped by nothing but one's self-interest. Since the bargain model assumes it can do without any reference to morality, it can make no appeal to fairness. It has no conception of pre-existing moral powers. It perceives "no moral equality underneath our natural physical inequality".[99] The bargain here is not used to give substance to more abstract rights which are prior to it. Rather, it is used in an effort to create rights where none existed before.[100] The Bargain model can not explain the move of stripping away the individuality of the parties during the bargaining process, about why the parties should accept anything decided in Dramatic Ignorance.[101] And it simply has no theory or notion about what – if anything – would be left behind once the parties' individuality has been thus removed.[102] So Dramatic Ignorance is forbidden to this model. The use of Dramatic Ignorance in the ACM requires significant philosophical commitments.[103] But if it were to make those commitments, the Creditors' Bargain would cease to be what it is, a model based on the (false) claim of moral neutrality.[104] Expositors of the bargain model want to make that claim, and

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98 Gauthier's mutual advantage theory is more sophisticated than Posner's and Jackson's; see *Morals*, pp 243-4. But this does not affect the substance of the point made here, which contrasts theories based on moral concerns with those founded on simple expedience.

99 Kymlicka, *Philosophy*, p 126, about mutual advantage theories in general.

100 In his mutual advantage theory, Gauthier, *Morals*, p 222, notes that "the idea of morals by agreement may mislead, if it is supposed that rights must be the product or outcome of [the bargain]." But his conception of the "rights" each party takes into the bargaining process is focused solely on the party's natural endowments and abilities. His initial bargaining position presupposes no *moral* equality, and thus no right to have each party's concerns and interests given equal consideration; see *ibid*. The point made in the text here therefore remains valid.

101 See Gauthier's own attempt in *Morals*, Ch VIII, especially pp 265-7. The attempt fails. It is of course impossible to do justice to a work as powerful and thoughtful as Gauthier's in a footnote or two, and no attempt to do so is made here. But on this point and crudely, Gauthier fails to show why one must enter into any agreement at all with those systematically weaker than oneself. What is more, these pages contradict positions taken elsewhere in the book; see e.g. pp 18 (especially fn 30), 231-2, 294-8, etc. Or if they do not, then Gauthier's argument is tautological, showing no more than that equally strong (because equally "rational"; p 231) individuals would cooperate as if they were equal (p 232). In any case, Gauthier can not (and does not) make a case for regarding natural and social differences in abilities as irrelevant, and in fact disclaims any concern with impartiality (p 265). He thus provides no justification for Dramatic Ignorance. This is true *a fortiori* of the far less sophisticated theories of Posner and Jackson.

102 See Gauthier, *Morals*, p 256: "The real individual... has his own particular and defining characteristics -- capacities, talents, attitudes, preferences. He acts taking these as given, and his rationality is expressed in his endeavour to maximize the fulfilment of his preferences given his capacities and other traits of character, in the circumstances, whatever they may be, in which he finds himself... [T]here is no other conception of the person involved." This is, as it were, a textbook definition of Natural Ignorance; it is also the creed of mutual advantage theories like the Creditors' Bargain.

103 As already noted, of course, the ambit of the claims made by the model are restricted to a particular type of society. This, it should be made clear, is motivated not by any belief in moral relativism on this author's part but only by the desire to avoid the argument being intolerably lengthy.

104 See e.g. Carlson, "Philosophy", pp 1354 and 1364 fn. 79 for one view of why the Bargain model is not neutral.

so can not make those commitments. It should be clear, then, that in both premises and conclusions, the Creditors' Bargain and the ACM are worlds apart.[105]

7. Conclusion

This seems an appropriate point at which to consolidate the discussion in Chapters II and III. Chapter II pits the long-established Creditors' Bargain construct against a model that is developed in Chapter III. The Creditors' Bargain was first put through its paces, and its fundamentals, rationale, and construction examined in some detail. The Creditors' Bargain was found unable to describe a central part of insolvency law, was arbitrary and incoherent, and lacked justificatory force. It tried to legitimate the automatic stay by suggesting actual creditors at a hypothetical pre-transaction stage would agree to just such a rule. But it failed.

> The confusion inherent in the Creditors' Bargain makes it clear that:
>
> [One] cannot merely invoke the fact that under circumstances C agent A would prefer option O. One must explain the propriety of describing the circumstances in a particular way, of attributing particular characteristics and interests to the agents in the choice position, and of giving them a particular menu of options. Perhaps this would take legal writers too far into the muddles of moral philosophy. If so, it might be the better part of valor to eschew appeal to arguments of this kind.[106]

[105] The final sentence paraphrases Kymlicka, *Ibid*., p 128.
[106] Brudney, "Consent", p 262 (footnote omitted).

All that is true, and the warning is apt. But a principled analysis and justification of this central feature of insolvency law must surely by sought. So the ACM sets off to avoid the faults of the Creditors' Bargain. It decides on the menu of options to present to the parties in the choice position by asking, "What makes insolvency law special?" It defends the characteristics it attributes to the parties by claiming the legal and political culture of society demands citizens be considered free, equal, and reasonable, when consulted on the design of institutions meant to govern them. And it justifies the propriety of defining the choice position in a particular way by pointing out that the choice of principles should not be influenced by morally irrelevant features and considerations of legislators, who in turn should act rationally in choosing such principles. It is therefore claimed the resulting model can analyse and justify corporate insolvency law and its longest-standing feature. The ACM is now ready to be utilised where required to analyse and if appropriate, to justify that law.

Chapter IV: The *Pari Passu* Principle and its Relationship with Other Methods of Insolvency Distribution

1. Introduction

This Chapter aims to analyse the *pari passu* principle of insolvency law, and to ask how it relates to other principles available for the treatment of claims in corporate liquidation. The discussion in Section 2, below, reveals that the principle has rather limited effect in governing distributions of the insolvent's estate. Not only do various types of secured claim fall beyond its ambit, even unsecured claims are often exempt from its application. Nevertheless, the principle thrives both in judicial rhetoric and in academic arguments. For example, many a challenge to the different priorities accorded to different types of claim in a company's insolvency begins with an incantation of the *pari passu* principle. Finch states (on the second page of her encyclopaedic recent study on secured credit):

> The normal rule in a corporate insolvency is that all creditors are treated on an equal footing -- *pari passu* -- and share in insolvency assets pro rate according to their pre-insolvency entitlements or the sums they are owed. Security avoids the effects of *pari passu* distribution by creating rights that have priority over the claims of unsecured creditors.[1]

Bridge sees an inherent tension between the "two fundamental principles of credit and insolvency law", that of the freedom of contract which allows one to bargain for priority, and the mandatory *pari passu* principle.[2] And Cranston, after considering and discounting lesser objections to the existence of secured credit, concludes that "there are other social policies antipathetical to extensive security, like the *pari passu* principle[,] which are less easily refuted."[3]

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[1] Venessa Finch, "Security, insolvency and risk" (1999) 62 MLR 633, 634 (footnotes omitted). It is unclear whether Finch is making an all-inclusive claim: that the normal rule is that *all creditors*, of whatever type, are treated equally. If she is, then the claim is too broad; there is not and has never been any such "normal rule". Only those in "relative positions of equality", judged by reference to the general (non-insolvency) law, are covered by the principle: see Oditah, "Assets and the treatment of claims in insolvency" (1992) 108 LQR 459, 463. This point is taken up again below. See also Goode, "Is the law too favourable to secured creditors?" (1983-4) 8 Canadian Business LJ 53, 58-9, and Goode, "Proprietary rights and unsecured creditors", in Barry Rider (ed.), *The Realm of Company Law* (London, Kluwer, 1998), 183, 184.

[2] Michael Bridge, "The *Quistclose* Trust in a world of secured transactions" (1992) 12 OJLS 333, 340.

[3] Ross Cranston, *Principles of Banking Law* (Oxford, Clarendon, 1997), p. 436.

The *pari passu* principle is said to be "the foremost principle in the law of insolvency around the world".[4] Commentators claim to have found this principle entrenched in jurisdictions far removed from ours in geography and time.[5] At English law, statute itself seems to confirm Finch's "normal rule", that all creditors of an insolvent company are to be treated "equally" by having their pre-insolvency claims abated rate and rate alike.[6] The principle is thought to be "all-pervasive", and its effect is to "strike down all agreements which have as their object or result the unfair preference of a particular creditor by removal from the estate on winding up of an asset that would otherwise have been available for the general body of creditors."[7] The Cork Committee, despite noting significant exceptions to the principle, reiterated its fundamental importance.[8] The principle is said to be supported both by the need for an orderly liquidation of insolvents' estates, and by requirements of fairness. So it is not surprising that its invocation as the starting point for, say, the debate on the priority of secured or preferential claims, weights the argument in a particular way. Since the *pari passu* principle has been recognised so widely and for so long as vital, and since it serves such desirable aims as orderliness in liquidation and fairness to all creditors, any deviation from it must be a cause for concern. It seem to follow therefore that:

> Before a creditor is entitled to claim a preferred position it must be demonstrated that deviation from the inveterate and equitable *pari passu* principle is warranted.[9]

On this view, the priority (say) of secured or preferential claims is an abnormality, a pathology to be diagnosed and controlled, perhaps even "cured". Since 'equality' is the norm, the onus must be on those supporting differing priorities to justify their claim. To the extent that their efforts are unpersuasive, the case for priority must be considered not established, and the "default principle" of 'equality' must prevail.[10]

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[4] See Andrew Keay and Peter Walton, "The preferential debts regime in liquidation law: in the public interest?" [1999] CfiLR 84, 85.

[5] See e.g. J. Garrido, "The distributional question in insolvency: comparative aspects" (1995) 4 IIR 25, 29, and the sources cited in G.E. Brunstad, Jr., "Bankruptcy and the problems of economic futility: A theory on the unique role of bankruptcy law" (2000) 55 Business Lawyer 499, 525 fn. 107.

[6] Insolvency Act 1986 (hereafter, "IA") s. 107 (voluntary liquidation; however, the section begins: "Subject to the provisions of this Act as to preferential payments...") and Insolvency Rules 1986, 4.181(1) (compulsory liquidation). The principle can be traced back to the first attempt to deal with insolvency issues by statute; see 34 & 35 Hen 8 c. 4, s. 2.

[7] Goode, *Principle of Corporate Insolvency Law* (London, Sweet & Maxwell, 1997) (2nd ed.) (hereafter, *Insolvency*), p. 142.

[8] *Insolvency Law and Practice* (Cmnd. 8558, 1982), hereafter, "Cork Report", para 1220.

[9] Keay and Walton, "Preferential debts", p. 92.

[10] *Ibid*. The Report by the Review Group, *A Review of Company Rescue and Business Reconstruction Mechanisms* (DTI, May 2000) reiterates the same orthodoxy; see p. 10 para. 24.

This Chapter seeks to overturn this order of things. It is argued here that the *pari passu* principle is rather less important than it is sometimes made out to be, and does not fulfil any of the functions often attributed to it. It does not constitute an accurate description of how the assets of insolvent companies are in fact distributed. It has no role to play in ensuring an orderly winding up of such companies. Nor does it underlie, explain, or justify distinctive features of the formal insolvency regime, notably, its collectivity. The case-law said to support the *pari passu* principle serves actually to undermine its importance. And the principle has nothing to do with fairness in liquidation. An important part of the argument here seeks to explain the actual role of the principle. If the arguments made here succeed, then the initial onus of justifying their position shifts from those arguing in favour of the priority of secured and preferential creditors etc., to those who support a more "equal" distribution of the insolvent's estate.[11] The Chapter concludes by analysing recent proposals to abolish the preferential treatment accorded to certain tax claims.

Since there is confusion in the literature about the correct identification of the *pari passu* principle, it would be useful to begin with a word on terminology. The *pari passu* principle, as it appears in (corporate) insolvency law, has a fairly specific purpose. It seeks to be informative, to answer the broad question how insolvency law decides on the treatment of different types of creditor. The answer offered by this principle is that insolvency law "takes them exactly as it finds them."[12] Put differently, creditors holding formally similar claims under non-insolvency law are to be paid back the same proportion of their debt in their debtor's insolvency.[13] The *pari passu* principle, then, is one manifestation of formal equality in insolvency law.

However, it is not the only one. As explained in the following Section, insolvency law itself creates exceptions to the *pari passu* principle, the most notable for our purposes being that in favour of preferential creditors. Some of the claims held by the insolvent's employees, and some tax liabilities owed by the insolvent, rank ahead of general claims, such that all preferential

[11] References to 'equality' (within single quotation marks) are to be read as indicating *formal equality*, defined for the moment as that understanding of equality espoused by the supporters of the *pari passu* principle; see e.g. the quotation from Finch which opened this Section. This is to be contrasted with the true equality which results from treating people as equals. This is explained in Section 5, below.
[12] *Re Smith, Knight & Co., ex p. Ashbury* (1868) LR 5 Eq. 223, at 226, *per* Lord Romilly M.R.
[13] See e.g. *Worsley v Demattos* (1758) 1 Burr 467; 97 ER 407, 412, *per* Lord Mansfield, who identified as one of the purposes of bankruptcy law an "equal distribution among creditors who equally gave *a general personal credit* to the bankrupt" (emphasis added). So personal creditors but not proprietary ones (both types defined by non-insolvency law) are to rank equally *inter se* for the purpose of bankruptcy distribution.

debts must be discharged in full before general unsecured creditors are paid anything.[14] The factor which causes confusion is that preferential claims also abate rateably as amongst themselves. Some commentators have therefore been led to regard the treatment of preferential creditors *inter se* as another application of the same *pari passu* principle.[15] But this view is unsound in several different ways. Most obviously, it ignores the received understanding of the nature of the 'equality' principle, that the determination of 'equality' is to be made by *pre*-insolvency law.[16] Second, it reduces the principle to triviality, since the principle now provides simply that those determined by *insolvency* law to be equal are to be treated equally by insolvency law. But now *pari passu* is not a rule or a restriction or a standard. It neither imposes a requirement which insolvency law must fulfil, nor does it shape that law in any way. It is merely a description of what insolvency law actually does, and it fits perfectly with whatever scheme of priorities that law might devise. As a triviality the principle is harmless, but for the same reason it is also uninformative. It no longer says anything about *why* insolvency law chooses to declare certain creditors to be "equals". Finally though, and confusingly, the commentators who regard the distribution to preferential creditors *inter se* to be governed by the *pari passu* principle, still accept that the existence of preferential claims itself constitutes an exception to that principle.[17] Viewed thus, their position becomes something of a paradox: the treatment of preferred claims is both an *exception to*, and yet an *application of* the *pari passu* rule! It is difficult to imagine too many other situations which both exemplify and contradict one and the same principle.

It is respectfully suggested that this view of the 'equality' principle, which renders the principle both trivial and paradoxical, is unhelpful and should be abandoned. A little care with terminology dissolves the paradox and restores the principle to its roots. A distinction must be drawn between the sort of formal equality represented by *pari passu* (the equality of creditors as determined by the *pre-insolvency* form of their claim) and other manifestations of formal equality introduced by *insolvency law* itself (such as that which holds between some employee- and some Crown-claims, but not between these and claims held by a trade creditor, say).

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[14] IA, s. 175.
[15] For example, Goode, *Insolvency*, p. 156, states that "preferential debts rank *pari passu* among themselves". See also Finch, "Is pari passu passé?" [2000] Insolvency Lawyer 194, 194 and 199, including fn. 36; the definition of the principle that she embraces in this article seems to be inconsistent with the one quoted at the beginning of this Section.
[16] See the discussion above, and especially *Re Smith, Knight & Co.* (1868) LR 5 Eq 223, 226.
[17] See Goode, *Insolvency*, pp. 152 and 156, and Finch, "Pari passu", pp. 194 and 195.

Accordingly, references to *pari passu* in this Chapter are to be understood in line with this distinction. To break the monotony of recurrence, "the 'equality' rule (or principle, or norm)" will sometimes be employed as synonymous with *pari passu*. Formal equality other than that enshrined in the *pari passu* principle will be clearly identified by the context.

2. The myth of pari passu *distribution*

Despite the hold exercised by the 'equality' principle on the imagination of insolvency lawyers, the principle is sometimes acknowledged, as a descriptive matter, not to have too much application in the real world. After proclaiming that the principle is "fundamental and all-pervasive", Goode adds that "This, at least, is the theory of insolvency law."[18] Fidelis Oditah, who also regards it as "fundamental", explains at the same time that the *pari passu* norm is "shallow", since it is subject to numerous exceptions, and since it does not in itself acknowledge the "obvious truth" that insolvency law often exempts those holding certain dissimilar pre-insolvency rights from having to submit to an "equal" distribution.[19] The Cork Report noted that rateable distribution among creditors is rarely achieved.[20] And Keay and Walton state that the 'equality' principle is "nothing more, and has little relevance, other than to act as a convenient default principle."[21]

It would be instructive to consider just how extensive these deviations from the "normal rule" really are. Disregard for the moment the priority given to those with a consensual property right. Goode explains that the treatment of secured creditors, suppliers of goods under reservation of title (ROT) clauses, and "creditors for whom the [debtor] company holds assets on trust", all are not to be considered true exceptions to the *pari passu* principle, since "such assets do not belong to the company and thus do not fall to be distributed among creditors on any basis."[22] Some four categories of true exceptions established by statute can still be identified.

[18] *Insolvency*, p. 142-3.
[19] "Assets", p. 463.
[20] Para 1396.
[21] "Preferential debts", p. 94. It is suggested below that even this might be over-stating the principle's significance.
[22] *Insolvency*, p. 152. Satisfactory or not, the same reasoning applies to hire-purchase agreements and finance leases.

First are rights of insolvency set-off, which are wider in effect than those available outside insolvency. Set-off applies whenever there have been mutual credits, mutual debits or other mutual dealings, before the onset of liquidation, between the debtor and any of its creditors.[23] The cross-claims need not impeach the debt owed to the insolvent, so long as the requirement of mutuality is satisfied.[24] "The right of set-off on insolvency represents a major incursion into the *pari passu* principle", since to the extent that there are mutual credits, debits or other dealings, the creditor able to assert set-off rights gets a *pro tanto* priority over others.[25] What is especially significant given our focus, this priority is *mandated* by the Legislature,[26] and operates automatically at the date of the winding-up order without the need for any intervention by either party.[27] Parties, in other words, are *compelled* to breach the *pari passu* principle.

A second category is constituted by pre-liquidation creditors who can compel payment by virtue of their ability to inflict certain types of harm on the insolvent estate. This category covers payments to avoid forfeiture of a lease, distress or termination of a contract.[28] In general, creditors whose continued co-operation is desired by the liquidator may be able to extract payments in respect of pre-insolvency debts.[29]

Then there are preferential claims themselves. These include various taxes collected by the debtor on behalf of the Crown, including some PAYE deductions, unpaid VAT, unpaid car tax, general betting, bingo, and gaming licence duties, some pool betting duties, and unpaid social security contributions.[30] Levies on coal and steel production, beer duty, lottery duty, insurance premium tax, air passenger duty and landfill tax have also been added to this list.[31] Then there are certain debts related to the insolvent's employees. These include any sums in relation to

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[23] Insolvency Rules 1986, r. 4.90.
[24] *Peat v Jones* (1881) 8 QBD 147; *Mersey Steel & Iron Co. v Naylor, Benzon & Co.* (1882) 9 QBD 648, (1884) 9 App. Cas. 434.
[25] Goode, *Insolvency*, p. 153.
[26] *National Westminster Bank Ltd. v Halesowen Presswork and Assemblies Ltd.* [1972] AC 785 (HL); see the discussion in Section 4, below.
[27] *Stein v Blake* [1996] 1 AC 243 (HL); *Gye v McIntyre* (1991) 171 CLR 609 (High Court of Australia). The relationship between rights of insolvency set-off and those of secured creditors holding charge-backs is itself a vexed one; for the view that in certain circumstances, set-off should operate despite the existence of a charge-back, see Mokal, "Resolving the *MS Fashions* 'paradox'" [1999] CfiLR 106.
[28] Goode, *Insolvency*, p. 156.
[29] Oditah, "Assets", p. 467, citing *Re Levi & Co. Ltd.* [1919] 1 Ch 416 as an example. This existence of this distributive principle has now been upheld despite being "contrary to the normal *pari passu* rule" by Lord Hoffman in *Khan v Inland Revenue Commissioners* [2002] 1 WLR 671, paras. 25-9.
[30] IA, Sch. 6.
[31] *Ibid.*

occupational pension schemes, remuneration of employees up to £800, accrued holiday pay, and any sums loaned and used for the specific purpose of paying employees' remuneration.[32]

Finally, various types of debt have been deferred by statute. These include debts owed by the insolvent to a director (including shadow director) found liable for wrongful or fraudulent trading, and ordered to be deferred by the court.[33] Claims held by the debtor's shareholders or other members *qua* members also fall under this head.[34]

Many commentators consider there to be another statutory exception to the 'equality' principle.[35] Creditors whose claims arise after the winding-up order has been handed down are given a privileged position. Statute provides that their claims are to be treated as part of the expenses of liquidation, are therefore to be given "pre-preferential" status (i.e. ranking ahead of preferential creditors), and are to be paid, not proved.[36] In addition, utility suppliers "may make it a condition of the giving of the supply that the [liquidator] personally guarantees the payment of any charges in respect of the supply".[37] However, it is submitted this type of claim cannot properly be regarded as an exception to the *pari passu* principle, since, as explained above, that principle governs the treatment of those holding formally similar claims under *pre*-insolvency law. By definition, *post*-liquidation creditors do not, in that capacity, have any pre-liquidation claims, so pre-insolvency law has nothing to say about the nature of their claims. It follows that they simply do not fall within the ambit of the 'equality' principle.[38]

So the claims of creditors able to assert set-off, utility companies, pre-liquidation creditors with post-insolvency leverage, nineteen different types of preferential claims, and claims of deferred creditors, all are exempt from the *pari passu* principle. And even these "deviations" from the "normal rule", while apparently substantial, might in fact be "something of a minor

[32] *Ibid*. See generally the useful summary in Keay and Walton, "Preferential debts", pp. 91-2.
[33] IA, s. 213 (fraudulent trading), 214 (wrongful trading), s. 215(4).
[34] IA, s. 74(2)(f).
[35] See e.g. Goode, *Insolvency*, pp. 154-5; Oditah, "Assets", pp. 466-8; Mokal, "Priority as pathology: the *pari passu* myth" [2001] CLJ 581, 586.
[36] IA, ss. 115 (voluntary winding-up), 156; IR, rr. 12.2 and 4.218.
[37] IA, s. 233(2)(a).
[38] Perhaps the reason why this type of claim has come to be regarded as an exception to the 'equality' principle has to do with a misunderstanding about the scope of the principle. Someone who thinks the principle governs *all* the payments from the insolvent's estate, rather than the treatment of a particular category of claims against it, would naturally see post-petition creditors as benefiting from an exception.

qualification" to the 'equality' norm.[39] There are numerous other types of creditor not affected by it. Under certain circumstances, this includes claims held by accountants, solicitors, stockbrokers, factors and bankers, all of whom might be able to benefit from common law liens which arise by operation of law.[40] Statute gives the unpaid seller a lien on the goods sold, and rights of stoppage in transit.[41] If the insolvent was insured, a party injured by its actions (a tort creditor) is subrogated to its rights against the insurer.[42] If the liability in question arose under circumstances governed by the Road Traffic Act 1988, the insurer might be liable to the tort creditor even in those circumstances where it would have been able to avoid or cancel the policy as against the insured.[43] This of course continues to disregard those able to assert consensual property rights in some assets ostensibly within the insolvent's estate.

Consider these principles in the light of recent data on the sources of external funding for small to medium sized enterprises (SMEs),[44] which provide insolvency law with most of its business.[45] In a survey covering the period 1995-1997, 47 per cent of this was found to have been provided by banks (who often take security), 27 per cent by hire purchase/leasing firms (proprietary rights), six per cent by partners and shareholders (may or may not be deferred by statute), six per cent by factoring businesses (liens and consensual proprietary rights), four per cent by other individuals, four per cent by other sources, three per cent by venture capitalists (equity claimants, hence ranking below debtors), and one per cent by trade customers (who have the option of setting up *Kayford* trusts[46]). Also important, especially for small businesses, is trade credit. By some estimates, stocks and flows of trade credit are twice the size of bank credit.[47] At least some of the credit in this category also generally falls beyond the application of the

[39] Oditah, "Assets", p. 467.
[40] *Ibid*., p. 469 fn. 67, citing *Snell's Equity* (29th ed.), Chap. 10.
[41] Sale of Goods Act 1979, ss. 39 and 41-6.
[42] Third Parties (Rights Against Insurers) Act 1930, s. 1(1).
[43] See s. 151(5).
[44] Finch provides a useful summary; see "Security", p. 636, and the sources she cites in fn. 18.
[45] Society of Practitioners of Insolvency, *Survey: Company Insolvency in the United Kingdom* (London, SPI, 1999) (the 8th Survey), p. 7, shows that in the year to June 1998, 83% of companies which became subject to a formal insolvency proceeding had a turnover less than £5m, and only 9% had a turnover greater than this (information was not available about the remaining 8%).
[46] *In re. Kayford (in liq.)* [1975] 1 WLR 279; for a critical discussion, see Goodhart and Jones, "The infiltration of equitable doctrine into English commercial law" (1980) 43 MLR 489. The *Re Kayford* method seems to have been upheld by the Court of Appeal in *Re Chelsea Cloisters Ltd.* (1981) 41 P&CR 98, but that case is criticised as "an exercise in discretionary justice" by Bridge, "*Quistclose*", pp. 356-7.
[47] Bank of England, *Finance for Small Firms: A Seventh Report* (January 2000), p. 26 fn. 17, referring to Singleton and Wilson, *Sources and Use of External Finance: An Empirical Study of UK Small Firms.*

'equality' norm. One survey found that well over half the suppliers surveyed (59%) used ROT clauses.[48] This figure seems to rise dramatically, the more troubled the debtor in question.[49]

These are of course the sources from which firms raise capital while they are solvent. These figures do not directly indicate the composition of the overall debt of firms which are in financial distress, or which are undergoing some formal insolvency procedure. Intuitively, however, it would be surprising if the debt outstanding when a firm became distressed generally had a structure very different from the one mentioned above. And in fact there is some fresh data which confirms this intuition. Julian Franks and Oren Sussman have recently compiled a data set of more than 500 firms which had bank debt, and which were in financial distress.[50] This confirms that the structure of debt of the firms in the "rescue units" of the three banks studied is very similar to that for solvent firms as a whole.[51]

Even more significant is the fact that, in an overwhelming majority of formal insolvency proceedings, *nothing* is distributed to general unsecured creditors (the only category of claimant truly subject to the *pari passu* rule[52]). It is estimated that there are zero returns to them in 88% of administrative receiverships, 75% of creditors' voluntary liquidations, and 78% of compulsory liquidations. On average, they receive 7% of what they are owed.[53]

So while the matter is an empirical one, and while the position would of course vary from debtor to insolvent debtor, the discussion so far and these statistics show that most types of claim either are or can be exempted from the application of the *pari passu* principle. It is also likely

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[48] J. Spencer, "The commercial realities of reservation of title clauses" [1989] JBL 220, 221.

[49] S. Wheeler, *Reservation of Title Clauses* (Oxford, OUP, 1991), p. 5, found that in the fifteen receiverships and liquidations studied, 92% of suppliers had employed some sort of ROT provision. None of this implies, of course, that all of these clauses would be fully effective according to their terms.

[50] *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies*, Institute of Finance and Accounting (London Business School) Working Paper 306-2000, April 2000 (published on 2.11.00).

[51] For the three banks respectively, the mean debt owed to the types of creditor indicated as a percentage of total outstanding debt, was as follows: Main Bank 38.2%, 49%, 41.9%; Trade Creditors 24%, 37.4%, 40.2%; Other Financial Institution 2.3%, 2.8%, 7.5%; Other Creditors 29.4%, 8.3%, 8%; "Owner"-Directors 6.1%, 2.5%, 2.4%; see *ibid.*, p. 8, Table 3.

[52] See J.H. Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy* (New York, Matthew Bender, 1986), 2-18: the 'equality' principle "prevails at most between the [insolvent's] nonsecured, nonpreferred creditors...".

[53] SPI, *Survey*, p. 4. This is supported by the Franks-Sussman data, which shows that the median recovery rate for unsecured creditors in a sample of 27 administrative receiverships is 0%; see *Cycle*, p. 14, Table 9, n. 1. The figures for liquidation are likely to be worse; see e.g. SPI, *Survey*, p. 4.

that in most if not all liquidations, hardly any claimant is paid *pari passu*. Given these reasonable deductions, one might perhaps be forgiven for questioning whether it is fair to describe the *pari passu* principle as "the normal rule in a corporate insolvency".[54] In fact, it is the *differing priorities* of claims which seem to represent the rule. What seems certain is that, in the distribution of the assets of insolvent estates, 'equality' between different types of claim must be very much the exception. As Professor Jan H. Dalhuisen has put it, "It is... the *ranking*... and *not* the equality, that is the essence of bankruptcy and of creditors['] relationships more generally."[55] Put differently, even if unsecured claims other than preferential claims form the bulk of the *claims* in most liquidations, most of the available assets would not be *distributed* "equally". The *pari passu* rule is supposed to govern distributions. It should be obvious, however, that distribution in accordance with this rule is virtually non-existent.[56]

Some readers would object that the discussion so far does little more than state the obvious, since *everyone knows* the current law leaves little room for anything to be distributed *pari passu* in an overwhelming proportion of insolvencies. These readers dramatically underestimate the extent to which insolvency scholarship still clings to the *pari passu* myth. Leading insolvency scholars (and courts) regularly assert that this jurisdiction has a "*pari passu* insolvency regime", that the 'equality' rule has been varied "*only slightly* [] in respect of personal claimants", that the "*present* law [] is disinclined to force particular classes of creditors to shoulder greater burdens" than others by causing derogations from the 'equality' principle in

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[54] To this author, 'normal' indicates a state of affairs which is usual, regular, common, average, or typical.

[55] Jan H. Dalhuisen, *Dalhuisen on International Commercial, Financial and Trade Law* (Oxford, Hart, 2000) (hereafter, *Dalhuisen*), p. 661 (original emphasis), in the context of the distinction between finance sales and secured transactions.

[56] The implications of this distinction between the constitution of claims and the pattern of distribution are discussed further in Section 6 of this Chapter. To the extent that the argument here is correct, there are interesting consequences for the view that the 'equality' principle underlies the adjustment provisions; e.g. Prof. Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet & Maxwell, 2001), p. 547, observes that the "consequence of the policy of *pari passu* distribution is that transactions which effect the disposition of assets or other property before the commencement of winding up should be reviewed and adjusted *if they affect the principle of equal distribution*" (emphasis added). Given that such "equal" distribution will not happen in *any* case in an overwhelming majority of liquidations (something Prof. Keay also accepts; see e.g. *ibid*., p. 713-4), would it not seem to follow that it would be impossible, say, for one of the insolvent's creditors to be given a preference, contrary to IA, s. 239, in any of *these* liquidations? It is respectfully submitted that, to the extent that this proposition is considered unacceptable, there is reason for doubting that the *pari passu* principle constitutes the rationale for adjustment provisions like s. 239. This point is discussed further in the next Section.

favour of the latter (or against the former).[57] With respect, such assertions very misleadingly push the *pari passu* principle to the fore as *currently* the dominant method for the distribution of insolvent estates. They are then used as premises in further analysis which in turn is often (not always) distorted as a result. That is to be regretted. Much of science could not progress till it had rejected the false geocentric picture of the cosmos. In its rather more modest sphere, insolvency scholarship must somehow tear itself away from the equally false view that the 'equality' principle occupies the centre of the insolvency law universe.[58]

Still, let us take seriously the objection noted above. Perhaps the discussion so far *has* missed the point. The claim that priority is a pathology might not be a descriptive one after all. Those making it might, on reflection, be willing to concede that the *pari passu* principle reflects little of reality, which (they might come to accept) consists of widely divergent priorities accorded to different types of claim. The critics of differential priority might now argue the 'equality' norm constitutes the *ideal* against which our existing insolvency law must be judged, since it enshrines desirable goals that any reasonable insolvency regime must attain. Deviations from *pari passu* are to be condemned for making the attainment of those goals more unlikely, and they are to be condemned even more precisely because they are so widespread. It is to this claim that we now turn.

3. The immunity/priority fallacy

For English lawyers, it seems the primary attraction of the *pari passu* principle is its ability to provide for an orderly liquidation. Goode makes the point firmly:

> It is this principle of rateable distribution which marks off the rights of creditors in a winding up from their pre-liquidation entitlements. Prior to winding up each creditor is free to pursue whatever enforcement measures are open to him... The rule here, in the absence of an insolvency proceeding, is that the race goes to the swiftest... Liquidation puts an end to the race. The principle first come first served gives way to that of orderly realisation of assets by the liquidator for the benefit of all unsecured creditors and distribution of the net proceeds *pari passu*.[59]

Keay and Walton see the principle as the embodiment of similar virtues:

[57] These quotations are from Finch and Worthington, "The *pari passu* principle and ranking of restitutionary rights", in Rose (ed.), *Restitution and Insolvency* (Mansfield, Oxford, 2000), 1, pp. 14-5, 2 and 7, including fn. 33 (emphases added).
[58] This respectfully echoes comments made by *Dalhuisen,* p. 661; further on this, see below.
[59] *Insolvency*, p. 142.

> the whole idea of *pari passu* distribution is to ensure parity of benefit, no matter what resources one has -- if there were no *pari passu* distribution we would return to the 'first come, first served' policy of mediaeval times, which saw those with the greatest resources and power taking the debtor's estate.[60]

And for Finch, the 'equality' principle "conduces to an orderly, collective means of dealing with unsecured creditor claims and [] involves lower distributional costs than alternative processes such as 'first come, first served'."[61] For these commentators, the choice is clearly between a free-for-all where weak creditors would inevitably be beaten into last place by better-resourced competitors, and where the advantages associated with an orderly liquidation would be lost, and the *pari passu* principle which alone stands as a bulwark against this.

What is more, and even given its less than universal efficacy, the *pari passu* principle is said to "retain[] some practical importance, if only in a negative sense, in that it may have the effect of invalidating pre-liquidation transactions by which a creditor hopes to secure an advantage over his competitors."[62] The principle is widely seen to be "very much at the heart of the rationale for the avoidance of pre-liquidation transactions".[63] Oditah notes that "In one sense, avoiding powers provide illustrations of insolvency law's commitment to the principle of equality."[64] And Goode observes that "the principle of equity among creditors which underlies the *pari passu* rule of insolvency law will in certain conditions require the adjustment of concluded transactions which but for the winding-up of the company would have remained binding on the company".[65]

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[60] Keay and Walton, "Preferential debts", p. 95; see also pp. 92-3. Bridge also regards the 'equality' principle as reflecting the law's interest in an orderly liquidation; see "*Quistclose*", p.340, though he strikes a note of scepticism on the same page: just how "fundamental" could the principle be "when one [must] look[] for it in the Insolvency Rules and not in the body of the [Insolvency] Act itself[?]" (footnote omitted).

[61] Finch, "Pari passu", p. 194, noting a "traditional justification" for the principle. See also Finch and Worthington, "*Pari passu*", pp. 2-3.

[62] *Insolvency*, p. 144.

[63] Keay and Walton, "Preferential debts", p. 93 fn. 74, citing Keay, *Avoidance Provisions in Insolvency Law* (Sydney, LBC Information Services, 1997), 40-9.

[64] "Assets", p. 465.

[65] *Insolvency*, p. 344; see also pp. 345-8, where the link between the adjustment provisions of the Insolvency Act and insolvency law's 'equality' principle is reiterated, pp. 387, 389-90 (preferences), and p. 423, which explains the rule against post-petition dispositions by invoking the principle. Goode does point out, however, that the principle can not explain certain important nuances of some of these provisions; see especially p. 347; for a dramatic modification of the claim quoted in the text and the references above, see p. 441.

Given that the *pari passu* principle lies at the very heart of the orderly liquidation regime, and given its role in justifying some of the most distinctive and well-established aspects of insolvency law (its preference and other adjustment provisions), any deviations from it must naturally be considered odious at least prima facie. 'Equality' of treatment serves key practical and justificatory purposes which bring social benefits, so differential priority, its opposite, must result in a diminution of all those benefits. Those defending the priority (say) of secured claims must therefore bear a heavy burden of proof.

It is respectfully submitted that these arguments are based on a misunderstanding of the nature of the liquidation regime. All these arguments commit what will be referred to as the *immunity/priority fallacy*. Once that fallacy is exposed and exploded, the rationales given by those supporting the *pari passu* principle will be seen to provide no justification for it. And that principle in turn is shown not to play any role in bolstering the desirable properties of the liquidation regime.

Let us start by understanding the distinction between *priority* and *immunity*.[66] Recall again the old image, that of the debtor firm's estate forming a pool of assets. As the firm approaches the stage where its assets are insufficient to meet its liabilities,[67] and in the absence of a special liquidation regime, the firm's creditors have an incentive to rush to enforce their claims. The earlier they can get a judgment and execute it, the more likely it is they would get paid in full, or at all. The tardy creditor would find that nothing is left for him, the pool already having been drained of all its contents. Further, and on the eve of insolvency, creditors aware of the firm's troubles and able to influence its decisions might try to steal the first drink from the asset pool by getting the debtor to repay them. Their gain is a collective loss. The 'first come, first served' system encourages creditors to engage in duplicative (hence wasteful) monitoring of their debtor in order not to be left behind in any race to the pool. It adds uncertainty and therefore decreases the utility of risk averse creditors. And for the debtor whose assets are more valuable if disposed of together as a going concern, the individualistic system increases the possibility that those

[66] See Chapter III.5. For the ancestry of this distinction, see Douglas Baird and Thomas Jackson, *Cases, Problems, and Materials on Security Interests in Personal Property* (Mineola, NY, Foundation Press, 1987), 67 (discussing the "property right" and the "priority right" of secured creditors); see further, Baird and Robert Rasmussen, "Control rights, priority rights, and the conceptual foundations of corporate reorganizations" (2001) 87 Virginia LR 921.

[67] IA, s. 123.

assets would be broken up nonetheless and sold piecemeal to satisfy claims as they arise.[68] It is this value-destroying activity that the dedicated liquidation regime must prevent. Notice the cause of all the trouble: each creditor faces the necessity, and has the ability, to act *individually*, in disregard of the interests of all others. Hence the obvious solution: the dedicated liquidation regime is *collective*, decisions being taken on behalf of all those interested in the asset pool.

The analogy and the insight can be taken further. The individualistic pre-insolvency debt-collection regime is a mad race to the asset pool. Since that race is undesirable, the collective insolvency system steps in to stop it. The creditors are now forced to *queue up* to have access to the pool. Voidable preferences and post-petition dispositions of assets etc. can now be seen as attempts by some creditors to bypass this queue. In other words, they represent efforts to gain *immunity* from the collective system. Insolvency law deploys various mechanisms to deny them this immunity.[69] So long as there is no race to the pool, no one succeeds in stealing a drink from it, and creditors await their turn to have access to the debtor's resources, decisions can be made systematically and in the common interest. Crucially, though, note that ensuring that creditors take their place in the queue is one thing. *The order in which they line up* is, in general, quite another. Each creditor's *priority* is their place in the queue relative to each other creditor. But espousing the aim that creditors all line up does not entail any particular order in which they should line up. It does not commit the system to placing all creditors (as it were) unidistant from the asset pool. The *pari passu* principle would put each ("similar") creditor side by side rather than (say) one after the other. But this arrangement is not a necessary concomitant to the absence of the value-destroying race. So long as there is a queue (with creditors standing side by side, one after the other, or in whatever order), there is no race.

Consider now the various comments noted at the beginning of this Section. It can be seen that they represent the immunity/priority fallacy. This can be defined as the attribution of the benefits resulting from the absence of immunity from a collective insolvency system, to an imaginary and irrelevant state of equal priority (the realm of *pari passu*). If the pre-insolvency 'first come, first served' system is objectionable in a firm's insolvency, it is so because of the monitoring, uncertainty, administrative, and loss of synergetic value costs described above. All these costs result from an individualistic regime, and all of them are avoided by a collective one.

[68] See Chs. II and III, above.
[69] For example, IA, ss. 239 (preferences) and 127 (post-petition dispositions).

As long as *all those creditors whose actions would inflict those costs* participate in the collective regime or submit to collective decision-making, how their claims are ranked relative to each other within the collective scheme of distribution is (for these purposes) irrelevant.[70]

Similarly, if certain attempts to gain preference are undesirable, that is because they undermine the benefits associated with collective decision-making. Consider the following situation. In the liquidation of a particular company, there is only one general unsecured creditor (say a trade creditor without the benefit of an effective ROT clause) and one preferential creditor (the Crown). Suppose the former engineers a (voidable) preference in her favour, so that both she and the preferential creditor finally get back the same proportion of their debts.[71] Now the situation here simply cannot be objectionable on the basis that the *pari passu* rule has been breached. In fact, the outcome would probably be *perfectly in accord with this rule*, since the general creditor is likely to hold the same sort of non-insolvency claim as the preferential one. So if the rule applies, she *should* get back the same proportion of her debt as the latter. However, the voidable preference provisions have been violated nevertheless. So the *pari passu* principle could not possibly underlie these provisions, at least as they apply here. If this much is accepted, then the argument can be pressed further. It would not help to suggest that the principle justifies the preference avoidance provisions as they apply to a trade creditor who has been paid a greater proportion of his debt than another (say), but not when they apply to a trade creditor and an employee who both get the same proportion of what they are owed. To advocate this position would again be to create something of a paradox: that the need to provide 'equal' treatment *legitimates* the avoidance of a preference in the first situation, but actually providing such treatment *constitutes* the objectionable preference in the latter!

In fact, to understand the basis of the preference avoidance provisions, we must switch to the perspective suggested above. The party given the voidable preference has been allowed to leave the place assigned to her by the insolvency system. She has been allowed to skip the queue for the insolvent's assets. This is the factor which creates the preference.[72] This example should

[70] The reader would have noted the italicised qualification as significant. Without entering into the debate about its justifiability here, it should be pointed out that secured creditors, e.g., acquire both priority and immunity in their debtor's insolvency. See Ch. V, below.
[71] This contravenes the rule that general unsecured creditors are to be paid nothing until all preferential debts have been fully honoured; see IA, s. 175.
[72] David Milman and Rebecca Parry "Challenging transactional integrity on insolvency: An evaluation of the new law" (1997) 48 Northern Ireland LQ 24, 25-6, perhaps come closest to the view expressed here.

make it clear *pari passu* is not simply irrelevant to understanding the preference (and several other) avoidance provisions. In fact, the focus on the 'equality' principle can be positively misleading in this regard.[73]

4. The pari passu *principle in action?*

It is to be noted that the argument here is not one for a change in the law, for example to abolish the *pari passu* rule. The point is rather that the alleged manifestations of the principle are nothing of the sort. The law *as it stands today* is better understood by adopting the analysis in the previous Section. That the veneration of the *pari passu* principle is false becomes clear when one examines some of the case-law said to support it.[74] It must be emphasised that the only purpose of discussing these decisions is to show reliance on them in support of the *pari passu* principle is misguided. Note also that the order in which these cases are discussed is thematic, not historical.

Goode seems to cite *Ex parte Mackay*[75] as authority for the proposition that "The *pari passu* rule may not be excluded by contract".[76] In this case, A and B entered into an agreement for A to sell a patent to B. B promised in return to pay over to A the royalties received, and in addition, lent A £12,500. It was also agreed that, for satisfaction of this debt, B would have a lien over one-half of the royalties received, except if A became bankrupt, in which case B might

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See also Keay, *Liquidation*, p. 550: "the adjustment provisions have been included in the [Insolvency] Act to foster a general purpose of liquidation law, *i.e.*, to provide an orderly process for dealing with the affairs of insolvents" (footnote omitted). In *Worsley v Demattos* (1758) 1 Burr 467; 97 ER 407, 412, Lord Mansfield seems to regard as distinct two types of violation of bankruptcy law which result from a voidable preference. The creditor accorded such a preference gains immunity from the management decisions taken in the collective interests of all creditors by the trustee, and *in addition*, escapes having to participate in the rateable distribution of the estate.

[73] For the "policy of section 127" of IA, which provides for the avoidance of post-petition dispositions of assets, see Lightman J in *Coutts & Co. v Stock* [2000]1 WLR 906, 909 (and approved by the Court of Appeal in *Hollicourt (Contracts) Ltd. v Bank of Ireland* [2001] 2 WLR 290, 296): the provision is "part of the statutory scheme designed to prevent the directors of a company, when liquidation is imminent, from disposing of the company's assets to the prejudice of its creditors and to preserve those assets for the benefit of the general body of creditors." Again, the focus is clearly on the preservation of the insolvent's estate with a view to its eventual distribution under the statutory scheme of distribution; needless to say, whether that distribution should be "equal" or otherwise simply is not implicated in the policy of this section.

[74] What follows is not, and could not hope to be, an examination of all the cases which might be cited in support of the 'equality' principle. Nor will space permit discussion of several areas of law potentially affected by the arguments here, e.g. direct payment clauses; on those, see e.g. Capper, "Direct payment clauses and the pari passu principle" (1998) 2 CfiLR 54, and Keay, *Liquidation*, pp. 720-22.

[75] (1873) 8 Ch. App. 643.

retain all the royalties. A became bankrupt. It was held on appeal that the provision allowing for B to have *additional* security in the event of A's bankruptcy was void as being a fraud on the bankrupt laws.[77] Goode quotes the following parts of the judgment in support of the inexcludibility of the *pari passu* rule:

> ...a man is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy *from that which the law provides*.[78]
>
> ...a person cannot make it a part of his contract that, in the event of his bankruptcy, he is then to get *some additional advantage* which prevents the property being distributed *under the bankruptcy laws*.[79]

But neither of these dicta (nor any other portion of the judgments) make any reference to the *pari passu* principle. What they do indicate is, simply, that the bankrupt's property is not to be distributed except under the rules of the bankruptcy system. Crucially, a creditor can not, even *ex ante*, "get some additional advantage" in any way not itself allowed by that system. To resort to the analogy introduced above, he may not skip his assigned place in the queue, whatever that place might be. The decision provides absolutely no support for the very different proposition that under the liquidation system, the places assigned to creditors are all unidistant from the asset pool.[80] Quite the reverse is in fact true. Remember that *pari passu* was almost as rare in practice at the time of this judgment as it is now. The decision must be seen against the background of a system which (for example) gave extensive preferences to the Crown, including by s. 32 of the Bankruptcy Act 1869. The Crown also had statutory liens over various types of property by virtue of the different Excise Acts. And the Bankruptcy Act 1869, s. 32, had enhanced the pre-existing preference for certain debts owed to the bankrupt's servants and clerks.[81] In addition, the

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[76] *Insolvency*, p. 144. Goode's position is not unambiguous, since his argument on this point is rather brief, and is heavily qualified later on in the text. See also Oditah, "Assets", p. 464 and the text accompanying fn. 37, who uses *ex p. Mackay* to similar effect.

[77] See 8 Ch. App. 643, 648, *per* Mellish LJ.

[78] James LJ at 647 (emphasis added) (the same judge whose dictum concerning secured creditors was reproduced above).

[79] Mellish LJ, at 648 (emphasis added).

[80] That is the proposition it would have to endorse if it *were* supporting the 'equality' principle. See also the only authority referred to in the judgment, *Higinbotham v Holme* (1812) 19 Ves.Jun 88; 34 ER 451, which was directly applied by Mellish LJ (at 647-8). Here, a marriage settlement provided that in case the husband, having previously been educated for orders, should enter into trade and become bankrupt, his life interest would determine. The husband later entered into trade as a cotton manufacturer, and eventually became bankrupt. Lord Eldon LC struck down the relevant clauses of the marriage settlement as a fraud on the bankrupt laws (p. 453). There can be no doubt that 'equality' of distribution simply was not at issue. The only objection was clearly to the attempt to evade the disposal of the bankrupt's property by way of collective proceedings for his creditors' benefit (pp. 452-3). Thanks to John Armour for emphasising to the author the relevance of this decision.

[81] See Keay and Walton's summary of the history of "Preferential debts", pp. 86-91.

Bankruptcy Act 1869, s. 39, provided for mandatory set-off in bankruptcy in the appropriate circumstances.[82]

It should be clear distribution according to the bankruptcy laws was *not* distribution *pari passu*. The bankruptcy laws did not place all creditors side by side. The 'equality' principle was part of that regime, but it was by no means the only part (it might not even have been the most important one). Note in addition, of course, that on the facts of this case, the priority provided to B by way of the lien over one-half of the royalties was upheld as perfectly proper by the same judgment.[83] So to cite *ex parte Mackay* as an authority supporting only equal distribution is, with respect, quite wrong, since it is at least as much an authority for the *prior* inexcludibility of *un*equal treatment of claims, also provided for by the same laws. The only proposition this decision can be said to support is that one may not bargain for immunity from the collective bankruptcy regime (except as provided by the law).[84]

The sceptical reader should turn to *National Westminster Bank Ltd. v Halesowen Presswork and Assemblies Ltd.*[85] The House of Lords held (by a majority of three to one) that since the regime for the administration of insolvent estates embodies important elements of public policy, and since the rights of insolvency set-off form part of that regime, the creditor given such set-off rights can not contract out of them. This despite the fact that the agreement which precluded insolvency set-off, and which was struck down by their Lordships, seemed specifically to have been concluded (*inter alia*) to ensure that "certain large payments which were due to the [now-insolvent] company should be available for distribution pro rata amongst

[82] See *Ex p. Barnett, In re Deveze* (1874) 9 Ch.App. 293, 295-6, *per* Lord Selborne LC. Interestingly, the other judges in this case, both of whom concurred in the Lord Chancellor's decision, were Mellish and James LJJ, the judges who decided *Ex p. Mackay*. Being aware of this deviation from *pari passu* provided by the Bankruptcy Act 1869 (as undoubtedly of the others already mentioned), they could not possibly be taken to be laying down or upholding some overriding or general rule in favour of "equal" distribution in *Ex p. Mackay* (especially since any such rule gets not a single mention in either judgment). On insolvency set-off, see the discussion in the text, below.

[83] See e.g. James LJ, at 647.

[84] An identical analysis applies to *Ex p. Williams* (1877) 7 Ch.D 138 and *Ex p. Jackson* (1880) 14 Ch.D 725. In both cases, the mortgagee's right to distrain on the chattels upon the mortgaged property was a clear attempt to grant him immunity from the collective bankruptcy proceedings to which the mortgagors were subject, to the extent of the value of the chattels distrained upon. See also the similar case of *Re Johns* [1928] Ch 737. All three cases are used by Oditah, "Assets", p. 464 fn. 37, as demonstrating the operation of the *pari passu* principle. For reasons discussed in the text to which this note is attached, it is submitted that they deal with an entirely different point, with immunity, not priority.

[85] [1972] AC 785 (HL).

its creditors."[86] The liquidator's view -- that the party now asserting set-off should be "in no better position than any other creditor" in the debtor company's insolvency -- was noted,[87] but rejected.

So an *exception* to the 'equality' principle -- the contractual disapplication of which might have led to a more 'equal' distribution -- is as mandatory as any other part of the liquidation regime. What can not be contracted out of (in an unacceptable way) is not the *pari passu* principle, but the whole collective system for the winding-up of insolvent estates. Not only is it forbidden for a creditor to leave his assigned place in the queue and step ahead of others, he can not even leave his place ahead of others and stand in line with them. The inequality inherent in the system (in this case by way of insolvency set-off) is every bit as binding as the equality. Note again that the focus is on attempts to frustrate (some of) the rules of the liquidation regime. Whether that would lead to an increase or decrease in the 'equality' of distribution is simply irrelevant.[88]

Consider *British International Air Lines Ltd. v Compagnie Nationale Air France*[89]. British Eagle (BE) was a member of a clearing house scheme operated by the International Air Transport Association (IATA). Sums due from participating airlines to each other were netted out at the end of every month. Those with a net credit balance would then receive a payment from the clearing house, while those with a net debit balance were required to pay into the system. BE having gone into liquidation, it was found that it owed money to various airlines, but had a claim against Air France (AF). A bare majority of their Lordships allowed the liquidator to recover that sum on the basis that the netting arrangements contravened the *pari passu* principle. The Lords rejected AF's contention that the liquidator's only claim lay against the clearing house, and that it could only be for the amount (if any) which remained to BE's credit after the netting-off. According to the majority, the netting arrangements captured for the benefit of the members of the clearing house an asset (the claim against AF) which, but for those arrangements, would have been available for distribution among BE's general creditors.

[86] See the submission on behalf of the company, *ibid*., p. 792A.
[87] Expressly so by at least one of their Lordships; see *per* Viscount Dilhorne, p. 801E.
[88] To similar effect, see e.g. *Ex p. Barnett, In re Deveze* (1874) 9 Ch.App. 293.
[89] [1975] 1 WLR 758 (HL). For criticism of the decision, see the Cork Report, paras. 1341-2.

That this case has been described as "[undoubtedly the] leading modern authority on the pre-eminence of the *pari passu* principle"[90] is not without irony. The case could not possibly provide any support for the *pari passu* principle. Recall that this principle requires '*equals*' to be treated 'equally'.[91] And the determination of 'equality' is generally left to non-insolvency law:

> The Act of Parliament unquestionably says that everybody shall be paid *pari passu*, but that means everybody after the winding up has commenced. It does not mean that the Court shall look into past transactions, and equalise all the creditors... It takes them exactly as it finds them.[92]

But even Lord Cross, speaking for the majority, accepted that AF, and other members of the clearing house, were never equal to BE's general creditors outside liquidation.[93] During BE's solvency, the members of IATA could not (unlike BE's non-IATA creditors) just have ignored the clearing house arrangements and sued BE for any sums owed. Correspondingly, BE could not, while solvent, have proceeded directly against AF. It could only have claimed against the clearing house for any net balance due to it.[94] And yet BE's liquidator was allowed to do precisely what BE would not have been able to. By the same stroke, BE's IATA creditors were forced to claim directly against BE (by proving in its liquidation) while they would have been neither required nor even allowed to do so before the commencement of its winding-up. Pre-insolvency *unequals* were forcibly 'equalised' in insolvency. This hardly constitutes a vindication of the *pari passu* principle, no matter what the judicial rhetoric. And in any case, the sums recovered as a result of this decision would not have been distributed *pari passu*. Pre-preferential and preferential creditors etc. would have taken the first bite.[95]

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[90] Oditah, "Assets", p. 465; it must be emphasised that Oditah is nevertheless unimpressed by the decision, and subjects it to cogent criticism; see p. 466.

[91] The rule that all those who correctly answer *x* number of questions in an exam are to get *x* marks, enshrines one type of equality. The rule that all those who take the exam are to get *x* marks represents quite another. The *pari passu* principle is traditionally conceived as analogous to the former rather than the latter rule.

[92] *Re Smith, Knight & Co., ex p. Ashbury* (1868) LR 5 Eq. 223, at 226, *per* Lord Romilly M.R. See also Oditah, "Assets", pp. 463 and 468.

[93] [1975] 1 WLR 758, 777C-H; to the same effect, see Lord Morris (dissenting), pp. 764F, 765A and 765E; and Lord Simon (dissenting), p. 771F-H.

[94] *Ibid*., p. 777C-D (*per* Lord Cross).

[95] This point is impliedly noted *ibid*., at pp. 761B (Lord Morris) and 778H (Lord Cross). And needless to say, had there been a floating charge over the relevant assets, its holder would have been repaid in preference to general unsecured creditors. The same point again seems to have been missed by the Court of Appeal in *In re Celtic Extraction Ltd. (in liq.)* [2000] 2 WLR 991, 1005D, where Morrit LJ (delivering the Court's judgment), invoked "the very considerable... public policy requirement that the property of insolvents should be divided equally amongst their unsecured creditors", to uphold the official receiver's ability to disclaim a waste disposal licence as onerous property. The Court's assertion, that any assets preserved by the disclaimer (none, on the facts) would be distributed *pari passu* amongst general creditors,

Perhaps a better way of understanding the disputed issues in *British Eagle* would be to look at the netting arrangements simply as an attempt on part of IATA to prevent its members from having to submit to the collective liquidation regime. Or at least this is how they seem to have been viewed by the majority of their Lordships.[96] That such contracting-out (i.e. immunity) was not objectionable *per se* was also accepted. Lord Cross implied that, had the IATA arrangements created charges in favour of the IATA creditors with effects equivalent to the disputed netting scheme, those would have been effective against the liquidator if duly registered.[97] So the objection was not to the granting of immunity to only some of BE's creditors (or indeed to granting them priority over others). Rather, the majority were of the view that the advantages associated with recognising this *novel* way of acquiring immunity were not sufficient to outweigh (what they saw as) the costs of such a significant derogation from the collective regime.[98] This conceptualisation of the majority's decision then also allows one to make sense of the strong dissenting speech by Lord Morris, who emphasised the benefits which flowed from having the netting arrangements.[99] On the arguments made here, the thrust of the dissenting speeches would of course have to be that these benefits (of allowing the arrangements to prevail) would outweigh any associated costs.

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is of course without foundation. Any such assets would mostly go to any floating charge holder and to pre-preferential and preferential creditors.

[96] *Ibid*., p. 780G-H: "[What Air France] are saying here is that the parties to the 'clearing house' arrangements by agreeing that simple contract duties are to be satisfied in a particular way have succeeded in 'contracting out' of the provisions… for the payment of unsecured debts 'pari passu.'" Note the unnecessary (and inaccurate) emphasis on 'equality' at the end of this quotation: what would have been contracted out of was the *whole* collective regime, its inequality (e.g. in favour of pre-preferential and preferential creditors) as well as its 'equality'.

[97] *Ibid*., p. 780C. The existence of such charges would of course accord priority over BE's general creditors to IATA creditors, as well as granting the latter immunity from the collective liquidation regime.

[98] *Ibid*., p. 780H-781A: "[It] is to my mind irrelevant that the parties to the 'clearing house' arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a 'contracting out' must... be contrary to public policy. The question is, in essence, whether what was called... the 'mini liquidation' flowing from the clearing house arrangements is to yield to or prevail over the general liquidation. I cannot doubt that on principle the rules of the general liquidation should prevail."

Despite appearances, the objection to granting immunity from the collective regime was not an absolute one. As already noted, the judge had implied earlier in the same paragraph that he would have been content to allow immunity for the IATA creditors by way of security. This also shows the objection was not one of principle. There was no principle involved which laid down, say, that no one can bargain for immunity. The matter was rather of policy. One could only bargain for immunity in an acceptable way (the authority for this is *British Eagle* itself), and for the right reasons. Even if the method of attaining immunity was acceptable, the reasons might not. In *Ex p. Mackay,* the only discernible reason for the extra security was the desire of the creditor to better his own position in his debtor's insolvency. Other creditors suffered harm without receiving any compensating benefit.

[99] See e.g. [1975] 1 WLR 758, 761F-G, 762D-763C.

Unfortunately, though, there seems to have been no suggestion in the arguments that the issue should be regarded thus, as a question of balancing the commercial advantages of recognising this novel way of gaining immunity from the liquidation regime, against any lessening of the advantages associated with having a collective system. As already mentioned, the latter include the ability to preserve the going concern surplus if there is one, and the minimisation of uncertainty, monitoring and administrative costs. The IATA netting system should have been upheld if the costs to the actors resulting from any increases in uncertainty, monitoring and administrative costs, in the risk that a going concern surplus would be lost, and in the diminution of the pool of assets entailed by the existence of immunity for IATA creditors, were outweighed by the benefits it brought *to the same actors*.[100] (Note that this is a sufficient but not necessary condition, since the initial distribution scheme provided by the liquidation regime is not self-evidently appropriate and therefore must itself be argued for.) The *pari passu* red herring served massively to confuse this issue. In failing to consider it clearly, it is submitted the *British Eagle* decision is deeply unsatisfactory.[101] Be that as it may, for the reasons discussed, the leading modern authority on the pre-eminence of the *pari passu* principle actually stands more for its hollowness than its hallowedness.

Ex parte Barter; Ex parte Black[102] is another interesting decision cited in support of the *pari passu* principle.[103] Simplifying the facts somewhat, X, a Portuguese steamship company, entered into an agreement with Y, who were shipbuilders. Under the agreement, Y were to build and sell to X a steamship, the price for which was to be paid in instalments as the construction work progressed. On payment of the first instalment, the agreement provided that the steamship,

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[100] That was almost certainly the case; it follows that the IATA scheme should have been upheld. Parliament seems to have taken a somewhat similar view; see Companies Act 1989, Part VII, which reversed the effects of the decision with respect to financial markets. The Act creates yet another exception (if the *British Eagle* decision were to be taken at face value) to the 'equality' principle. The recent decision of Neuberger in *Money Markets International Stockbrokers Ltd v London Stock Exchange and Another* (Transcript, 10 July 2001), recognises yet another exception to the principle, this time concerning property the ownership of which depends on the personal characteristics of the owner, and further, assets so inextricably linked to such property that they could be considered "ancillary" to it (see e.g. paras. 110-3). In this case, these were, respectively, the membership of the London Stock Exchange, and a "'B' share" entitling the holder (roughly) to vote on decisions about how the company which owned the Exchange was to be run, and to participate in the distribution of the value released because of that company's demutualisation.

[101] See Goode's misgivings about the decision, *Insolvency*, pp. 181-2, and those of Oditah, "Assets", p. 466. For an uncritical invocation of the decision in favour of the 'equality' principle, see Finch, "Pari passu", pp. 198 fn. 28 and 199-200.

[102] (1884) 26 Ch.D 510.

[103] Oditah, "Assets", p. 464 fn. 36.

its engines, and all associated materials were to be vested in X, the buyers (the Court of Appeal referred to this as the "vesting clause"). It was also agreed that X would have the right to seize all these materials if the construction work remained discontinued for a specified period, or if the ship was not delivered on time, or if Y became insolvent or bankrupt (the "seizure clause"). Finally, the agreement stipulated that should any of the events mentioned above occur, X would have the right to employ alternative builders to complete the ship, and to use Y's shipyard, premises, machinery, plant, tools and any other materials present on Y's premises suitable to the purpose (the "user clause"). The work commenced and the first instalment was paid. Subsequently, on Y's insolvency, X exercised its rights under the "seizure clause" and took possession of the ship, engines and related materials. This was upheld by the Court of Appeal: X was merely seizing property which already belonged to it by virtue of the "vesting clause".[104] However, the "user clause" was struck down, since "a power upon bankruptcy to control the user after bankruptcy of property vested in the bankrupt at the date of the bankruptcy is invalid."[105]

The Court's decision is hardly surprising... in view of the extravagance of the terms of the "user clause" if for no other reason. But in any case, the relevant issues are very clear on the facts. Note the two most important points. First and yet again, there was no absolute bar to the parties bargaining for immunity from the collective regime. This was quite obviously the effect of the "vesting" and "seizure" clauses. Instead of lining up with the rest of Y's creditors and submitting to the collective decisions made by Y's trustee, X was able to remove itself from the queue to the extent of the value of the materials covered by the two clauses. But second, the "user clause" was an attempt to commandeer Y's remaining estate for the sole benefit of X, removing that too from the ambit of the trustee's decision-making. This was regarded as unjustifiable. Even as to the "user clause", X had argued that it would redound to the general good of all of Y's creditors, since the completion of the ship would reduce *pro tanto* the amount for which X would prove in the bankruptcy for Y's breach of contract.[106] The Court of Appeal disagreed: in the absence of the clause, the trustee would have decided whether to complete the ship and claim the contractual price, or to abandon the contract, and this decision would have been made for the benefit of all of Y's creditors. But the "user clause" removed the trustee's ability to make that choice, and instead vested that choice in X.[107] To the extent to which X was a

[104] 26 Ch.D 510, 518-9 (*per* Fry LJ, delivering the Court's judgment).
[105] *Ibid*., p. 519.
[106] *Ibid*., p. 520.
[107] *Ibid*.

creditor for damages for Y's breach of contract, the clause purported to grant X immunity from having to participate in the collective bankruptcy regime. *This* attempt to gain immunity was regarded as unacceptable.

Now whatever one might think of the distinctions made in the Court's judgment about acceptable and unacceptable ways of by-passing the collective regime, note once again that the *pari passu* principle was not at issue. The "user clause" would have by-passed the inequality of the regime (inherent in the rules governing set-off, pre-preferential and preferential claims etc.) *before* it evaded its 'equality'. The crucial issue was not X's place in the queue relative to other creditors but the fact that he would not have had to queue up at all, and -- if that was not enough -- would have prevented the trustee being able to make a collective decision about much of the remaining pool of assets.[108]

The same point can be made again and again. Cases cited in support of the 'equality' principle either support that principle only as part of a significantly "unequal" insolvency regime, or more frequently, show nothing except the law's intolerance towards attempts to gain immunity from the collective liquidation system in unacceptable or unfamiliar ways. In view of all this, the *pari passu* principle could not possibly be necessary for there to be an orderly liquidation. In addition to all the arguments above, to the extent that the current liquidation regime is accepted as fulfilling the requirements of orderliness and as replacing the value-destroying rush for an insolvent's assets, and given that *pari passu* is a very partial feature of the system, the present liquidation regime itself constitutes a rebuttal of any such claim.[109] What is more, the very significant departure from this principle represented by insolvency set-off has been regarded at the highest judicial level as itself necessary for a "proper and orderly" administration of the

[108] *Ex p. Jay* (1880) 14 Ch.D 19 is a similar case, and is cited by Good, *Principles*, p. 151 fn. 39 and Oditah, "Assets", p. 464 fn. 36, as an application of the 'equality' principle. Here, X attempted to vest the *title* to portions of Y's estate (and not merely the use, as in *Ex p. Barter*) in herself on Y's bankruptcy. This was struck down, but the reason was (as discussed) the unacceptable attempt to circumvent the operation of the collective regime. With respect, the *pari passu* rule simply was not relevant to the decision one way or the other.

[109] It would be otherwise if the claim were that the liquidation system *could not* be "orderly" in the appropriate sense to the extent that it diverges from an "equal" distribution. But such a claim would be trivial, and would amount to saying that, to the extent that the system diverges from the *pari passu* principle, it diverges from the *pari passu* principle! None of the commentators cited above in support of the principle seem to be taking that position, and all of them seem to accept that the current liquidation regime (despite its less-than-perfect adherence to the *pari passu* ideal) at least provides a fair degree of order to the process of winding up insolvent estates.

estates of insolvent companies.[110] But then, since "equal" treatment of different types of claim is not required to gain the practical advantages associated with the orderly winding up of insolvent estates, and since it is not necessary to justify insolvency law's peculiar features (e.g. its collectivity, and the avoidance of preferences and post-petition dispositions), the existence of differential priority -- including that of secured creditors -- can not be impugned on the ground that it interferes with the attainment of these goals.

Finally and in the interests of completeness, a decision which allows parties to bargain for a priority different from the one they would have had without that agreement -- but without allowing immunity from the rules of the liquidation regime -- is *Re Maxwell Communications Corporation*.[111] This case concerned an agreement whereby certain bonds issued by M Ltd. (held by parties referred to hereafter as "the Bondholders") were guaranteed by M Plc. "on a subordinated basis". Subsequently, M Ltd. being insolvent, M Plc. was placed in administration. The administrator applied for an order to exclude the Bondholders from participation in a scheme of arrangement under which, secured and preferential creditors having been paid, the remainder would be distributed *pari passu* among M Plc.'s other unsecured creditors. In accordance with the subordination agreement, the Bondholders would only be paid if these other unsecured creditors were first paid off in full. It was clear on the facts that, if this scheme was approved, the Bondholders would get nothing.[112]

It was argued on behalf of the Bondholders that the subordination agreement was void as being in breach of the *pari passu* principle: "the liquidator ought not to be required or entitled to look behind a proof to determine whether a creditor submitting a proof was entitled to payment pari passu with other unsecured creditors."[113] In effect, the submission was that the *pari passu* principle should be given effect with respect to all those general creditors who submitted a proof, the liquidator being required to turn a blind eye to the pre-insolvency dealings between the debtor and (some of) its creditors. This was rejected. Vinelott J pointed out that "There are situations under the Insolvency Act 1986 in which an unsecured debt is postponed to other

[110] *National Westminster Bank Ltd. v Halesowen Presswork Ltd.* [1972] AC 785, 809A, *per* Lord Simon; to similar effect but expressed with greater reservation, see the view of Lord Kilbrandon, pp. 822C and 824A. For the proposition that insolvency set-off exists, not to further any such general purpose, but only for the benefit of the party having mutual dealings with the bankrupt, see the sole dissenting speech of Lord Cross, *ibid*., pp. 812-3.
[111] [1993] 1 WLR 1402.
[112] At p. 1404G.

unsecured debt."[114] In these situations, the liquidator might well need to have regard to the pre-insolvency status of different unsecured creditors. So if the liquidator had no difficulty in determining the pre-insolvency positions of various unsecured creditors and giving effect to statutory subordination, he would face no greater hurdle in dealing with contractual subordination.[115] The judge read *British Eagle* as laying down the rule that "a creditor cannot validly contract with his debtor that he will enjoy some advantage in a bankruptcy or winding-up which is denied to other creditors." However, he held that this did not preclude an agreement between A and B Ltd. for the latter's debt to A to be subordinated in B's insolvency to that owed to B's other unsecured creditors.[116]

For the reader who is still not convinced, this decision should make it clear that the *pari passu* principle is far from sacrosanct. It is obvious that *Re Maxwell* allows parties to avoid it. The Bondholders, who would have ranked *pari passu* with M Plc.'s other creditors, were relegated because of the terms of their agreement with M Plc. to a position inferior to those other creditors. But this aspect of the decision should not tempt one to the hasty conclusion that the inexcludibility confirmed by *British Eagle* "applie[s] only to those rules the infringement of which would give one creditor an advantage denied to other creditors."[117] Resorting once again to the analogy of the common pool, this would amount to saying that the rule is that within the insolvency regime, one can contract out of one's assigned place in the queue if the result would be to increase the insolvency value available for the remaining unsecured creditors,[118] but not if it would decrease that value. But this interpretation would be quite inconsistent with the House of Lords' judgment in *Natwest v Halesowen*.[119] That case shows one is not allowed to change one's place in the queue for the pool of the insolvent's assets simply because that would increase the insolvency share of the remaining creditors. As already noted, the Lords there struck down an

[113] At p. 1412C.
[114] *Ibid*., mentioning as examples IA, ss. 74(1)(f) (sums payable to a member of the insolvency company) and 215(4) (sums owed to a director who has been held liable for fraudulent or wrongful trading).
[115] *Ibid*., p. 1412E.
[116] *Ibid*.
[117] Goode, *Insolvency*, p. 146, does reach that conclusion. He refers to *Natwest v Halesowen* rather than *British Eagle*, but for the reason discussed in the text immediately below, this is almost certainly an oversight.
[118] That the *Re Maxwell* decision has this effect is noted by Goode, *Insolvency*, p. 146 fn. 19.
[119] See the discussion of this case above.

agreement which, by altering a creditor's priority position, would have brought about just such an increase.[120]

So *when* should parties be allowed to change their priority position within the collective liquidation regime, in other words, to alter their relative places in the queue to the pool of the insolvent's assets? Most obviously, an agreement to alter the priority position of creditors within the liquidation regime should be allowed when -- for all the creditors whose priority position in their debtor's insolvency would be made worse off because of the agreement -- the expected *overall* benefits of the agreement (i.e. not merely those accruing if and when the debtor does become insolvent) to those same creditors outweigh its expected *overall* costs.[121] (This again is a sufficient but not necessary condition, and is discussed further in the next Section.) More abstractly, it is submitted that such an agreement must be upheld if it would be sanctioned by principles acceptable to all the affected parties bargaining with each other in the choice position of the ACM.

5. Fairness as 'equality'

We have considered -- and rejected -- the claim that the 'equality' principle is essential for the orderly liquidation of companies, and that it underlies important and distinctive features of the collective insolvency regime. This Section challenges the other main role often assigned to it. The *pari passu* principle requires that all creditors (in positions of relative equality as determined by pre-insolvency law) should be paid back the same proportion of their debt in their debtor's liquidation. Since this type of 'equality' represents fairness, runs this argument, the *pari passu* rule ensures all creditors are treated fairly. Keay and Walton are of the view that "The underlying aim behind the use of the equality principle is to produce fairness, so that every creditor is treated

[120] The creditor, National Westminster Bank, would have been deprived by the agreement of its ability to combine two accounts of the insolvent, and to set off the insolvent's liability to it on the overdrawn account against the credit balance in the other. Needless to say, the judicial disapproval of the agreement resulted in the Bank's having priority over the insolvent's other creditors to the extent of the amount set off.

[121] For an illustration, see *Re Maxwell Plc.* [1993] 1 WLR 1402 itself, at p. 1416F-H. It would often be the case that a troubled company can only mount a rescue attempt if some of its existing creditors (EC) create an incentive for outside financiers (new creditors or NC) to lend to the company, by agreeing to subordinate their (EC's) claims to those of NC, should the debtor company be liquidated. The loss in insolvency value to EC resulting from the subordination agreement is outweighed by the benefit to them of the increased possibility that the company would be able to avoid liquidation altogether with the help of the funds injected into it by NC. See also *Re Portbase Clothing Ltd.* [1993] Ch 388. For the reasons given in Goode, *Insolvency*, pp. 170-1, which are consistent with the analysis in this Section, it is respectfully suggested the *Portbase* decision is quite unsatisfactory.

in the same way."[122] As noted above, they argue that to abolish this principle would be to return to the "mediaeval" policy of allowing those with the greatest resources and power to deprive poorer and weaker creditors of anything in their debtor's insolvency.[123] This would be normatively unattractive. Several other commentators have suggested in a similar vein that the 'equality' principle enshrines fairness in liquidation.[124]

The debate about equality as a political ideal is long and complex.[125] The discussion here will have to be quite a summary one. However, it is respectfully suggested that even this should suffice, at the very least, to cast serious doubt on the claim that the *pari passu* principle conduces to fairness in liquidation.

There can be no doubt that real equality is a -- some would say the only -- form of fairness. But a set of laws enshrines real equality only when it treats all those subject to it as equals. However, "There is a difference between treating people equally, with respect to one or another commodity or opportunity, and treating them as equals."[126] It is this crucial distinction which is universally overlooked by supporters of the *pari passu* principle.

Let us distinguish, in a rough and ready way, between formal and real equality. In the relevant context, *formal equality* holds when the same rule applies to all people. That everyone must stop at a red traffic light is an example. This type of equality, while undoubtedly important, results in a fairly superficial form of fairness, the limits of which are easy to expose. It is not obviously fair to insist that an ambulance should be obliged to wait at the red signal just like any other vehicle, even though carrying a seriously ill patient. That access to a building is provided "equally" to all by way of a steep staircase does not necessarily prevent those using wheelchairs

[122] "Preferential debts", pp. 93-4, including the references in fn. 78.
[123] *Ibid*., p. 95.
[124] See e.g. Finch and Worthington, "*Pari passu*", p. 3; Finch, "Pari passu", p. 194, noting another "traditional justification" of the principle; John McCoid, "Bankruptcy, preferences, and efficiency: An expression of doubt" (1981) 67 Virginia LR 249, 271; Thomas Ward and Jay Shulman, "In defence of the Bankruptcy Code's radical integration of the preference rules affecting commercial financing" (1983) 61 Washington University LQ 1, 16. For a rather more nuanced approach which still regards the 'equality' principle as the default rule, see Korobkin, "Contractarianism and the normative foundations of bankruptcy law" (1993) 71 Texas LR 541, 601-2 and 607-9. See also John Farrar, "Public policy and the pari passu rule" [1980] NZLJ 100, who mentions the argument that it would be unfair for some creditors to be allowed to contract out of the liquidation regime (not just the 'equality' principle), but finds it "questionable", sometimes even "wide of the mark"; see p. 100.
[125] See further the discussion in Ch. I, above.
[126] Dworkin, *Virtue*, p. 11.

from being treated unfairly. Or think of a flat-rate income tax: regardless of how much you earn, let us say 25% of your annual income is to be paid over to the state. Many (perhaps most) readers would intuitively find this method of taxation normatively unappealing. That you are to be deprived of the same proportion of your income, whether you earn £10,000 or £10m per annum, would not strike them as particularly fair. Note here the parallel with the *pari passu* rule, which represents the decision that all creditors are to be deprived of the same proportion of their debts, should their debtor become insolvent. The problem is that a rule based on formal equality does not take into account important *differences* between people, even though those differences are relevant to any consideration of the rule's fairness. Of course equals must be treated as equals, but who is to be considered equal to whom, and in what respect? Merely formal equality might resolve these vital questions by reference to trivial, or irrelevant, or meaningless attributes. But for equality to result in fairness (a morally charged concept), the determination of who constitutes an equal must be based on characteristics which themselves are morally significant. So in important ways, a rule based on formal equality is empty of normative content. To treat people with only formal equality often is not to treat them as equals.

How *do* we treat people, then, in order to treat them as equals? One attempt to describe what this entails in the specific context of corporate insolvency is of course the Authentic Consent Model,[127] and we can bring this to bear upon the analysis of the status of the *pari passu* principle. The peculiar insolvency issue is the distribution of assets in a corporate liquidation, and the proposal is that all those who hold a claim which non-insolvency law determines to be formally similar, are to get back the same proportion of what they are owed. Would the parties in the choice position, bargaining in Dramatic Ignorance about the governing principles appropriate to this situation, be tempted by formal equality of this sort?[128] It is submitted that they would not. The reason is straight-forward. *Non*-insolvency law does not *need* to determine the priority status of different types of creditor, since for most solvent debtors, all creditors get everything they are owed.[129] For that reason, non-insolvency law makes few formal distinctions between various types of claimant. The unsecured claim of a bank, a tax liability owed to the Crown, and the unpaid wages of an unskilled worker, all have the same pre-insolvency form. Non-insolvency law often does not resolve an issue which is (almost by definition) peculiar to insolvency itself -- who

[127] See Ch. III, above.
[128] Some scholars have asserted that creditors would in fact accept the *pari passu* rule; see e.g. Finch and Worthington, "*Pari passu*", p. 3, including fn. 7. For a detailed rebuttal of the Creditors' Bargain, often relied upon to this effect, see Ch. II, above.

should bear how much loss when a company is rendered terminally unable to meet its obligations?[130] So when an actor does become insolvent, to seek guidance from non-insolvency law to determine how different claimants ought to be treated -- as the *pari passu* principle purports to do -- is to commit the old formalist error identified above. The 'equality' principle determines who counts as an "equal" by reference to an attribute of the claimants (i.e. the non-insolvency *form* of their claim) which is irrelevant or meaningless as regards the appropriateness of any method of distribution of an insolvent's estate.

Here is a simple demonstration that parties conceived of as equals would not choose the *pari passu* rule. Let us isolate the issues of interest to us by making three assumptions. First, suppose there are only three types of creditor, commercial banks, the Crown, and the debtor's employees. Second, we also ignore for the moment the employee-creditors' rights under the Employment Rights Act 1996.[131] And finally, pretend that the parties in the choice position are allocating the bankrupt's estate without reference to their own pre-insolvency interests and commitments.[132] In Dramatic Ignorance, parties do not know whether they would turn out to be an employee, or to have their relevant interests represented by a bank or the Crown. They are aware, though, that banks lend to thousands of companies (or more) and are therefore well-diversified. Banks can balance the harm of receiving somewhat less in the insolvency of some of their debtors, against the profit they make from lending to the many more who pay back every penny with interest. By virtue of being repeat players, they have accumulated expertise in assessing the credit-worthiness of their borrowers. And since they are strong commercial players in an under-diversified market for the provision of credit,[133] they have a strong influence on the terms on which they lend. So bank-creditors are very well-placed to deal with being paid back less than they are owed in any individual insolvency.

On the other hand, employee-creditors might often be dependent solely on their salaries, might be unable to diversify by working for more than one employer, might have no insurance

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[129] This point is made by Goode, *Insolvency*, p. 39.

[130] There are some exceptions, most notably the status of secured claims. But even here, insolvency law must consider whether to take account of the pre-insolvency form of the claim for meaningful reasons, not because it fetishizes form. This is touched upon below.

[131] The implications of those are discussed in the next Section.

[132] For two reasons, this assumption must be treated with the greatest caution. First, it is difficult to sustain coherently and without self-contradiction. And second and despite this seemingly fatal feature, it has been unconsciously accepted and been the cause of many problems in insolvency scholarship. Both these points are discussed below.

because they are not able to join a trade union which would buy such insurance for its members, might have had no influence over the terms on which they were employed and therefore became creditors, and might be unable quickly to find work on being deprived of a job by virtue of their employer's insolvency.[134] Employees might be owed wages for several weeks or months, having supplied services to their company while it was in financial distress without demanding payment on time, in the hope that the company would recover. Such employee-creditors might suffer serious detriment if they lose too great a proportion of their outstanding debts.

In the choice position of the Authentic Consent Model, parties bargaining about the appropriate rule for the distribution of the insolvent's assets would find the suggestion that bank-creditors and employee-creditors both be treated "equally" by being paid back the same proportion of what they are owed, simply absurd. That the two types of creditor hold claims judged under non-insolvency law to be formally similar to each other would not carry too much weight. The parties do not know whether they would turn out to be (or to be represented by) bank- or employee-creditors, so they accord *equal* concern to the sets of interests associated with each. But this requires that those in a more vulnerable position in their debtor's insolvency be given *greater* protection than those better able to deal with the loss. Knowing that they could deal quite well with being paid back less on any individual loan if they turned out to be represented in the real world by a bank, all the parties would agree to provide greater protection to employee-claimants, just in case they found themselves vulnerable to great harm as one themselves. The construction of the choice position allows us to see this as one morally relevant factor here. Fairness does *not* result from treating the two types of creditor "equally", so the *pari passu* principle would be rejected outright as applied to bank- and employee-creditors with claims similar to each other under non-insolvency law. It is submitted the same reasoning holds *mutatis mutandis* for the various types of creditor different in this morally significant way, regardless of the formal legal nature of their claims. So for example, the principles of distribution resulting from this exercise are more likely to give employee-creditors at least a degree of priority in their employer's insolvency over most other types of claimant.[135]

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[133] Don Cruikshank, *Competition in UK Banking* (HMSO, 2000), pp. 149 and 155.
[134] See e.g. Ch. III.6, above, and Keay and Walton, "Preferential", pp. 95 and 99; but see also pp. 100-1.
[135] Compare IA, s. 175 (and s. 386), and Sch. 6, which create a priority regime for (*inter alia*) employee-creditors. This supersedes the 'equality' principle enshrined in e.g. IA, s. 107.

Note that the extent to which creditors are vulnerable to serious harm in their debtor's insolvency is only one of several relevant considerations for the parties in the choice position. The point here is not to identify all such factors (or even to defend the preferential debts regime as it stands today), but rather, to cast doubt on the *pari passu* principle as the guardian of fairness in liquidation. It should be obvious its crude 'equality' is almost entirely unattractive to parties treated as equals.

What about the alleged additional role of the *pari passu* principle, that it applies *within* the categories of creditor created by insolvency law itself? Some of the problems with this suggestion were noted in the first Section of this Chapter. But most importantly, this interpretation of the principle again can make no reference to fairness. Consider the example of preferential creditors, the Crown and the insolvent's employees. Again reasoning subject to the three assumptions stated above, there can be no question of the parties in the choice position accepting the same treatment for these two types of creditor. We have already seen that the greater vulnerability to harm suffered by employee-creditors would be one very important consideration for the parties, which might lead them to privilege employees' claims. But there is little that can be said for the Crown to enjoy the *same* priority as them. While the Crown does not choose its debtors, it is still maximally diversified (by being the universal creditor within its domain) and obviously therefore, is able to absorb a greater share of the loss than employee-creditors. Unlike them, it also has the ability to vary the rates at which it "lends", and can decide for itself how to use that ability. For example, it could put in place a mechanism to judge the risk of non-payment by some of its debtors, and to charge rates of interest on due but unpaid taxes accordingly.[136] For the parties bargaining in Dramatic Ignorance, its decision not to do so does not render it any more worthy of protection. It also has access to privileged information about its debtors, and enjoys immense economies of scale in keeping track of their financial prospects. Such mechanisms are of course not even remotely available to employee-creditors. It should be clear that even if the parties decided the Crown should receive some sort of preference over creditors who choose their debtors freely, this priority would be likely to be lower than that accorded to employee-creditors. 'Equality' does not conduce to fairness even within the category of preferential claimants, since these two types of claimant are *not* equal in crucial ways.[137]

[136] For the interesting Australian approach to this issue, see Keay and Walton, "Preferential", pp. 98-9.

This concludes the argument that the *pari passu* principle has nothing to do with fairness. But to leave the discussion at this point would be profoundly misleading. Recall the third assumption made above, that parties deciding on the choice of principles to govern distribution of an insolvent's assets are unconcerned about their *pre*-insolvency rights and obligations. This assumption allowed us to focus narrowly on whether 'equality' of distribution in corporate liquidation is normatively attractive. But while useful for that purpose, this assumption is problematic and of course totally counterfactual. Creditors of a firm which becomes insolvent do not suddenly develop a completely new set of interests without link or connection with the interests they had before this particular debtor became unable to pay its debts. In their capacity as actors on the commercial stage, they do not undergo a re-birth which purges them of pre-insolvency commitments. Their interests and obligations within liquidation flow from their pre-liquidation ones, and are inextricably linked. So for example, to accept the very existence of claims against the now-insolvent company is to acknowledge this inseverable link with the pre-insolvency commitments of the actors. And one of the reasons why employees are more deserving of protection in their employer's insolvency is their pre-insolvency inability to diversify, and (for many employees) to have an appreciable say about the terms of their employment, etc.

It follows that, while the pre-insolvency *form* of claims might not matter, the pre-insolvency *interests and obligations* of all the parties must always be taken into consideration when deciding about the priority of certain types of claimant over others. Fairness demands that each claimant be accorded equal care and concern. But this involves looking at the *totality* of the interests and obligations of each. So the principles of insolvency law, though dealing exclusively with peculiar insolvency issues, should not focus exclusively on the interests of parties *once a relevant actor is already insolvent*. Rather, they should affect the parties in a way which pays equal attention to both their pre- and post-insolvency interests and obligations, conceived of as the continuities that they actually are.

In the Authentic Consent Model, the parties may be Dramatically Ignorant, but they are not hemianopic.[138] They do not lose sight of their own pre-insolvency lives (though none of them knows which of these lives is their's). They realise that actors in the real world often interact

[137] The actual role of 'equality', here as elsewhere in the scheme of liquidation, is described in the next Section.

with each other in the shadow of insolvency law. So they select those principles to be part of that law which would uphold any pre-insolvency priority arrangements which, for example, serve the *entirety* of the interests of each of them. This despite the fact that those arrangements do not serve the *post*-insolvency interests of some of them.[139]

So parties in Dramatic Ignorance might approve principles of insolvency law which allow Creditor A and Debtor to agree that in Debtor's liquidation, A would rank higher than Creditor B. They would accept this situation even though each of them has an equal chance -- as against each other party -- of turning out to be B. This is because the agreement to grant A priority might nevertheless bring B greater, countervailing benefits, for example by reducing the risk that their mutual debtor would become insolvent in the first place. And parties in the choice position care about their non-insolvency lives as much as about their post-insolvency ones, since (because of the construction of Dramatic Ignorance) they do not know if their debtor would in fact become insolvent. So one of insolvency law's more challenging tasks is to distinguish between pre-insolvency priority arrangements which are mutually advantageous to all the relevant parties, and those which are merely exploitative.[140] The latter must of course be ruled out, but it would conduce to fairness actually to give effect to the unequal distribution resulting from the former.[141]

We should note the implications. The fact that creditor X receives 10% of his claim in the winding-up of its debtor and creditor Y receives 50% is, by itself, no reason at all for reaching any conclusion on the appropriateness of the result. One must peer behind these figures, since they are meaningless in isolation.[142] Similarly, arguments which, for example, bemoan the fact that there are so many security and quasi-security devices that little is left for distribution to

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[138] Hemianopia: loss of one-half of the field of vision in both eyes.

[139] The analogy is with a contract concluded freely and on perfectly fair terms between X and Y, and which is mutually advantageous to them at the time it is entered into. X might later find that to fulfil his obligations under it, though practicable, no longer serves his interests. It would be fair nevertheless to hold X to his contractual obligations, on the basis that it was in his own interests -- viewed as a whole -- to be allowed to enter into that contract by making a credible promise (i.e. one actionable at law).

[140] Compare the instructive comments of Simonds J. in *Re Destone Fabrics Ltd.* [1941] Ch 319, 324, a decision on the avoidance of a floating charge for past value: "The ultimate test in such cases may well be whether the transaction is to be regarded as one intended bona fide for the benefit of the company, or whether it is intended merely to provide certain moneys for the benefit of certain creditors of the company to the prejudice of other creditors of the company."

[141] Continuing the analogy above, contract law should not make it too easy for X to get out of performing inconvenient contractual obligations, since this would be to the detriment -- not only of Y and other promisees -- but also of other promisors and X himself across the totality of his dealings.

[142] See e.g. the discussion in connection with *Re Maxwell Communications Corporation*, above.

unsecured creditors in their debtor's insolvency, are by themselves of little consequence in the debate about the fairness of according priority to secured claims. That the liquidator in most proceedings has little to dole out to certain types of creditor may or may not be regrettable. For an answer, we would have to sift through the totality of dealings amongst all the concerned parties. We might find, as a result, that the existence of priority for secured claims does lead to the exploitation of unsecured creditors, or to other undesirable consequences. But that conclusion is not an *a priori* truth, nor can it be discovered simply by looking at the treatment in insolvency proceedings alone of unsecured creditors.[143]

This discussion serves to provide normative support for Professor Dalhuisen's observation that:

> The equality of creditors is often presented as a justified concern and as an argument against the [priority implications of] the proprietary effects of all kinds of financial schemes... However, this equality... is not truly the basis of the system of creditors' protection or a fundamental legal principle, although endlessly paraded as such. If it were, it would only be honoured in the breach and it distorts the discussion. In my researches of bankruptcy law I have always found that it is equitable, *not* equal, distribution that is the key, and what is equitable in this respect is now mostly a matter of statutory definition in domestic bankruptcy acts.[144]

In the terms adopted here, what matters is real equality of treatment of all the creditors (in other words, that they be treated "equitably"), not formal equality. The next Section asks in what circumstances the *latter* is and should be resorted to.

[143] The following Chapter asks if the existence of security does lead to exploitation.
[144] *Dalhuisen*, p. 661 (original emphasis); see also *Dalhuisen on International Insolvency and Bankruptcy*, 2-17 to 2-19.

6. The role of 'equality'

The argument so far has concentrated on what the *pari passu* principle in particular, and formal equality in general, do *not* do. It would perhaps be useful to add a word here about what in fact their actual role is. Formal equality operates in three types of situations in liquidation, always for the same reason. First, consider the *pari passu* principle itself. Commonly understood as governing the claims of general unsecured creditors, it is submitted that this is not primarily a rule of distribution at all. To the contrary, it is a rule of *non*-distribution. The argument here can be broken down into four steps.

First, certain types of claim are considered 'important', in the sense that they should be met to a significant degree in most insolvencies. To ensure this is the case, they are allotted special priority positions, either by the parties to commercial transactions, or (where the parties cannot be trusted to reach the right result) by Parliament itself. Second, not to provide a particular priority position for a type of claim is to ensure it will receive little or nothing in most insolvencies. Third and following from that, there must still be a *fall-back provision* which covers the treatment of these latter claims. In view of the paucity of value to be distributed to those holding such claims, it is especially important that this fall-back provision be cost-effective. The conclusion is that the *pari passu* principle is the ideal fall-back provision. This is the basic structure of the argument, and it must now be fleshed out.

Note once again that in any formal insolvency proceeding, different claims are treated according to different priority rules, depending both on who holds those claims, and what sort of assets the claims are being applied to. Creditors able to assert set-off rights created and mandated by insolvency law beat all others to the extent of those rights. Assets subject to fixed charges are governed by the appropriate priority rules.[145] The trade creditor with the benefit of an acceptable ROT provision can reclaim the goods supplied. For property subject only to a floating charge, post-liquidation claimants rank ahead of preferential creditors who rank ahead of the floating charge holder, and so on. All these priority rules are thought to have different rationales. For example, insolvency set-off is said to be based on consideration of fairness.[146] The priority of (some) secured creditors arguably stems from strong efficiency considerations and being mutually advantageous to all, would be upheld by parties bargaining in the ACM's choice

[145] For example, in the charge-back situation, consistency demands the party able to assert set-off rights should be given precedence; see Mokal, "Resolving".

position.[147] Post-liquidation creditors are given precedence because they can not be expected to subsidise pre-existing claimants. Preferential creditors are said to be worthy of special treatment because they do not choose their debtor in any meaningful sense, do not negotiate the terms of their loans, and (in the case of employees) might be undiversified.[148] The list goes on. The different priority rules are all complex. It takes time, resources and effort for Parliament on the one hand, and debtors and creditors themselves on the other, to decide what types of claim should rank in what order, with respect to different types of asset.

Of course, however, the state of insolvency is by definition one where the debtor can not fulfil all its obligations. (As already suggested, priority rules are really crucial only against this background of insolvency.) What we would regard as general unsecured claims, then, are those which neither Parliament nor the parties themselves have provided specific rules of distribution for. View this in the context that generally, only secured, post-liquidation and preferential creditors get anything in their debtor's insolvency. There is little or (much more frequently) nothing for those ranking below them. So the interests regarded as more worthy of attention (and therefore arguably more important) by the rule-makers (public and private) are given precedence with respect to particular types of asset, in certain situations, to a specified extent. To decide not to provide for such a priority for a type of claim is in fact to decide not to have it met at all in most insolvencies. And it is this reasoning which provides the crucial insight into the true role of the 'equality' norm. It was suggested above that *pari passu* should not be viewed as a *default* rule. It can not accurately be regarded as the starting position, departures from which must be explained. Instead, it is now submitted, the rule is best seen as a fall-back provision. It is the rule which takes over when it would be pointless to provide any other.

Look at the argument again. Some types of claim are regarded as important, and rules are provided to govern how they should be dealt with in insolvency. But once this is done, nothing (or not much) would be left for distribution to other creditors. Recall that most insolvency proceedings (75% of them or more) yield nothing for general unsecured creditors. And when they do bring some returns, the yields are fairly small (about 7 pence on the pound on average). So there simply is no point in deciding how *these* claims should rank *vis-à-vis* each other. For

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[146] For example, see *ibid*., p. 112 fn. 40 and the accompanying text.
[147] This question is examined in greater detail in the following Chapter.
[148] See above; see also the discussion in Keay and Walton, "Preferential claims", who argue against elevating the Crown and employees to preferential status.

such claims to be governed by the *pari passu* rule makes very good sense, since the costs in terms of time, effort, and resources required to determine *their* appropriate (fair and efficient) rankings would far exceed any benefits. Why waste resources identifying and laying down different priorities, when it is obvious hardly any assets are likely to be distributed according to them? For such a situation, in fact, "equal" treatment is ideal. In most instances, this simply means some types of creditor equally get nothing. In the remaining minority of insolvencies, the tiny amounts available for distribution are all distributed proportionately, rather than being wasted in ascertaining the claimants' correct rankings. The *pari passu* principle applies, then, whenever the costs of providing for different rankings for different claims would exceed the benefits. The claims it governs mostly -- and necessarily -- constitute something approaching a distributively null set; they are held by those who will not receive anything. If they do receive something, it would not be much.

Now for the second application of formal equality in corporate liquidation, which lies in the treatment of the same "type" of claimant. For example, claims of all employees are treated "equally" and given preferential treatment over most other unsecured creditors. It was argued above that employees might be more deserving of protection in their employer's insolvency than other types of creditor, since they are more vulnerable to greater harm in these circumstances. But of course this is not equally true of all employees. It is not obvious that computer engineers, software designers, commercial lawyers, and others with scarce skills are in need of the same protection as unskilled workers. And one Information Technology expert might be much better placed to deal with the insolvency of his employer than another, perhaps because the former is younger and therefore considered more (re-)employable in that young industry.

But it makes sense nevertheless to treat all of them the same, simply because it would be too expensive to require the liquidator to investigate the relative positions of all the claimants in terms of vulnerability to serious detriment. What is more, it would be next to impossible for her to determine whether a particular employee was more vulnerable than others in this insolvency because, for example, he had been less cautious in planning for such a contingency than all the others, or because he had more expensive tastes for consumables like holidays, etc.[149] Most liquidators asked to embark upon such an exercise would necessarily exhaust all available assets

[149] These factors would be relevant for determining the appropriateness of any method of distribution according to any of a number of theories of fairness.

along the way, and no one would get anything. Apart from being inefficient, wastage of this nature does not lead to fairness either.[150] Again, then, 'equality' is resorted to because the costs of employing any more appropriate method of distribution (including one which is fairer in the abstract) would outweigh its benefits.[151]

The third manifestation of formal equality has already been mentioned. Preferential claims are also treated 'equally' *inter se*. It is interesting to note that even here, the reason behind this seems to be exactly the same. Notionally, of course, employees and the Crown are the two types of preferential claimant. But the employees of an insolvent firm, in recognition of their especially vulnerable position, have been accorded rights which -- *in their capacity as creditors* -- make them almost unconcerned about their employer's insolvency. This is because of the provisions of what is now the Employment Rights Act 1996 (ERA). This regime "provides for different and generally more extensive protection for an employee than under the Insolvency Act."[152] Under it, the Secretary of State, through the Redundancy Payment Service, makes payments to employees from the National Insurance Fund. The ERA scheme covers (*inter alia*) up to eight weeks of unpaid wages and salaries, wages during the statutory minimum notice period, up to six weeks of holiday pay, and a basic award for unfair dismissal. These payments are likely to be larger than

[150] For the argument that equal treatment of those unequal in some relevant respect is sometimes warranted because of the difficulty in identifying those who should be treated differently, see Kent Greenwalt, "How empty is the idea of equality?" (1983) 83 Columbia LR 1167, 1173-5. In the US context, Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* ((New Haven: Yale Univ. Press, 1997), has argued, *inter alia*, that bankruptcy judges should distinguish between *individual* creditors in approving distribution schemes for the bankrupt estate (in other words, *ex post* distinctions between individuals, instead of *ex ante* ones between broad categories of creditor, as it currently does both in the US and in this jurisdiction), on the basis of such factors as whether a creditor would use the proceeds to buy a luxury good rather than meet a necessity, whether it had been diligent in making the loan, and whether its current vulnerability to serious harm results from its own profligacy; see e.g. pp. 165-6. It is submitted this proposal is entirely self-defeating for the reasons mentioned in the text here (among others). The costs of making such inquiries about creditors can be expected to be far in excess of the assets available in almost every single insolvency. The one outcome not reasonably to be expected from the implementation of any such proposal is any improvement in the position of unsecured creditors. This and other proposals of Gross' are condemned in strong terms by, among others, James White, "*Failure and Forgiveness*: A review" (1999) 73 American Bankruptcy LJ 435, and Peter Alces, "Book Review: *Failure and Forgiveness: Rebalancing the Bankruptcy System*" (1999) 15 Bankruptcy Developments Journal 383.

[151] The limits on how much of the sums owed to employees rank as preferential debts can be seen as a more cost-effective way of ensuring that only the most vulnerable would truly benefit from the preferences regime; for details of these limits, see Keay and Walton, "Preferential", pp. 91-2, including fn. 54. The law of diminishing returns suggests that the more vulnerable the claimant, the more important it would be for him to receive even a smaller sum, and *vice versa*. The implications of this law seem not to have been noticed by Finch; see "Pari passu", p. 209.

[152] *Ibid*., p. 100.

those given preferential status by the Insolvency Act. For the payments made, the Secretary of State is subrogated to the employees' rights.[153]

Relevant to our discussion is the fact that, "once employees' rights under ERA are factored into the overall picture, [] the Crown, by subrogation, takes over the claims of employees in a very large proportion of cases and is often the sole preferential creditor."[154] Again, then, we have an excellent explanation (though historically perhaps a partial one) for the fact that preferential claims rank equally amongst themselves. Most of these claims are held by the same actor, the Crown. So again it would simply be pointless to provide for different priorities for these claims. Why expend resources differentiating these claims both *ex ante* and *ex post*, when in most cases any such differentiation would merely be notional? It is submitted that this provides further support for the proposition that formal equality in insolvency law (including that enshrined in the *pari passu* rule) is resorted to only when the costs of providing otherwise would outweigh the benefits. It is for this reason that the *pari passu* principle is best regarded as a fall-back provision. It is submitted that it plays no other role in insolvency distributions.[155]

Finally, note that even if analytically accurate, this claim is incomplete from a historical perspective. To plug this gap, here is one hypothesis. The search costs for ascertaining optimum rankings for different types of claim depend either on the availability of a theory of finance, or on a process of trial-error-adjustment by the parties themselves.[156] When the former method is unavailable or underdeveloped, the time component of search costs (incurred during trial-error-adjustment) is high. So initially, only the more obvious methods of distribution (e.g. *pari passu*), and of bargaining for priority (e.g. rudimentary forms of security), which have therefore been developed earlier and employed for longer, would be cost-effective. So after 1543, when statute first provided for claims against bankrupts to be paid in "a portion rate and rate like, according to the quantity of their debt",[157] this initially might in fact have been a rule of almost universal

[153] For an account, see *ibid*., which this paragraph draws on.
[154] *Ibid*.
[155] For suggestions which seem vaguely similar to the discussion here, see Finch and Worthington, "*Pari passu*", pp. 1 and 3; Finch, "Pari passu", 208-9, acknowledges a type of waste-prevention role for the 'equality' principle, but seems to regard this as only one of its many virtues; see e.g. p. 194.
[156] On search costs, see the seminal article by G. Stigler, "The economics of information" (1961) 69 J. Political Economy 213.
[157] See generally V. Markham Lester, *Victorian Insolvency: Bankruptcy Imprisonment for Debt, and Company Winding-Up in Nineteenth-Century England* (Clarendon, Oxford, 1995), Ch. 1.

application, perhaps only secured and Crown claims being exempt.[158] Again, this would have been so not because Parliament and the parties themselves at that time were fairer than they are now, but simply because no better method of distribution had then been discovered (i.e. none was cost-effective). But as better (fairer and more efficient) methods were discovered both through trial-error-adjustment and the development of theories of finance, *pari passu* would quickly be relegated to a mere fall-back provision even as applied to unsecured claims.

This hypothesis predicts that unless all creditors in real life are *truly* equal in all relevant respects, there would always be an increasing tendency for a fair and efficient insolvency law system to develop different priorities for different types of claim, to the full extent of all the assets generally available in liquidation. This then implies that attempts to 'equalise' distributions to creditors who are different in relevant respects are misguided, since they impede the development of a fairer and more efficient system.

7. The removal of tax claims preferences

The analysis in the previous Section allows us to examine the Government's recent proposal to remove the preferential status enjoyed by certain tax claims (discussed above).[159] The proposal is conceived as "an important and integral part" of a package of reforms to corporate insolvency law, which also includes the abolition of administrative receivership and changes to the administration procedure to make it more "streamlined", and thus the successor to receivership.[160] The White Paper suggests that in insolvencies where there is a floating charge, a certain proportion of the funds generated by assets subject to it would be "ringfenced" to ensure the benefit of the proposed change goes to unsecured creditors rather than to the charge-holder.[161] The Government predicts that the removal of tax claim preferences will bring "major benefits to trade and other unsecured creditors, including small businesses".[162] Importantly, however, the "preferential status of certain claims by employees in insolvency proceedings... within certain limits [also discussed above] will remain, as will the rights of those subrogated to them".[163] It

[158] See e.g. *The Case of the Bankrupts* (1584) 2 Co. Rep. 25a; 76 ER 441, 463-472. Note though that this decision seems partly to be based on the need to prevent a wrongly preferred creditor (and the debtor himself) being able to secure immunity from the collective bankruptcy regime; see pp. 473-4: it would be "a great defect in the law, if, after [] he hath utterly discredited himself by becoming a bankrupt, the law should credit him to make distribution of his goods to whom he pleased, being a bankrupt man, and of no credit; but the law... hath appointed certain commissioners, of indifferency and credit, to make the distribution of his goods to every one of his creditors, rate and rate alike..."

will be argued in this Section that the proposal to remove the preferential status of tax claims is unlikely (at least directly) to bring any significant benefit to unsecured creditors, and thus may not fulfil its stated objective. In addition, the proposal is incoherent.

In order to evaluate the proposal, we should begin by trying to estimate the quantum of the additional benefits to unsecured creditors which can be expected to result from its implementation. Even a very rough estimate requires a lengthy calculation, and because of the imprecision of the data available, the estimate here will indeed be rough. But it will soon become apparent that this does not matter to the point being made here. Unless otherwise stated, any doubts in the figures are resolved so as to maximise the expected additional benefit to unsecured creditors from the proposed change.

At the moment, total liabilities of companies that undergo a formal insolvency procedure during a year are estimated to be about £42b.[164] Of this, about 35% is owed to banks.[165] Let us suppose that 80% of bank debt is secured by the company's assets.[166] So *secured* creditors are owed, roughly, 28% of the total outstanding debt. *Preferential* creditors get back about 30% of what they are owed.[167] The amount actually paid out as dividends in right of tax claims preferences is around £100m.[168] So preferential tax claims themselves amount to some £333m. The amount owed in right of employee preferences is an estimated £200m.[169] Altogether, then, preferential debts constitute about 1.3% of the total debts owed by insolvent companies. It

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[159] See the White Paper, *Insolvency - A Second Chance* (The Stationary Office, 31 July 2001).
[160] *Ibid*., The Rt. Hon. Patricia Hewitt MP, "Foreword", and "Corporate Insolvency Proposals", paras. 2.19, 2.2-2.6, 2.18, and 2.7-2.17.
[161] *Ibid*., para. 2.19.
[162] *Ibid*., "Foreword".
[163] *Ibid*., para. 2.20.
[164] ABRP, *Survey*, p. 11.
[165] This comes from the calculation that for the Franks-Sussman sample, banks were owed about 40% of total outstanding liabilities when firms entered the 'central rescue unit' (see *Cycle*, p. 8), and for that sub-set which eventually ended up in the 'debt recovery unit' and hence in a formal proceeding, 12% of that debt was paid off while the firm was in the 'rescue unit' (*Cycle*, p. 11).
[166] *Ibid*., p. 13, Table 8, gives the value of collateral as a percentage of bank debt; the figure in the text is an estimated composite.
[167] Again, this is a composite figure derived from Franks-Sussman, *Cycle*, p. 3, and ABRP, *Survey*, p. 18.
[168] *Second Chance*, Annex D, para. 4.15. This figure is probably over-inclusive, in line with the practice here of resolving doubts in favour of maximising expected additional benefits to unsecured creditors.
[169] The figure in the text has been increased to take into account the age of the data currently available, and might be an overestimate; see the National Audit Office Press Notice, "The Department of Trade and Industry Redundancy Payments Service: Management and Recovery of Debt" (17 October 1996); available at URL: www.nao.gov.uk/pn/9596695.htm (which mentions a figure of £177m); see also Keay and Walton, "Preferential", p. 100, including fn. 131.

follows that *unsecured* creditors are owed about 70.7% of the total outstanding debt of companies in insolvency proceedings. This amounts to around £29.69b. They get an average of 7 pence on the pound,[170] or about £2.1b (£2100m) today.

Now the Government estimates that the removal of tax claims preferences would bring "up to" £100m more for unsecured creditors.[171] So after the removal of preferential status for tax claims, unsecured creditors will get £2200m.[172] In other words, their recoveries would go up to 7.4% once the proposal in implemented. This is of course an increase of less than one-half of one penny over what they currently get! And that does not take into account that all tax claims would then also rank alongside other unsecured claims.[173]

It should be obvious, then, that even if these calculations are wide of the mark (so that the actual increase will be twice, thrice, or even five times this much), the average recovery rates for unsecured creditors in an overwhelming majority of formal insolvency proceedings are unlikely to go up to the extent that such creditors would be appreciably better off. The Government's claim that this "important and integral" part of its reform package will bring "major benefits" to them therefore seems somewhat implausible.[174] In addition, and in line with the analysis in the previous Sections, it should be noted that it makes very obvious sense to subject to the *pari passu* rule the tiny additional sums which will become available in many formal insolvency proceedings because of the proposed change. For these additional sums, it would be entirely

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[170] ABRP, *Survy*, p. 18.

[171] *Second Chance*, Annex D, para. 4.15. Again, note the possible over-inclusivity of this figure.

[172] These calculations are subject to the assumption that in deciding on the proportion of floating charge assets to be 'ringfenced' for unsecured creditors, the Government will be true to its word that their proposed changes would not adversely affect the interests of secured creditors; *Second Chance*, para 2.6.

[173] Also ignored is the fact that the abolition of receivership would remove the costs of receiver "opportunism"; see Franks and Sussman, "Resolving financial distress by way of a contract: An empirical study of small UK companies" (22 October, 2000), p. 18; the paper is available at URL: www.ifk-cfs.de/papers/franks.pdf. However, these costs are relatively quite small, since they only arise in administrative receiverships, and then only in a proportion of those cases where the receiver's appointor is not fully paid. Their elimination is unlikely to make any noticeable difference to the result.

[174] Note however that some commentators, notably, A. Keay and P. Walton, "Preferential debts: An empirical study" [1999] Insolvency LJ 112, have argued that the removal of Crown preferences might bring other, more indirect, benefits, including savings on costs currently incurred on resolving and paying out preferential claims and greater chances of a troubled company's being rescued; see pp. 114-5 and 116. No position is taken here on such arguments (which might well have been implicitly accepted by the Government), except to point out that they would have to answer the same queries made about the direct benefits of the removal of tax claims preferences, *viz.*, whether the expected value of these indirect benefits would be sufficiently large to make unsecured creditors feel better off in a significant number of (potential) insolvencies.

wasteful to attempt to think up some other set of priorities. The costs of doing that would be quite unjustified in view of the size of the expected benefits.

So much for the suggestion that the proposal is likely to be inefficacious. To understand why it is incoherent, we should recall that because of the rights of employee-creditors of insolvent companies under the ERA, the claims apparently held by them and given preferential status, are mostly vested in the Crown by way of subrogation. So preferential tax claims and preferential 'employee' claims are in most cases held by the same actor. Nor does this fact go unnoticed in the White Paper. As already mentioned, the Paper not only states that certain employee claims will retain their preferential status, but also explicitly includes within this reservation "the rights of those subrogated to them",[175] or in other words, of the Crown itself. Now the supposed rationale for removing the preferential status of tax claims is presumably the well-rehearsed one that the Crown is better able to absorb the loss of not being paid by some of its debtors, than are some other categories of creditor, for example, weak trade creditors.[176] But if this is accepted, it surely follows that 'employee' claims, also generally held by the Crown, should lose their preferential status for exactly the same reason. Employees might deserve greater protection in their employer's insolvency than other types of claimant, but if they have already been reimbursed from the National Insurance Fund, then the competition is no longer between them and other unsecured creditors, but between the latter and the Crown. So there seems little sense in suggesting reform to only one category of preferential claims, when the reason why that reform is considered desirable is equally a reason to change the other category as well. This is especially relevant given that the stated aim of improving the prospects of unsecured creditors is expected to be fulfilled to a negligible degree in any case.[177]

At the very least, the Government bears the burden of showing what makes preferential tax claims different from most preferential 'employee' claims. One way in which it might attempt to do so would be to provide better data than is currently available, and thus rebut the premise of this argument, that the Crown holds, by subrogation, most preferential 'employee' claims. But even then, the obvious solution would be to adopt the approach enshrined in the US Bankruptcy Code, which provides that an entity subrogated to the rights of, *inter alia*, the employee-creditors

[175] *Second Chance*, "Corporate Insolvency Proposals", para. 2.20.
[176] This is implied in the "Foreword" to the White Paper; in any case, no other rationale is suggested there.
[177] It should be noted the point being made here merely addresses the coherence of the proposal, not its overall desirability.

of a bankrupt company, is not entitled to enjoy the statutory preferential status provided to some of their claims.[178] This would ensure that the preferential status of 'employee' debts was retained only to the extent that employees themselves would benefit from it. Unless the Government explains why this is unacceptable, it seems difficult to avoid the conclusion that its proposal is based on an arbitrary and thus unjustifiable distinction.

8. Conclusion

Some years ago, Bridge concluded his brief review of the clash between *pari passu* distribution on the one hand, and the freedom of contract which allows parties to grant and take security on the other, by framing the issue thus:

> Is the *pari passu* principle so strong that the burden of proving efficiency rests upon those who support secured credit, or is freedom of contract paramount so that the burden falls upon those who oppose security?[179]

Even without invoking freedom of contract,[180] here (it is submitted) is the answer. The first premise of those attacking the priority accorded to secured claims -- that unequal treatment of claims is anomalous, somehow a deviation from the "strong" 'equality' norm -- is quite false. If anything, it is the *pari passu* principle which constitutes an isolated enclave of 'equality' in a (formally) unequal insolvency world. In that real world, its status -- considered as a rule governing distribution of assets -- hovers somewhere between falsehood and tautology. So with respect, assertions that this principle is all-pervasive in the liquidation regime, that it underlies some of the best-known adjustment provisions of that regime, or that it provides the only alternative to an undesirable free-for-all, all stand rebutted as based on a fallacy. They must all be abandoned. So must the argument that the *pari passu* principle is necessary to ensure fairness in liquidation.

It is submitted that it is the critics of differing priorities for different types of claim, including those attacking the full priority of secured claims, who must now be on the defensive, at least on these grounds. The general rule in insolvency law, its deeply-embedded norm, seems to be that the assets available in insolvent estates are to be distributed 'unequally', unless attempting to do so would be wasteful because pointless. It might be that the different priorities

[178] Section 507(d). Many thanks to Look Ho for drawing attention to this.
[179] Bridge, "*Quistclose*", p. 342.

afforded to different types of claimant are sometimes arbitrary. It might be that this area of the law could do with extensive re-thinking and rationalisation. Even then, it would not follow that what should replace the current system is one which crudely equalises all creditors in their debtor's insolvency. Formal equality of that sort is not the natural alternative. It will not win by default. Not only is it rare and unnecessary in the real world, it is also useless as an ideal. So it must be argued for as much as any other system of priorities -- whether the one we now have, or any proposed as a replacement for the present one -- and it would be at least as contentious as any of them. Those arguing for (a more) "equal" treatment of all claims must therefore bear the heavy burden of showing why moves towards formal equality are desirable.

[180] Since Parliament itself (and not just the parties in commercial transactions) has reduced *pari passu* to the sham that it is.

Chapter V: The Priority of Secured Credit -- A Defence

1. Introduction

It is especially when the debtor is on the brink of or actually in insolvency that the existence of security assumes the greatest significance. From the perspective of English (corporate) insolvency law, a way of distinguishing secured from unsecured creditors might be drawn out from the discussion in previous Chapters. Secured creditors of a debtor subject to that part of the law are treated differently from its unsecured creditors in two ways. First, the secured creditor generally stands at the head of the queue for recoupment, from the proceeds of sale of the collateral, of what it is owed. It has *priority* over other creditors. So for example, the holders of properly perfected fixed charges are entitled to be paid out from the proceeds of sale of the collateral before anyone else gets anything. As for creditors holding floating charges, their claim to be paid out of the proceeds of the charged assets is postponed to the expenses of the winding-up and the claims of statutory preferential creditors, but "only to the extent that the free assets of the [debtor] are insufficient for payment of the [expenses of the winding-up and the] preferential debts."[1] And second, *un*secured creditors lose their ability independently to pursue their claims, and a special collective insolvency regime takes over.[2] However, secured claimants have *immunity* from having to participate in this regime, and might for example seize and sell the collateral for the satisfaction of their debt. Here once again is the much-quoted dictum of James LJ:

> [The insolvency rules which deprive unsecured creditors of the ability independently to proceed against their debtor] were intended, not for the purpose of harassing, or impeding, or injuring third persons, but for the purpose of preserving the limited assets of the company... in the best way for distribution among all persons who have claims upon them... But that has really nothing to do with the case of the man who for present purposes is to be considered as entirely outside the company, who is merely seeking to enforce a

[1] See Insolvency Act 1986 (hereafter, "IA"), s. 40(2) and (3) (administrative receivership) and s. 175 (liquidation). Schedule 6 of the Act lists the categories of preferential debt. In a recent White Paper called *Insolvency - A Second Chance* (The Stationary Office, 31 July 2001), the Government proposes to remove from most of those secured creditors who can appoint administrative receivers the right to do so, as well as the right to block the appointment of an administrator. The quotation in the text here is from R. Goode, *Principles of Corporate Insolvency Law* (London, Sweet & Maxwell, 1997), pp. 169-70, including fn. 22.

[2] For an analysis of the collectivity of the liquidation system, see Ch. III, above.

claim, not against the company, but to his own property... Why a mortgagee should be prevented from doing that I cannot understand.[3]

The aim of this Chapter is to examine the priority accorded to secured creditors in corporate insolvency, and to ask if it has any consequences which would make it unacceptable to all the relevant parties treated as equals. Issues peculiar to 'functional' or 'quasi-' security devices (e.g. retention of title clauses or *Quistclose* trusts) are excluded except insofar as these are relevant to the debate about the priority of secured loan finance.[4] Also excluded are matters concerned with the immunity of secured creditors, which, as discussed in Chapters III and IV above, are generally quite distinct.

The advantages accorded to the secured creditor have not gone unnoticed. There has always been some feeling -- at least among some academic commentators -- that the balance is tilted too far in favour of those holding security.[5] The Report of the Insolvency Law Review Committee proposed certain restrictions on the secured creditors' ability to enforce their security.[6] Famously, it suggested that 10% of the value of the assets subject to a floating charge be set aside in a company's insolvency for distribution to unsecured creditors.[7] The ability of secured creditors to appoint a receiver to manage assets subject to their security was also considered, and the Committee proposed a suspension of the security holder's right to enforce that security for twelve months, should a receiver or administrator be appointed.[8] Neither of these proposals was reflected in the Insolvency Act 1986, enacted in response to the Cork Report.

In the United States, the late 1970's saw the emergence of a debate on the desirability of the priority of secured claims, and on whether and how this should be affected by the onset of the

[3] *Re David Lloyd & Co.* (1877) 6 Ch D 339, 344-5. Note the restrictions on this immunity (irrelevant here) imposed by IA, s. 11(3)(c) and (d): during the time that an administration order is in force, no steps may be taken to enforce any security over the debtor's property.
[4] In the terms adopted by Jan H. Dalhuisen, *Dalhuisen on International Commercial, Financial and Trade Law* (Oxford, Hart, 2000), 626, the discussion will relate to arrangements commonly associated with "loan agreements", and not those associated with "late payment agreements".
[5] See generally, Roy Goode, "The death of insolvency law" (1980) 1 Company Law 123 and "Is the law too favourable to secured creditors?" (1983-4) 8 Canadian Business LJ 53.
[6] *Insolvency Law and Practice* (Cmnd. 8558, 1982), hereafter, "the Cork Report".
[7] *Ibid.*, para 1538 *et seq*.
[8] *Ibid.*, paras 1506-7. The chargee would have had the right to apply to court if the suspension of enforcement rights would prejudice him.

debtor's bankruptcy. The literature is now voluminous.[9] Commentators in this jurisdiction have taken note.[10] A perusal of most recent scholarship here suggests the pendulum has swung from one extreme to the other. In a regime marked by such a tolerant attitude towards the taking of security and its enforcement, security in its present form is now often condemned as unfair and inefficient. Various proposals to rein in the secured creditor are receiving attention.[11] This Chapter will argue that the academic pendulum has swung too far.

The Chapter identifies the main lines of attack on the institution of secured credit, and attempts a defence based on empirical and theoretical (and to a lesser extent, doctrinal) grounds.[12] Some critics of security have argued that it exists mainly to take value away from certain types of unsecured creditor. In particular, debate has centred on the position of various

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[9] The following list lays no claim to completeness. In particular, no attempt is made to include the literature on this subject in the Finance and Economics journals. Thomas Jackson and Anthony Kronman, "Secured financing and priorities among creditors" (1979) 88 Yale LJ 1143; Alan Schwartz, "Security interests and bankruptcy priorities" (1981) 10 J of Legal Studies 1; Saul Levmore, "Monitors and freeriders in commercial and corporate settings" (1982) 92 Yale LJ 49; James White, "Efficiency justifications for personal property security" (1984) 37 Vand LR 473; Schwartz, "The continuing puzzle of secured debt" (1984) 37 Vand LR 1051; F. Buckley, "The bankruptcy priority puzzle" (1986) 72 Virginia LR 1393; Robert Scott, "A relational theory of secured financing" (1986) 86 Columbia LR 901; Schwartz, "A theory of loan priorities" (1989) 18 J of Legal Studies 209; Paul Schupack, "Solving the puzzle of secured transactions" (1989) 41 Rutgers LR 1067; James Bowers, "Whither what hits the fan?: Murphy's Law, bankruptcy theory, and the elementary economics of loss distribution" (1991) 26 Georgia LR 27; Jochen Drukarczyk, "Secured debt, bankruptcy, and the creditors' bargain model" (1991) 11 Int Rev Law and Economics 203; Randal Picker, "Security interests, misbehavior, and common pools" (1992) 59 Chicago LR 645; George Triantis, "Secured debt under conditions of imperfect information" (1992) 21 J of Legal Studies 225; Barry Adler, "An equity-agency solution to the bankruptcy-priority puzzle" (1993) 22 J of Legal Studies 73; Richard Barnes, "The efficiency justification for secured transactions" (1993) 42 Kansas LR 13; the articles on this subject in (1994) 80 Virginia LR, and in particular, Lynn LoPucki, "The unsecured creditor's bargain" (1994) 80 Virginia LR 1887; J. Hudson, "The case against secured lending" (1995) 15 Int Rev of Law and Economics 47; Lucian Bebchuk and Jesse Fried, "The uneasy case for the priority of secured claims in bankruptcy" (1996) 105 Yale LJ 857; Ronald Mann, "Explaining the pattern of secured credit" (1997) 110 Harvard LR 625; the Symposium on this subject in (1997) 82 Cornell LR 1279-1567; Steven Schwarcz, "The easy case for the priority of secured claims in bankruptcy" (1997) 47 Duke LJ 425; Ponoroff and Kinppenberg, "The immovable object versus the irresistible force: rethinking the relationship between secured credit and bankruptcy policy" (1997) 95 Michigan LR 2234; William Nacy, "Survival underwater: wholly-unsecured security interests in bankruptcy" (2000) 40 Washburn LJ 87; G. Triantis, "Financial slack policy and the law of secured transactions" (2000) 20 J. Legal Studies 35.

[10] See in particular the important papers by Alison Clarke, "Security interests as property: Re-locating security interests within the property framework", in Harris (ed.), *Property Problems from Genes to Pension Funds* (London, Kluwer, 1997), the valuable and comprehensive piece by Venessa Finch, "Security, insolvency and risk: who pays the price?" (1999) 62 MLR 633, and the monograph by David Milman and David Mond, *Security and Corporate Rescue* (Manchester, Hodgsons, 1999). See also A. Diamond, *A Review of Security Interests in Property* (London, HMSO, 1989), and J. Armour, "Secured credit: A theoretical review" (Cambridge, unpublished, 1999).

[11] See e.g. Hudson, "Case", pp. 57-61, and Finch, "Security", pp. 651-660.

sorts of 'involuntary' or 'reluctant' creditors. It has also been argued that some 'unsophisticated' or 'uninformed' creditors are unable to price their loans properly, which allows them to be exploited, through the use of security, by coalitions of debtors and better-informed creditors. Such arguments are of course crucial to the project of this thesis: parties which have been exploited have not been treated as equals. So if these arguments are proved, then consistent with the premises laid out in Chapters I and III, above, they must lead us to condemn the priority of secured credit as unjustifiable.

Related but distinct are attacks on the inefficiency that this priority supposedly creates. These are also founded on identifying various types of 'non-adjusting' creditor – involuntary, small-claim holders, tax authorities, those who lend before secured credit is issued, etc. Critics argue that secured credit will sometimes be issued, not because it is socially value-maximising, but simply because it allows debtors and some creditors to drain away bankruptcy value from non-adjusting creditors. This is said to lead to various types of inefficiency. Most of this work seems to assume that efficiency is a substantive goal of the law, which is inconsistent with the position taken here.[13] However, it is possible to read the leading attacks on the efficiency of security as suggesting that its priority creates unnecessary motivation costs harmful to all the parties as a group.[14] On this view, to the extent that priority creates those costs, it could not be regarded as part of a rational scheme of fair co-operation amongst equals.

This Chapter examines both these lines of attack, and finds them wanting. Instead, it reaches the conclusion that the existence of the priority of secured credit, by increasing the liquidity of the debtor, is mutually value-enhancing for all those interested in the company's undertaking, and would thus be acceptable to all the relevant parties bargaining within the framework of the ACM.

2. The **pari passu** *myth again*

First, however, the ground must be cleared for debate to be joined on the issues of substance. It is submitted that discussions about the priority of security are too often premised on a fundamental

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[12] Unless indicated otherwise by the context, all empirical evidence employed here comes from this jurisdiction.
[13] See Ch. I.7, above.

error about the structure of insolvency law. This error has already been identified in the previous Chapter. It is submitted that the mythology surrounding the *pari passu*(or *par conditio creditorum*) principle has been a particularly fruitful source of confusion. As already noted, challenges to the different priorities accorded to different types of claim in a company's insolvency, including those to the priority of secured credit, often begin by stressing the universality and importance of the *pari passu* principle.[15] The 'equality' norm is said to be responsible for ensuring an orderly and fair liquidation, so any 'deviations' from it must stand in need of special justification.

These issues have received detailed consideration in Chapter IV, above, but a summary of the conclusions might be helpful at this point. It has been suggested the *pari passu* principle does not constitute an accurate description of how the assets of insolvent companies are in fact distributed, has no role to play in ensuring an orderly winding up of such companies, does not explain or justify distinctive features of the formal insolvency regime, and has little to do with fairness in liquidation. The actual role of the principle, it was argued, is merely to provide a low-cost method for dealing with those types of claim which both Parliament and commercial parties themselves have decided should receive little or nothing in most insolvencies. The principle, long regarded as the core distributional principle in corporate liquidation, is more properly understood as a principle of *non*-distribution.

The reader would of course make up their own mind about whether these arguments succeed. To the extent that they do, the initial onus of justifying their position shifts from those arguing in favour of the priority of secured credit, to those who support a more 'equal' distribution of the insolvent's estate. The attacks on security discussed below can be regarded as attempts to discharge that burden, and the following Sections consider whether they are successful. It should not be forgotten, however, that *supporters* of the priority of secured credit also have the burden of showing why that priority is fair and efficient. This is the subject of the penultimate Section of this Chapter.

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[14] See e.g. the discussion of the alleged effect of the priority of security on the incentives of some creditors to monitor their debtor, in Section 5, below.

[15] See e.g. Finch, "Security", p. 634 (footnotes omitted); Bridge, "The *Quistclose* Trust in a world of secured transactions" (1992) 12 OJLS 333, 340; Cranston, *Principles of Banking Law* (Oxford, Clarendon, 1997), p. 436; Keay and Walton, "The preferential debts regime in liquidation law: in the public interest?" [1999] CfiLR 84, 85, etc. For the repeated deployment of a slightly different version of the same strategy,

3. Tort creditors and the Exploitation Hypothesis

Here is the basic insight on which the attacks on the priority of secured credit are based.[16] Consider the world of Debtor, who wishes to borrow from various Creditors. Creditors all start off being equal in every respect (including their share of the Debtor's estate if the latter becomes insolvent). In this world, all Creditors are aware of Debtor's dealings with all other Creditors, and each writes their loan contract with Debtor on the basis of, and relying on, this information. Now if one Creditor (called Bank) demands a security interest and the Debtor complies, all remaining Creditors realise they would have less distributed to them, should Debtor fail (what would have been available for distribution *pari passu* will first go towards satisfying Bank's debt). But other Creditors are not harmed. They simply raise the interest rates they charge Debtor to compensate for the loss of insolvency value. At its worst in this imagined world, security is absolutely harmless.

The assumptions just made are of course unrealistic, and this is what critics of security seize on. That not all creditors would be perfectly informed of their debtor's behaviour, and separately, that not all of them would be able to modify their dealings with the debtor to compensate for the loss in insolvency value, is the basis for almost all the attacks on secured credit. In the real world, critics argue, secured credit can be used to siphon away insolvency value from certain types of unsecured creditor, to the debtor and secured creditors. The argument comes in two varieties, which will be called the *Exploitation* and the *Inefficiency Hypotheses*. This Section, and the next, deal with the first of these. In answering the question why parties sometimes agree to security arrangements, Lynn LoPucki has presented a "promising malignant explanation[] for the existence of secured debt".[17] He argues that "the deceptive nature of security enables secured creditors and debtors to extract a subsidy from those who involuntarily become unsecured creditors."[18] A similar subsidy is said to be extracted from "relatively uninformed unsecured creditors who predictably miscalculate their likelihoods of recovery."[19]

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see Bebchuk and Fried, "Uneasy case", pp. 868-9, 870, 871, 872, etc.; see also Bebchuk and Fried, "Further thoughts", pp. 1285-7.

[16] See e.g. Bebchuk-Fried, "Uneasy case", pp. 881-2, and Hudson, "Case", p. 48.

[17] LoPucki, "Unsecured", p. 1895.

[18] *Ibid*., p. 1891.

[19] *Ibid*. This is the subject of the next Section.

"The ability to victimize [such] creditors", claims LoPucki, "may in significant part explain why secured credit is such a widespread phenomenon."[20]

a. Secured credit and large firms

It would be useful to begin with an examination of the facts on which these arguments are based, and of their assumptions. It is important also to keep in mind these arguments were originally made in the US context. The same concerns have been voiced recently in this jurisdiction, notably by Finch.[21] So we might wish to consider whether the differences between the two legal systems have an impact on the transferability of the arguments.

Let us start by identifying the categories of creditor supposedly "exploited" through the use of security. LoPucki mentions eight such categories, whom he classifies as "involuntary" or "reluctant".[22] Without wishing to construct watertight categories, perhaps five could be regarded as "tort" creditors, widely construed. These include product liability claimants, victims of business torts ("ranging from negligence to intentional interference with contractual relations"), victims of antitrust violations, unfair competition, patent, trademark and copyright infringement, environmental agencies which perform clean-ups, and creditors who acquire that status because of the debtor's fraud. The remaining categories consist of taxing authorities and certain other government agencies, and utility companies. These are all to be considered "involuntary", argues LoPucki, since they are "not in the business of extending credit and [do] not seek credit relationships."[23]

LoPucki claims that "Any debtor who either has, or expects in the future to have, involuntary unsecured creditors will find economic advantage in 'selling' secured status to its voluntary creditors."[24] He explains that to the extent that the debtor's capital structure consists of equity, its shareholders are exposed to liability. Claims against the firm by involuntary creditors

[20] *Ibid.*, p. 1897 (footnote omitted).
[21] In "Security".
[22] *Ibid.*, pp. 1896-7; the latter term comes from Teresa Sullivan, Elizabeth Warren, and Jay Westbrook, *As We Forgive Our Debtors* (New York, OUP, 1989).
[23] LoPucki, "Unsecured", pp. 1896-7 (footnote omitted). That the use of "involuntary" in the sense just mentioned is questionable as applied to some of these categories has been noted by LoPucki himself; see e.g. *ibid.*, p 1897, fn. 42: "Government and its agencies arguably do not belong on this list", but concluding nonetheless that they do.
[24] *Ibid.*, p. 1898.

would be met out of the firm's assets. This reduces the firm's value and therefore directly hurts shareholders, the only other claimants to those assets. The existence of *debt* in the firm's capital structure reduces shareholders' "real exposure" to that liability. "Real exposure" is that part of its tort liability that the debtor is forced to pay, rather than being able to defeat through declaring bankruptcy. So once debt has been issued, some of the firm's value comes from creditors, and some of the involuntary claims would be met from that value. This line of reasoning indicates that the *shareholders'* real exposure to tort liability is "almost eliminated" once all of the tort-feasor's assets, including its future stream of income, have been fully encumbered. Should involuntary claims now arise, and should shareholders wish the firm to avoid having to repay them, the firm can declare insolvency and shareholders can walk away without further liability to anyone.[25]

The simple example used by LoPucki illustrates nicely how the argument is supposed to work.[26] D has assets of $100 and owes C a debt of $100. D's activities then tortiously cause T an injury of $100, without thereby gaining D anything in return. D is subsequently liquidated with $100 of assets and $200 of debt. If C is unsecured, both it and T will receive $50 each. If C is secured, it receives everything, and T gets nothing. So D obviously has an incentive before the liquidation (for businesses *expected* to inflict such injuries, perhaps well before it) to offer C security. This is because C in return will offer a decrease in its interest charges to reflect the reduced risk of being left with less than full payment in D's insolvency. Tort victim T, being an involuntary creditor, cannot of course raise its interest rates to compensate. So D pockets the difference. This subsidy, caused by the "externalization of tort risk" onto T, creates incentives for firms to undertake more risk-laden projects.[27] This will happen not because those projects are socially efficient, but simply because some of their costs are shifted onto involuntary third parties while the benefits go only to the tort-feasor's shareholders.

It seems clear the "involuntary" creditors who really concern LoPucki are tort victims.[28] The example reproduced above, and the supporting literature he refers to,[29] as well as most of his

[25] *Ibid*., pp. 1898-9, including fn. 48.
[26] *Ibid*., p. 1898.
[27] *Ibid*., quoting David Leebron, "Limited liability, tort victims, and creditors" (1991) Columbia LR 1565, 1648.
[28] This point has been noted before; see Susan Block-Lieb, "The unsecured creditor's bargain: A reply" (1994) 80 Virginia LR 1989, 1993, and Steve Knippenberg, "The unsecured creditor's bargain: An essay in reply, reprisal, or support?" (1994) 80 Virginia LR 1967, 1969-70 fn. 13.

discussion, all are concerned overwhelmingly with tort liability. Further, the main thrust of his argument is that security allows additional 'risk' (meaning here the potential to cause tortious harm) to be created and externalised. This would generally describe the undertaking of riskier projects which would not otherwise have been undertaken, or projects which -- in the absence of secured creditors' priority over "involuntary" ones -- would have been executed in a less risky way, i.e. by employing more (costly) precautions. "Involuntary" liabilities which arise regardless of the riskiness of the company's activities, e.g. utility bills and taxes, would not in most cases be covered by this line of argument. For this reason, the treatment here of the Exploitation Hypothesis focuses on tort creditors (construed broadly, as above).[30]

How, then, should LoPucki's argument be evaluated? The charge is of course a serious one: that some (perhaps most) debtors who issue security do so in order to profit from inflicting uncompensated harm on others. To put into context the magnitude of this assertion, in the US, domestic borrowers alone are estimated to have about two trillion dollars of secured debt.[31] Finch, who (as mentioned) has deployed LoPucki's argument in relation to secured credit in England and regards it as part of "the core objection to the provision of security",[32] asserts that "Security taking is the norm in relation to most borrowings".[33] So English debtors too must be "victimizing" tort creditors on a massive scale.[34] Keeping in mind the gravity of this objection to security, we should perhaps begin by asking what evidence is presented in its support.

Citing US research which is supposed to have found twenty-three percent of the unsecured debt of consumer bankrupts to be owed to "reluctant" creditors,[35] LoPucki "speculate[s] that money owed to reluctant creditors constitutes an even larger portion of the debt of financially distressed companies."[36] In support, he states that in a study of "the 43 largest reorganizations of the 1980s" (hereafter, the LoPucki-Whitford study), it was found that for two of the companies

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[29] Apart from Leebron's article, see also the literature mentioned in "Unsecured", fns. 36, 47, 51, 54, 57, 58, 62, 65, 70, 81, 82, 88, etc.
[30] The rest are considered in Section 5, below.
[31] Mann, "Explaining", p 627, including fn. 1.
[32] Reading what here has been called the Exploitation Hypothesis together with the Inefficiency one; see e.g. "Security", p. 644 (first paragraph), p. 645 (bottom of the page, running over to p. 646), etc.
[33] "Security", p. 634.
[34] *Ibid*., p. 646 (first full paragraph), arguing that security leads to excessive risk-taking, the costs of which are then externalised onto unsecured creditors. However, it is not clear whether the reference to "risk" here indicates a higher probability of insolvency, or a greater potential to inflict tortious harm.
[35] Sullivan *et al*, *Forgive*, p. 294. The formula "supposed to have" is used since no position is taken here on whether such creditors are properly regarded as "reluctant".

studied, more than two-thirds of the unsecured debt was “involuntary”. These were Johns-Manville Corporation, “with well in excess of $2 billion in asbestos personal injury claims alone”, and Smith International, which had “a $205 million judgment against it for patent infringement.”[37] Further, in “at least 7 more of [the] 43 companies, management had fraudulently concealed the financial problems of the company in the period before bankruptcy, casting doubt on whether any of their unsecured creditors should be considered to have consented to the status they were given”. So overall and importantly, “in nearly a third of the cases [] studied, substantial portions of the unsecured debt were held by creditors who had not meaningfully agreed to their status as such.”[38]

It would not be unfair to say this demonstration that corporate debtors engaged in formal bankruptcy proceedings have substantial “involuntary” unsecured liabilities has entered the mythology of those supporting restrictions on secured credit. Apart from LoPucki himself, it is cited by Bebchuk and Fried (hereafter, ‘Bebchuk-Fried’) as part of their attack on security.[39] Finch cites it no less than five times.[40] Even those who are generally supportive of the priority of secured credit have been known to refer to it as indicating the possible malignant effects of security.[41] No other evidence seems to be available to show that (especially in this jurisdiction) there are significant tort claims against companies in financial distress. As it is, the LoPucki-Whitford study has been used to back up all manner of proposals to cut down on the rights of secured creditors on both sides of the Atlantic.[42] And in particular, it has been widely taken as proof that the ability of debtors to transfer value from “involuntary” to secured creditors is in fact

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[36] “Unsecured”, p. 1896.

[37] *Ibid*., fn. 41, citing LoPucki and William Whitford, “Corporate governance in the bankruptcy reorganization of large, publicly held companies” (1993) 141 U. Pa. LR 669, 738, including fns. 226-7. Two other companies not included in that study are also mentioned: Texaco, Inc. with an $11.1 billion tort judgment against it, and A. H. Robins, with $2.5 billion in tort claims.

[38] “Unsecured”, pp. 1896-7, fn. 41 (these included non-tort “involuntary” creditors). LoPucki again returns to the examples mentioned above (Johns Manville and Texaco) to derive support for the proposition that large US corporations are underinsured for certain types of tort liability; see *ibid*., p. 1906, fn. 81. These and other cases referred to in the text here are discussed below.

[39] See e.g. “Uneasy case”, p. 883, fn. 89: noting that “while uninsured tort claims do not surface often in bankruptcy, when they do turn up, they can be substantial.” They cite it again in “Further thoughts”, p. 1296-7, fn. 60.

[40] “Security”, pp. 645 fn. 80, 655 fn. 138, 661 (twice) fns. 167 and 170, and indirectly at 644 fn. 73.

[41] As examples, see Robert Scott, “The truth about secured financing” (1997) 82 Cornell LR 1436, 1459 fn. 54; James White, “*Failure and Forgiveness*: A review” (1999) 73 American Bankruptcy LJ 435, 443 fn. 36; R. Cooter and T. Ulen, *Law and Economics* (3rd. ed.) (Reading, MA, Addison-Wesley, 2000), 336, include. fn. 8, referring to, *inter alia*, identical arguments made by LoPucki in “The death of liability” (1996) 106 Yale LJ 1.

[42] See the sources mentioned above.

encouraging excessive amounts of corporate risk-taking and an unacceptable degree of uncompensated harm (including tortious harm).

Things, however, are not as they seem. The LoPucki-Whitford study, far from providing any support for the Exploitation Hypothesis, in fact goes some way towards disproving it. Let us begin by noting that the study focused on the "*largest* reorganizations of the 1980s".[43] It follows that each of the 43 companies studied had extensive business interests, and correspondingly, the capacity to incur substantial "involuntary" debts. Save in the most exceptional circumstances, smaller companies simply would not have the ability (say) to inflict "well in excess of $2 billion" of personal injuries, or face realistic claims of $205 million for patent infringement.[44] The reader can be forgiven for thinking that to point this out is to state what is blatantly obvious. But here lies the problem for LoPucki's (and therefore Finch's) thesis. It is universally acknowledged (even by critics of security) that the larger the company, the more *unlikely* it is to issue secured debt.

Here is some of the evidence. Bebchuk-Fried themselves have stated that "In the United States, large, publicly traded firms tend not to borrow on a secured basis" and that "most commercial secured debt [] is issued by small- and medium-sized companies."[45] Ronald Mann calls it "the most well-established aspect of [the] actual practice" of lending that "the strongest companies in our economy ordinarily do not secure their debts."[46] Steven Schwarcz found in an analysis of fourteen investment grade public companies selected at random that "with extremely limited exceptions, only their non-recourse debt is secured." He concluded that his research, though based on a small sample, "[did] suggest that investment grade companies have little or no secured debt and little non-recourse debt."[47] This is strongly supported by UK evidence. Ameziane Lasfer's study of all the companies quoted on the London Stock Exchange in the 1984-96 period (for which the relevant data was available in machine-readable form) showed that "secured debt is negatively related to firm size; small firms hold more than three times [the

[43] LoPucki, "Unsecured", p. 1897 fn. 41 (emphasis added).
[44] *Ibid*.
[45] "Uneasy case", pp. 859-60 (citing James Booth, "Contract costs, bank loans, and the cross-monitoring hypothesis" (1992) J. Fin. Econ. 25, 40 fn. 10), and p. 924, respectively.
[46] Mann, "Pattern", pp. 629-30 fn. 15, and the sources therein cited. This evidence comes from the US, as does that mentioned in the following footnote.
[47] "Priority", p. 446 fn. 91. For further evidence that the size of the firm and the incidence of secured debt are inversely related, see Michael Barclay and Clifford Smith, Jr., "The priority structure of corporate

amount of] secured debt than do larger companies. The proportion of small companies' debt that is secured is 61%, while that of the larger companies is 17%."[48]

Perhaps most interestingly, the LoPucki-Whitford study, on which most of the Exploitation Hypothesis is based,[49] itself found that "many of [the large companies studied] issued little or no secured debt, *even as they approached bankruptcy reorganization*."[50] In particular, Johns-Manville Corporation, which LoPucki had earlier mentioned as a particularly good case in support of the Hypothesis because it had tort debts "well in excess of $2 billion" and insufficient insurance cover (of "only approximately $700 million")[51], also "had assets of $2.2 billion... and secured debt of approximately $40 million".[52] Smith International, the only other company mentioned in the study as having a huge tort judgment against it, actually paid 107.1 cents on the dollar to its unsecured creditors.[53] Nor were these cases exceptional. LoPucki blandly states that "Liquidations of [many of the] companies [in the sample], even in bankruptcy, would yield substantial recoveries for unsecured creditors."[54] He notes that:

liabilities" (1995) 50 J. Finance 899, 912, and Arnoud Boot *et al*, "Secured lending and default risk: Equilibrium analysis, policy implications and empirical results" (1991) 101 Econ. J. 458, 470-1.

[48] Lasfer, "Debt structure, agency costs and firm's size: An empirial investigation" (24 November 1999), available at URL: http://www.business.city.ac.uk/af/wopapers/mez/debtStructure.pdf>.

[49] As are important parts of Bebchuk-Fried's and Finch's attacks on security; see above.

[50] LoPucki, "Unsecured", pp. 1924-5 (emphasis added), including fns. 145-6.

[51] *Ibid*., p. 1906 fn. 81.

[52] *Ibid*., pp. 1924-5 fn. 145. The reader is left to do the sums.

[53] This company was in fact solvent! See LoPucki and Whitford, "Bargaining over equity's share in the bankruptcy reorganization of large, publicly held companies" (1990) 139 U. Penn. LR 125, 176 Table IV(B). All the figures given by LoPucki as supporting the Exploitation Hypothesis must be treated cautiously. For example, the only other companies mentioned by name as having "substantial 'reluctant unsecured debt'" are Baldwin-United, Charter Company, McLouth Steel Corporation, and Braniff ("Unsecured", pp. 1896-7, fn. 41). As it happens, Baldwin-United paid 54.3 cents on the dollar to unsecured creditors, and Charter was actually solvent, its unsecured creditors bargaining to accept 86.3 cents on the dollar in breach of the 'absolute priority rule'. Only McLouth's and Braniff's unsecured creditors fared less well, getting 18.2 cents and 4.9 cents for every dollar of their claims respectively (LoPucki-Whitford, "Bargaining", pp. 166-7, including Table IV(A), and p. 142, Table III). Note also that Texaco, Inc., which LoPucki mentions in "Unsecured", pp. 1896-7 fn. 41 as not included in the original study but as bolstering his argument since it had an "$11.1 billion tort judgment" against it, actually settled for $3 billion. What is more relevant, the alleged tort there had been committed, not against someone vulnerable whom one might think critics of security were concerned to protect, but against the multi-billion dollar giant Pennzoil, which could be expected to look after itself; see e.g. David Cutler and Lawrence Summers, "The costs of conflict resolution and financial distress: Evidence from the Texaco-Pennzoil litigation" (1988) 19 Rand J. Economics 157. Again, the invocation of this and any similar cases in support of the Exploitation Hypothesis seems inappropriate.

[54] LoPucki, "Unsecured", pp. 1924-5, noting at fn. 146, e.g., that "In at least five cases in which the debtor did not liquidate, the liquidation value of the assets exceeded the secured debt by a sufficient amount that it was clear beyond argument that unsecured creditors would have substantial recoveries in liquidation."

> In 28 of the 42 cases (67%) in which the debtor had bank debt, the primary banks were wholly or substantially unsecured as bankruptcy approached. The banks demanded security in at least 20 of the 28 cases (71%). The debtor refused to grant security in 10 of the 20 cases (50%). In five of the 10 cases in which security was granted shortly before bankruptcy, the bankruptcy was filed within the 90-day preferences period and the grant was attacked. [In fact], it would appear that companies are more likely to grant security when they *avoid* bankruptcy.[55]

Further, of the seven companies whose unsecured creditors are regarded as “reluctant” by LoPucki because they might have made their loans on the basis of fraudulent information provided by the debtor’s management, or the fraudulent concealment of information by it, two were solvent.[56] The creditors of three others could expect “substantial” recoveries from claims pursued by the debtor’s replacement management against its displaced one, or because the latter settled the administrative charges brought against them by the SEC, or both.[57] So not only do we have no indication that these seven companies had issued substantial secured debt, there were, in addition, significant recoveries by the unsecured creditors of five of them in any case.

We should note the significance of the analysis so far. It has been pointed out that these are the very cases that have repeatedly been used to support versions of the Exploitation Hypothesis. These are also *par excellence* instances where (if the Hypothesis held, so that the existence of security is to be explained by virtue of its ability to shift costs onto “involuntary” or “reluctant” creditors) the managers and shareholders of these large firms would have the *greatest* incentive to issue secured debt, since they would have massive tort and other “involuntary” liabilities to externalise. And yet secured borrowings were relatively minuscule and there were

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[55] LoPucki, “Unsecured”, p. 1927 fn. 153 (emphasis added).

[56] AM International and Penn-Dixie; see LoPucki and Whitford, “Corporate governance in the bankruptcy reorganization of large, publicly held companies” (1993) 141 U. Pennsylvania LR 669, 738, fns. 226-7, and LoPucki-Whitford, “Bargaining”, p. 166, Table IV(A).

[57] LoPucki-Whitford, “Corporate governance”, pp. 738-9, including fns. 227-8. One of these companies was EPIC; accurate information about the expected total dividend paid to its unsecured creditors was not available; LoPucki-Whitford, “Bargaining”, p. 141 fn. 33. So their total recoveries may or may not have been even greater than the “significant” damages won on their (and the other claimants’) behalf by the replacement management. Of the remaining three, for two companies, Technical Equities and Baldwin-United, taking into account both the proceeds of the actions against the debtors’ displaced management and dividends from reorganisation, their unsecured creditors recovered in excess of 50 cents on the dollar on their outstanding debts against the insolvent debtor; see LoPucki-Whitford, “Bargaining”, p. 142 Table III. The value of the settlement in case of the third, Nucorp, was $41m, and this went to the shareholders, the plaintiffs in the class action there; see LoPucki-Whitford, “Corporate governance”, p. 238 fn. 227.

actually sufficient assets available to meet much of those liabilities. Secured debt was not then being used to externalise costs, nor were "involuntary" creditors (of whatever description) being "victimized". It must therefore be reasonable to conclude that the LoPucki-Whitford study provides no support at all for the Exploitation Hypothesis.

Further and importantly, we must note the differences between the US legal system, where LoPucki-Whitford's data originates, and that prevalent in this jurisdiction, where, as noted above, it has recently been used as a basis for some arguments about secured credit. For the LoPucki-Whitford study, in cases where some of the management of the debtor was implicated in fraud, the authors themselves note that the Chapter 11 "reorganization procedure sometimes enables managers to escape liability for their wrongdoing", since the entrenchment of existing management brought about by that procedure "gives even badly tainted managers leverage to negotiate their exit". The managers may be able to employ this leverage to demand "a release of liability", or to "hinder[] or delay[] actions by defrauded creditors and shareholders".[58] In this jurisdiction, by contrast, the 'existing management out' response of formal insolvency procedures makes such activity much more unlikely. To the extent that the knowledge that they would necessarily be displaced by an independent party, should their firm enter a formal proceeding, feeds into the decision-making of managers *ex ante*, they have a stronger incentive (compared to their US counterparts) not to engage in such activities in the first place. This weakens even further whatever force LoPucki's arguments might have in the US context.

b. Strategic liquidation and small firms

Suppose now that the defender of the Hypothesis were to concede that large companies do not generally issue secured debt, so the Hypothesis does not apply to them. But it could still apply to smaller firms, who might well have resorted to significant amounts of secured credit. *Their* motivation might be to "sell" the insolvency share of tort creditors to others by issuing security. However, this suggestion seems to have its own problems. We should recall that the Hypothesis turns on the ability of shareholders to reduce their "real exposure" to tort liability etc. It would be no good engaging in excessively risky activities and acquiring a reduction in the price of credit by issuing security, only to have the savings paid out as compensation to all those affected by the

[58] LoPucki-Whitford, "Corporate Governance", pp. 739-40, including fns. 229-32.

excessive risks taken. So for the argument to work, it must be possible "to defeat [the liability] through insolvency or bankruptcy":[59]

> To freeze out their involuntary creditors, firms would have to incur secured debt to the liquidation value of their assets and be willing to go through some kind of liquidation if the involuntary creditors refused to settle.[60]
>
> A firm must be willing to liquidate in order to nullify its tort liability by means of an all-secured debt capital structure.[61]

However, for smaller firms, especially those which have operated sufficiently long and widely to have incurred significant "involuntary" (in particular, tort) liabilities,[62] the costs to the firm's decision-makers associated with liquidating it are likely to be significant. The managers of smaller firms, especially those becoming subject to insolvency proceedings in this country, are very likely to have a substantial equity stake in their company.[63] Such shareholder-managers would also have firm-specific skills and idiosyncratic value invested in it.[64] Very frequently, they would have guaranteed some of their company's debt,[65] and many would also have lent it significant amounts.[66] So a significant proportion of their wealth, material and non-pecuniary, is

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[59] *Ibid*., p. 1898, including fn. 48.
[60] *Ibid*., p. 1903.
[61] *Ibid*., p. 1905 fn. 77.
[62] Most ways in which significant tortious harm could be inflicted ordinarily require a wide or at least a long-running operation on part of the tortfeasor; consider as examples the following situations: injuring customers through selling defective products, or employees by creating an unsafe working environment, or the neighbourhood by emitting pollutants, or contracting parties by defrauding them, etc.
[63] There is evidence that only 2% of the companies engaged in an insolvency procedure were quoted on a recognised stock exchange, no share capital was held by institutional investors in 93% of the cases, and in only 2% of such proceedings had the insolvent firm benefited from a rights issue or other equity investment in the 12 months leading upto the insolvency proceedings; see the Association of Business Recovery Professionals (or ABRP; formerly, SPI), *Survey of Business Recovery in the UK: 9th. Survey* (2001, available at URL: WWW.SPI.ORG.UK/9thc/), p. 12. So most such firms are closely-held.
[64] See e.g. Thomas Jackson and Robert Scott, "On the nature of bankruptcy: An essay on bankruptcy sharing and the creditors' bargain" (1989) 75 Virginia LR 155, 174.
[65] This point is absolutely crucial, and is discussed below.
[66] Julian Franks and Oren Sussman, *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies*, IFA Working Paper 306 (April 2000), in their study of firms in the 'business support units" of three large UK clearing banks, found that for the firms in their sample, shareholder-directors were owed an average (for the three banks respectively) of 6.1%, 2.5% and 2.4% of the total debt outstanding. The authors note that "Although owners' loans are a small percentage of the total debt, in absolute size they may be significant for the owner." See pp. 7-8, including Table 3. This is of course to be added to their massive equity stake in the firm (most such firms being closely-held), and to

likely to be invested in the firm, and this investment will be undiversified. For this reason, far from being all too ready to liquidate them strategically, shareholder-managers can be expected to fight single-mindedly to keep them afloat.[67] It should be clear the (non-legal) costs of liquidation to them are likely in most cases to be very high indeed.

Consider also the differences in the legal context in which the Exploitation Hypothesis was originally expounded, and here in England where it is now being deployed. One significant difference is the 'existing management out' approach of English insolvency law, which stands in stark contrast to Chapter 11 of the US Bankruptcy Code. Chapter 11 perversely "provides a vehicle for a liquidation that can discharge unsecured creditors even while the owner-managers retain control."[68] If that were not enough, bankruptcy courts frequently allow the 'absolute priority rule' (requiring senior claimants to be fully paid off before junior classes receive anything) to be breached in return for "new value", so that shareholder-managers may retain an equity interest even though creditors are not fully paid.[69] So the costs to "owner"-managers of "liquidation" in the US, in terms of equity interest, job security and firm-specific human capital, are noticeably lower than in England.[70] In addition, LoPucki states that tort creditors may have little protection from the law if, for example, "an initially adequately capitalized corporation [] sank into insolvency and continued to operate in that condition" merely on the basis of the gain derived from externalising tort liability.[71] Here, of course, directors would be under the obligation, once there remained no reasonable prospect of avoiding insolvent liquidation, to take all the steps they reasonably ought to, to minimise harm to unsecured creditors. Any default on this obligation would be punished by an award of personal liability against them.[72] Yet another difference lies in the attitude of the two jurisdictions towards the granting of security to cover

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their exposure to the firm's losses as guarantors of its loans, to get a fairer picture of the pecuniary costs of liquidation to them.

[67] See also Ch. VI, below.

[68] LoPucki, "Unsecured", p. 1903 (footnote omitted), explaining a crucial step in his argument. On this point, see Armour, Cheffins and Skeel, "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the UK" [2002] Vanderbilt LR (forthcoming).

[69] See e.g. Lawrence Weiss, "Bankruptcy resolution: Direct costs and violation of priority of claims" (1990) 27 J. Financial Economics 285, though noting that this might happen much more frequently in larger than smaller firms, and might be more common in some US jurisdictions than others.

[70] This should be read subject to the observation that these differences have been decreasing since LoPucki's article was published, both because US law has become tougher on the managers of small firms, and because English law might be becoming marginally more lenient; see Armour, Cheffins and Skeel, "Corporate Ownership".

[71] "Unsecured", p. 1904, in the context of the doctrine of piercing the corporate veil

[72] IA, s. 214; Ch. VI, below, runs through this argument in detail.

antecedent debts, another step in the process through which (LoPucki maintains) tort risks can be externalised: "Granting security for an antecedent debt will never run afoul of [the relevant fraudulent transfer] provision because... value is given if an antecedent debt is secured".[73] In England, this would be liable to be challenged as a voidable preference by the liquidator.[74] With respect, these differences between the two jurisdictions may not have received the attention they deserve from those attempting to transplant the Exploitation Hypothesis to this country.

Consider the implications of the points just made. All the costs mentioned above (legal and otherwise) must be weighed in the scales against the benefits to be derived from liquidating a company in order to externalise tort and other liabilities. For smaller companies (i.e. most of those likely to become subject to insolvency law), the costs are significant, as already noted. Their shareholder-managers would lose their jobs, their equity stake, and substantial undiversified firm-specific wealth.[75] They might also become subject to legal liability. Creditors who accept security in such circumstances might face the possibility of having the objectionable transactions reversed. So the expected benefits from the externalisation of tort risks etc. would have to be very substantial to outweigh the expected costs. However, as already noted, smaller firms are unlikely to be able to operate on a scale large enough to incur extensive involuntary debts.[76] Now recall that the benefits of risk externalisation are supposed to arise from the reduction in interest rates on secured loans.[77] These "subsidies" are likely to be very small in comparison with the costs of liquidation.

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[73] "Unsecured", p. 1905 fn. 76. LoPucki focuses on the Uniform Fraudulent Transfer Act on this point, rather than on the preference avoidance provisions (s. 547) of the Bankruptcy Code, which *would* catch the grant of security; see e.g. *In re Lawson* 122 F.3d 1237 (1997). This is perhaps because of the restrictive 90-day 'twilight' period within which security must be granted before the onset 76.
of bankruptcy, if it is to be caught by these provisions.

[74] IA, s. 239; less importantly, see also IA, s. 245 (floating charge to secure past indebtedness).

[75] This argument does not apply when what is liquidated is a subsidiary company. However, remember that what is being challenged here is the claim that the Exploitation Hypothesis explains the *ubiquity* of secured credit, that the type of company which most often borrow secured and most often become insolvent are SME's, and that there are unlikely to be many SME's whose corporate and debt structures render them tort judgment proof in this way. At the very least, no evidence to this effect is provided by the critics of security.

[76] In fact, an overwhelming number of firms in insolvency proceedings (81%) have liabilities less than £1 million, and less than 5% have liabilities of more than £5 million; see SPI, *Survey of Company Insolvency: 8th. Survey* (London, 1999), p. 7. There is no data from this jurisdiction to indicate whether and how much of the debt of insolvent companies is owed to involuntary creditors.

[77] This crucial issue of the relationship between secured credit and interest rates is taken up in Section 5, below.

To illustrate this point, we can work through a simple numerical example. Given that most firms have less than £1 million of total liabilities when they become subject to insolvency proceedings, give LoPucki benefit of the doubt by assuming a fairly large secured loan from Lender to Debtor which will stand at £500,000 at the time of liquidation.[78] Now banks do not lend at all, secured or unsecured, at rates 7.5% over base rate.[79] Let the base rate be 8%. Assume that without security, Debtor would only be able to borrow at the rate of 15% (i.e. at about the limit beyond which banks refuse to lend) because of the riskiness of its proposed project, but with security, the rate falls incredibly to 10% (this again gives LoPucki benefit of the doubt by maximising the interest rate benefit of security).[80] Debtor is to remain in business for ten years before liquidating.[81] This gives a generously long period for the objectionable "subsidy" to continue and allows for plenty of "involuntary" debts to be accumulated. Note though that this also, inevitably, increases the costs of liquidation in terms of the shareholder-manager's human capital and idiosyncratic investments. Lender lends in four equal instalments at 2.5 year intervals starting in the first year, and let us assume (in LoPucki's favour) that the whole of the capital is outstanding at the end of the period. The total "subsidy" is therefore £156,250.[82] This figure is by no means negligible, even if the "saving" *accrues over ten years*. In return for this sum, however, which results from stated and un-stated assumptions incredibly favourable to his thesis, LoPucki's argument requires the shareholder-manager to incur tort debts and then liquidate his firm, thereby losing material and non-pecuniary investments worth a decade of his life and risking legal liability. In light of this example,[83] it is fairly certain that for shareholder-managers of smaller firms, externalisation-motivated liquidation would very rarely (if ever at all) be a viable proposition.[84]

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[78] Overall, average individual debts range from £6,000 among property companies to £484,000 in construction; SPI, *Survey*, p. 9.

[79] Bank of England, *Finance for Small Firms: A Seventh Report*, January 2000, p. 19. The explanation for this ceiling is probably that high rates invite adverse selection and create moral hazard; see Section 5a, below.

[80] The mean margin over base rate for banks was 3.4% in the first half of 1999; see *ibid*., p. 19. For firms in financial distress, one important recent study found the interest rate spread was less than 4%; see Franks and Sussman, *Cycle*, pp. 13 Table 8, and 19 Table 10a (this study is discussed in greater detail below). In our example, the margin is a low 2% after security is given.

[81] 74% of firms in insolvency proceedings are ten years of age or less; SPI, *Survey*, p. 8.

[82] (5% x 125,000 x 10) + (5% x 125,000 x 7.5) + (5% x 125,000 x 5) + (5% x 125,000 x 2.5).

[83] The reader is invited to modify the figures to identify the parameters within which the benefits of the "subsidy" intuitively seem to outweigh the costs of liquidation to shareholder-managers. The author makes the statement to which this note is attached after having performed this exercise.

[84] LoPucki, "Unsecured", p. 1905, fn. 77, makes the following concession: The reason why most firms today are not tort-judgment proof is because "The transaction costs of liquidation [even under the lax US regime] may exceed the benefit to be gained by escaping tort liability." It is submitted that they almost

Here, then, are the reasons for thinking LoPucki's arguments apply to a null set. Large firms with potentially a large number of involuntary creditors do not give security even when facing very extensive such liabilities, and mostly end up paying those debts. Smaller firms, which do issue secured debt and which constitute an overwhelming proportion of the subjects of insolvency law, ordinarily do not have the capacity to incur involuntary debts large enough to render attractive any externalisation-motivated attempt to liquidate. The Exploitation Hypothesis is therefore left with no part of the corporate world to which to apply. Therefore, it certainly does not explain "why secured credit is such a widespread phenomenon."[85] And because of the differences in the two legal systems, this is even truer here than in the US.[86]

What about evidence? We can to a certain extent test the Hypothesis using available empirical data from this jurisdiction. LoPucki would explain the pattern by which security becomes widely-employed by asserting that [*A*] firms would reduce equity in their capital structure, [*B*] create large amounts of tort liability, [*C*] "incur secured debt to the liquidation value of their assets", and then [*D*] undergo an insolvent liquidation.[87] As more and more firms discovered this easy way of making a profit, [*E*] the trend would be for firms to be increasingly tort judgment-proof:

> Equilibrium would be an all-secured debt capital structure because real tort exposure would be zero. Any change in that capital structure would increase real tort exposure. Reputational concerns would tend to disappear in the intense competition of a world where transaction costs are small.[88]

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always will, for all firms except those on the larger end of the spectrum (which rarely borrow secured). That LoPucki's argument seems mainly to apply only to larger firms has been noted by one of LoPucki's American critics; James White, "Corporate judgment proofing: A response to Lynn LoPucki's 'The death of liability'" (1998) 107 Yale LJ 1363 ("Professor LoPucki is concerned principally, if not exclusively, with the tort and statutory liabilities of public commercial firms"). See also LoPucki, "Unsecured", p. 1905 fn. 78, on the existence of reputational costs.

[85] LoPucki, "Unsecured", p. 1897 (footnote omitted).

[86] Even in the US context, LoPucki's views have been criticised; see e.g. White, "Judgment proofing", p. 1364, who (in response to a later and broader version of the argument being considered here) examines empirical evidence to conclude that "the story Professor LoPucki tells [about companies designing their capital structure so as to be able to defeat certain types of liability] is fictional"; and Steven Schwarcz, "The inherent irrationality of judgment proofing" (1999) 52 Stanford LR 1, 51, who concludes that "The claim that innovative business transactions will kill liability is simply wrong."

[87] LoPucki, "Unsecured", p. 1903.

[88] *Ibid*., p. 1905-6, including fn. 80.

But for small firms in the UK, which are the most likely to be liquidated insolvent, the trend is actually towards more equity and more internal finance in the firm's capital structure (therefore *more* real exposure to tort liability). In the 1987-90 period, 65% of small businesses sought external financing of *whatever* type. In 1995-97, this figure had fallen dramatically to only 39%.[89] Since equity is (and even more strongly, shareholder-managers' own funds are) not being reduced as a proportion of small firm capital structure, and since the trend is in the opposite direction, Propositions *A* and *E* are false. Further, according to the Hypothesis, it would be clearly more rewarding for businesses to shut down only once a substantial number of "involuntary" (especially tort) claimants had been swept up in its liability net and the firm was insolvent. However, twelve times as many businesses close without defaulting on *any* debts, as those that become insolvent.[90] So Proposition *D* is palpably false. We do not know how many tort debts go unpaid in liquidation,[91] and the data relied on by the supporters of the Exploitation Hypothesis shows when there are large liabilities of this nature, little secured debt is issued and those liabilities are mostly met. So Proposition *B* is either false, or more charitably, unproved. It must be said however that the likelihood of its being true is very remote indeed, for the reasons suggested above. We are left with Proposition *C*, that firms would issue secured debt to the liquidation value of their assets before liquidating. Even if true, this by itself would just beg the question, since *why* this should be so is precisely what the other -- false -- parts of the Hypothesis were trying to explain. Based on these predictions and data at least, few things are as demonstrably wrong in the debate about secured lending as the claim that it exists to externalise risk onto tort (or other "involuntary") creditors.

Even apart from all this, there is an additional reason to question the proposition that the existence of the priority of secured claims leads to the exploitation of tort creditors in insolvency. This is because, in this jurisdiction, most tort creditors are unlikely to bear the insolvency risk of their debtors in the first place, regardless of whether the latter have borrowed secured. Here is

[89] Bank of England, *Finance for Small Firms: A Sixth Report*, January 1999, p. 19 (footnotes omitted).

[90] Bank of England, *Sixth Report*, p. 22 including fn. 24, citing D. Storey, "Firm size and performance", in Acs and Audretsch (eds.), *Studies in Industrial Organization No. 11: The Economics of Small Firms* (London, Kluwer, 1990).

[91] What data we do have do not suggest there is significant tort debt in insolvent liquidations in this country; see Franks-Sussman, *Cycle*, p. 8, Table 3: for the three banks in their data set respectively, the mean debt owed to the types of creditor indicated as a percentage of total outstanding debt, was as follows: Main Bank 38.2%, 49%, 41.9%; Trade Creditors 24%, 37.4%, 40.2%; Other Financial Institution 2.3%, 2.8%, 7.5%; Other Creditors 29.4%, 8.3%, 8%; "Owner"-Directors 6.1%, 2.5%, 2.4%.

why. While we face once again the problem that little empirical evidence is available on this point, it is very likely that most tort claims arise either from diseases contracted or injuries sustained at the workplace, or from road accidents. And in both situations, the claim would be covered by extensive compulsory insurance schemes. In the employment context, the Employers' Liability (Compulsory Insurance) Regulations 1998 now require most employers to have a minimum cover of £5m for all risks. This is complimented by the 'no-fault' Industrial Injuries Scheme. As for road accidents, the Road Traffic Act 1988 requires that users of motor vehicles secure unlimited cover in respect of death or personal injury.[92] In either case, and should the insured party become insolvent, the Third Parties (Rights Against Insurers) Act 1930 effects a statutory transfer to the victim of the right to recover from the insurer.[93] In addition, section 151 of the Road Traffic Act restricts the insurers' ability to refuse to pay the injured person on the basis that they would have been entitled to cancel or avoid the insurance contract as against the insured. Finally, even if the driver involved in a road accident is uninsured or untraced, the victim may have recourse against the Motor Insurers' Bureau to make good his loss.[94] The cumulative effect of these provisions is to move the risk of the tort-feasor's insolvency from the victim to the insurer. This also means that any alleged "subsidy" that might have been created by subordinating tort claims to secured ones disappears: it is a fair bet the debtor's insurers would set premiums taking into account the level of risk associated with its business.[95]

So if there is any concern that secured credit is purposely being used to defeat "involuntary" liabilities on a large scale in this jurisdiction (as the Exploitation Hypothesis suggests), then it is surely imperative that empirical research be conducted to test whether that is the case. In particular, if significant amounts of(un-insured) tort debts are regularly going unpaid in corporate liquidations while secured creditors sweep up everything, that deserves to be a scandal and we should hear about it. However, such an argument (and a rather serious charge)

[92] Chris Parsons, "Employers' Liability Insurance – How secure is the system?" [1999] Industrial LJ 109, provides a helpful comparison and critique of the two regimes.
[93] A recent joint report from the Law Commissions of England and Scotland proposes greatly to streamline this legislation by, *inter alia*, allowing the injured party to proceed directly against the insurer before establishing the liability of the insured and without having to sue the latter, and by clarifying and expanding the circumstances in which the statutory transfer from the insured to the injured operates; see *Third Parties – Rights Against Insurers* (Cm 5217; SE/2001/134, July 2001).
[94] See e.g. Parsons, "Employers' Liability", pp. 125-6.
[95] To the extent that these premiums are based on an *ex ante* assessment of 'average' risk across a particular industry or sector of the market, the insurer itself may now be argued to be a 'non-adjusting' creditor seeking to be indemnified by the eventually insolvent debtor for what it pays out to the victim. To the extent

would be difficult to sustain on the strength of a study based in a very different legal system; it could not be made at all on the basis of evidence that seems in fact to repudiate the argument. Nor can this evidence be employed to justify proposals to "improve" the institution of secured credit, especially to "protect" tort victims.[96] It is suggested that unless hard facts and more persuasive arguments are forthcoming, the Exploitation Hypothesis should be retired from service. Tort claimants not being available for this purpose, critics of security must find someone else to save from secured creditors.[97]

4. The Exploitation Hypothesis and "uninformed" creditors

In view of the analysis above and given the present state of evidence and arguments, it is submitted the Exploitation Hypothesis is somewhat lacking in plausibility. That conclusion should carry over to this Section. Here, the exploitation is supposed to be of "incompetent"[98] creditors who systematically underestimate the risk of the debtor's business and who therefore charge less than they would if they could make a more accurate assessment. The argument is that the debtor can (as before) sell their insolvency share to secured creditors who, upon receiving security, do not then raise their rates (since their claims are not diluted by the addition of claims held by these "incompetent" creditors), while enjoying under-priced loans from such creditors in the first place. The blame, it seems, lies with the deceptive nature of the institution of secured credit.

It should be clearly understood that the dispute here is about the existence of a class of creditor that is "uninformed" about the need to deal with risk, and of the consequences of the

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that this is the case, the insurer's position falls to be addressed along with that of other 'non-adjusting' creditors, below.

[96] Even Finch herself does not seem to believe tort creditors are in need of special protection under English insolvency law; see Finch and Worthington, "The *pari passu* principle and ranking restitutionary rights", in Rose (ed.), *Restitution and Insolvency* (London, Mansfield, 2000), 1, at p. 4. It is at least troublesome, then, attempting to reconcile this with the many arguments she makes that either the institution of secured credit, or the justifications provided in its support, are defective because they overlook the special position of tort creditors; see "Security", e.g., pp. 655, 661, 662, 664, etc.

[97] The argument in this Section applies equally to Bebchuk-Fried's claim in "Uneasy case", pp. 898-900, and again in "Further thoughts", pp. 1319-1320, that the priority of secured credit encourages firms to take insufficient precautions to minimise tortious harm for the reasons described by LoPucki. It is submitted their argument is fallacious (at least as applied to English law) because they pay no attention to the considerable costs of liquidation to shareholder-managers of firms which issue secured debt. To the extent to which their argument on this point is distinct from the Exploitation Hypothesis, it is examined further in Section 5, below.

existence of security. No one would deny that some creditors often do not have all the relevant information about a particular debtor. There is every reason to think there are informational asymmetries of this sort, both between creditor and debtor, and between different types of creditor.[99] Rather, the controversy (insofar as it touches this point) concerns the argument that some creditors do not even realise the existence of such asymmetries, nor the consequences of their debtor's having borrowed on a secured basis, do not react appropriately in response, and are "exploited" as a result.

a. Uninformed in the market

It has to be said that the argument just summarised does not seem free of difficulties. First and importantly, it seems to ignore the fact that the required ability to deal with risk is not specific to the peculiarities of any one aspect of the legal system. So for example, a creditor would have to calculate the probability of its debtor's insolvency, or at least the average rate of default in its industry, even if there were no secured credit. It remains to be demonstrated that parties who can do this cannot then assimilate and react to the simple fact that (to mention just two relevant aspects) general unsecured creditors do not often get anything in their debtor's (insolvent) liquidation, and that most trade creditors in appropriate industries will use Retention of Title clauses (ROTs).[100] And contrary to this argument's basic premise, "it is generally acknowledged that small firms today are more professionally managed -- by people with more business acumen -- and assisted by a wider network of support agencies."[101] There is little reason to think this is any less true for firms that have to extend credit (probably most of them). Further, LoPucki does not quite succeed in revealing who these "uninformed" creditors are. The evidence he cites even for the existence of such creditors is, at its highest, anecdotal:

> As a lawyer practicing commercial and bankruptcy law in a small city for eight years, I came to the [] conclusion [that a] substantial proportion of the unsecured creditors who had showed up on bankruptcy schedules were not creditors who had knowingly assumed

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[98] The term comes from Alan Schwartz, "Security interests and bankruptcy priorities: A review of current theories" (1981) 10 J. Legal Studies 1, 36. See also LoPucki, "Unsecured", p. 1916.
[99] Indeed, some of the monitoring efficiencies said to arise from the existence of security build upon this proposition; see below.
[100] Both of these of course have an impact on the position of other types of creditor in their debtor's insolvency. This point is made again below. For interesting survey evidence from insolvency practitioners who often act as receivers, and some of whom see it as part of their job to dispute the validity of ROTs, see Armour and Frisby, "Rethinking receivership" (2001) 20 OJLS 73, text accompanying fns. 160-6.
[101] Bank of England, *Finance* (1999), p. 23.

> the risk of the debtor's business. They were creditors who, had they known the true state of the law and the debtor's finances when they made the fatal decision to extend credit (or not to withdraw from an extension already made), would have decided differently.[102]

LoPucki cites a reported case as demonstrating the potential for exploitation of "uninformed" creditors. However, as he himself notes, there was no "exploitation" even there; the eventual decision of the Supreme Court of Illinois ensured that in fact, the "uninformed" creditor prevailed![103] The LoPucki-Whitford study is also brandished again to show that "in 4 of the 43 cases [] studied (9%), the CEOs were indicted for fraud against creditors. In several others, the SEC brought administrative charges for such fraud."[104] But of course this is all quite irrelevant as an argument *against secured credit*, the amount of secured debt being relatively minuscule for almost all the firms in the study.[105] Again, if the argument is meant to show that secured credit exists (at least in part) to sell the share of "uninformed" creditors to secured ones, the study itself consists of stunning counter-examples.

Given that the identification of "uninformed" creditors is hazy at best and the evidence cited is inappropriate, this part of LoPucki's argument might well have been treated as no more than an irrelevance here. As it happens, though, Finch has seized on the basic insight that there might be a significant number of "unsophisticated" creditors ready to be taken advantage of by security in this jurisdiction. She seems to make several arguments premised on the existence of parties who act as if they were "uninformed", either because of personal or market reasons.[106] Keeping in mind that the Exploitation Hypothesis fails *ab initio* for "uninformed" creditors for the same reasons it was argued to have failed for tort ones,[107] Finch's arguments deserve

[102] See "Unsecured", p. 1916. But if the argument is to be won on the basis of anecdotes, here is Knippenberg, "Essay", p. 1971 fn. 19: "It is interesting to note the striking differences in the professional experience of lawyers. In Professor LoPukci's experience, clients were Bubbas [Knippenberg's term for LoPucki's "unsophisticated" actors]; their lawyers were relatively more sophisticated... In my experience, clients were mainly sophisticated, and their lawyers were often Bubbas"!
[103] *Ibid*., pp. 1916-7, fn. 115, citing *Chicago Limousine Serv. v Hartigan Cadillac*, 564 N.E.2d 797 (Ill. 1990). LoPucki is still able to use this case since he is not satisfied with the grounds on which the "uninformed" creditor was given victory; *ibid*. The reader is also referred to the other US decisions he mentions.
[104] *Ibid*.
[105] See discussion of the LoPucki-Whitford study in the previous Section.
[106] And they must be present in significant numbers, since an argument based on isolated exceptions could be used to support neither widespread criticism of the whole system, nor suggestions for dramatic reform.
[107] That it underestimates the costs of liquidation to shareholder-managers and exaggerates any "subsidies" achieved from selling the bankruptcy share of "uninformed" creditors to secured ones.

nevertheless to be examined, since they raise new issues that are interesting in themselves. Remember that they all aim to show how some players in the market systematically under-price their loans, thus allowing coalitions of debtors and security-holders to appropriate a part of their bankruptcy value.

First, Finch envisages a voluntary creditor who anticipates clearly that the granting of security by its debtor to another of its creditors would make its own position worse off. To compensate, it realises it should adjust the terms on which it does business in order to make up for the expected loss of insolvency value. However, the industry in which it trades contains "ill-informed and cavalier [operators who] may be willing to offer terms that undercut [our wiser but impotent protagonist] in the market. The [latter] will, accordingly, feel that it cannot adjust and, indeed, that resources spent on evaluating the need for adjustment... would be wasted." The same calculation is made by many (or most) operators in the industry. This state of affairs is undesirable.[108]

The obvious reply must, with respect, be that operators who are "cavalier" about accepting unjustified risks would soon go out of business, while the prudent operator who expends resources adjusting to risks would be rewarded with higher profits and commercial longevity. Finch herself notes a paragraph later that some "trade creditors [would] have gone out of business through their failure to adjust -- perhaps in their early weeks and years." She uses this as yet another argument against secured credit, stating that "These lost enterprises involve costs to society."[109] This is hard to understand. On her premises, in fact, such trade creditors should *systematically* include (by definition, since we *are* concerned with *risk*) a far higher proportion of those being "cavalier" about it than those dealing with it prudently. Indeed the more cavalier the operator or the more ill-informed it is about the consequences of its decisions, the more hasty should be its demise.[110] The trend should be for the market to be purged of the cavalier and the

[108] Finch, "Security", p. 644 (the operator in the example supplies roof tiles).
[109] *Ibid*.
[110] If operators resorting to a particular pattern of behaviour (say, any behaviour identified by Finch as demonstrating imprudence towards risk) did not suffer an increased probability of going out of business, then we would have serious reason to doubt the initial judgement that they were being "cavalier" about *risk* in the first place.

ill-informed. The persistence in the market of such actors seems unlikely to account for the existence of security, nor does it seem likely to provide a significant source of exploitation.[111]

Finch asserts that some “ill-informed and ill-equipped” parties may be unable to adjust and unable to learn because they “operate in dispersed, changing markets in which learning is difficult, the process of matching prices to risks may take a long time and may be delayed, distorted or prevented by changes of actors and the arrival in the market of numbers of unsophisticated operators who fail adequately to consider risks.”[112] Predictably, she produces LoPucki in support, which is unhelpful.[113] On its merits, too, Finch’s argument is (with great respect) not entirely satisfactory. What are these “dispersed, changing markets in which learning is difficult”, and in which industry do they exist?[114] Why are parties compelled to operate in the whole of these dispersed markets? Parties who suffered from having to operate thus would soon specialise in one (or some) sector(s), thereby improving their ability to learn and adjust. Or some newcomers -- though aware that operators in this industry traditionally traded widely -- would be forced through financial constraints to start out on a small scale in one such sector (or in fewer ones than is customary), and would find (on Finch’s assumptions) that they did better than competitors struggling in many different ones. Others would be likely to learn from their success and follow their example. Alternatively, suppose it is impossible (say for technological reasons) to specialise in some of these “dispersed” markets rather than operating in them all. If so, the

[111] The reader should note it is doubly difficult to evaluate Finch’s arguments, since (as mentioned) no information is provided either by her or by LoPucki about who such creditors are, which industries they operate in (the references by Finch to a roof tile supplier and a timber-window company, at pp. 644 and 645, are treated here as helpful but ‘made-up’ examples, and not as identifying special problems in these industries), and even about how the persistence or otherwise of such “uninformed” creditors in the market is to be tested.
[112] *Ibid*., pp. 644-5.
[113] As already noted, LoPucki relies on evidence (including the LoPucki-Whitford study and the *Chicago Limousine Serv.* decision) which, if anything, undermines his own argument. Apart from that, his reasoning here relies at crucial points on mere assertions; for a good example see p. 1958 and fn. 256: the text contains a statement which begins with “It is my impression that...” and is supported by nothing at all except a footnote which begins: “... if one examined the schedules filed by bankrupt debtors, one would find...”; despite appearances that he is making an *empirical* claim here, LoPucki seems to have relied only on the hypothetical argument that *if* the schedules were examined, they would bear him out. See also Finch, “Security”, p. 644, fn. 76, relying (*inter alia*) on this part of LoPucki’s article.
[114] In LoPucki’s version of this argument, *each debtor* is a separate market: “The problem facing a trade creditor... is not what interest rate to charge, but to whom to extend credit and in what amounts. In doing so, the creditor is deciding which markets to enter” (“Unsecured”, p. 1956). But surely this is saying nothing more than that trade creditors have to be careful who they do business with. It would be hard to disagree, but this is true not just for trade or other unsecured creditors but *everyone* else in the commercial world (including secured creditors); all must decide carefully who to trade with. Since nothing distinguishes

costs arising from the drawn out process of "matching prices to risks" cannot be regarded as objectionable, since *ex hypothesi* these costs cannot be avoided by any of the relevant players. It is submitted none of this constitutes an argument against the priority of secured claims.

b. Uninformed because 'unsophisticated'

Consider now the argument that, to this author at least, seems to have truly startling implications. The claim is that there might be "a permanent subsidy to borrowers" because of the continuous flow into the market of "ill-informed and *ill-equipped* parties".[115] Parties who are merely "ill-informed" because of market reasons would soon become informed; otherwise they would go out of business. So let us now focus on parties which are "ill-equipped", presumably because of personal reasons, to learn from the markets etc.[116] The assertion that these parties exist in the marketplace in significant numbers is meant to support proposals to "improve" the system of secured credit to "protect" them.[117] Disregard for the moment that because of the purging effect of the market, such individuals are unlikely to be numerous at any given time, so that "victimizing" them through the use of security is unlikely to be a profitable pursuit, and therefore unlikely to explain the ubiquity of secured credit.[118]

Think about the proposition at issue. Here are the three steps it is based on, and the conclusion that is supposed to follow. (1) Certain players enter into business some part of which requires them to extend credit. This in turn means they must understand (*inter alia*) how security operates in that industry, what are the laws governing its use, what the rates of default and of insolvency are in it, what commercial actors can expect if they do not have security and their debtor becomes insolvent, and if possible, what is the likelihood of its particular debtor defaulting or becoming insolvent. (2) The players we are concerned with, however, are "ill-equipped" to meet (some of) these requirements. They find the laws too complicated to understand. Or they cannot work out the implications, for them, of their debtor's bank having

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certain unsecured creditors in this respect from the rest of the world, no argument can be made that they represent a greater potential for exploitation than anyone else.

[115] *Ibid*., pp. 644-5 (emphasis added), citing LoPucki, "Unsecured", pp. 1956 (who refers, colourfully, to "suckers").

[116] So we are concerned now with business people who, according to LoPucki, "Unsecured", p. 1919, are at "the lowest level of sophistication" or thereabouts.

[117] See e.g. LoPucki's proposals, "Unsecured", pp. 1957-63.

[118] To this effect, see the argument concerning tort creditors above; see also Schwartz, "Security interests", pp. 34-6.

acquired a security interest. Perhaps they fail even to realise that for firms in trouble, this is what banks almost inevitably do. Nor, it seems, can they acquire the services of someone better able to deal with these issues to instruct them, or to act on their behalf. (3) This means they underestimate the prices they should charge in order to be compensated, should their debtor become insolvent at some point after having issued secured credit. It also means they are ejected from the market more frequently than other players not as "ill-equipped" as them. (4) This leads to the conclusion that the institution of secured credit, because of its complexity and inaccessibility, and because it does not sufficiently encourage the flow of information (even instruction) from debtors and secured creditors to "ill-equipped" ones, is both exploitative and inefficient.

This argument is troublesome. For one thing, the need to deal with risk is not related to the institution of secured credit, as already noted, and would inevitably exist even if no one ever lent secured. At least in a market economy, some business ventures would succeed and others fail,[119] and those deciding to enter the market would have to make judgements about the likelihood of failure of their proposed business partners (their suppliers and buyers). Given the ever-present possibility of failure, they would be reckless indeed not to think of what would happen, should failure strike those they do business with. Such considerations would include questions about the resilience of their own venture, should (say) a crucial buyer be rejected by its own customers, or a seller offering them attractive terms finds it can no longer afford to do so. Would their own business survive such contingencies, because they have diversified their customer- or client-base? Or would it collapse simply because it can no longer afford its raw material or find anyone interested in its products? Further, if the economy is based on credit, the possibility of insolvency must be thrown into the mix. Business people must school themselves in the art of deciding what they should charge for their product, taking into account all these complexities of commercial life. The existence of *secured* credit simply is not implicated in the story so far.

Now here is the challenge to the basic premise of the anti-priority argument now being considered, that the way security operates in this jurisdiction adds *unacceptably* to the complexity of the system. If the argument in the paragraph above is accepted (and indeed it consists mostly of truisms), then the addition of secured credit mainly adds one – dare it be said – relatively innocuous ingredient to an already potent brew. Parties must now also assimilate the

[119] 'Failure' in this context refers to a persistent inability to turn a profit, rather than to insolvency.

fact that (say) banks would virtually always take security from risky firms, suppliers who can would inevitably deploy ROTs, and should insolvency strike, most (non-preferential) creditors of the insolvent would probably end up with nothing. We should recall the point just made, that even without secured credit, commercial parties would still have to learn to calculate the risk of failure of their counter-parties. They would still have to find ways to survive, should that happen. Having done all that, and now with the addition of secured credit, they must learn to survive despite not being paid much on the loans they extended when their counter-party was teetering on the brink of insolvency. Of course this becomes more difficult since they would lose *more* money on loans already made (they would lose *some* money on such loans in any insolvency, even if there were no secured credit). This is hardly surprising given the priority-based nature of security. The point here is that this additional difficulty cannot be attributed to the complexity of secured credit, nor can it be used to support the proposition that security makes *planning in advance* more difficult. Parties who are "ill-equipped" to deal with this rather trivial additional complexity are unlikely to do much better even if the institution did not exist.[120] Focusing narrowly on secured credit hides the fact that the real difficulties of commercial life -- the issues which could *really* be expected to trouble "unsophisticated" creditors -- lie elsewhere. Tinkering with the details of the laws governing secured credit seems unlikely to make them go away.

Suppose though that we accept that such "ill-equipped" actors do occasionally enter the market, do then create a "subsidy" for others by under-pricing their loans, and are ejected from the market quicker than others. Does this mean the institution of secured credit, perhaps by hastening their demise, is exploitative or inefficient, and ought therefore to be reformed? It should be noted first of all how difficult it is to assess the merits of such a proposal. Suppose the level of protection accorded to "ill-equipped" parties from the effects of secured credit were to be significantly increased. Some creditors would still inevitably fall below the threshold of that

[120] In any case, contrast the premises of this part of the Exploitation Hypothesis with the findings of one of the largest non-government surveys of its type ever conducted. It was undertaken by researchers at Strathclyde University on behalf of the Federation of Small Businesses, *Barriers to Survival and Growth in UK Small Firms* (Glasgow, October 2000). The 21,858 responses received from small businesses showed that, for factors "internal" to the firm, "satisfaction was greatest with regard to skill levels [of the businesses' own managers] in management, marketing and sales and the implementation of new technologies'; see pp. 51-52 (including Table 49) and 60. In view of the arguments in this Section, it would surely be strange to assert such managers would consider themselves at a loss when required to digest the simple fact that, should one of their debtors become insolvent, they would receive little or nothing on the loans still outstanding, and that any assets in that debtor's estate would go primarily towards satisfying secured claims. This is especially true since their firm would often itself have borrowed on a secured basis and would be aware of the implications of this for its own creditors.

protection. What happens then? Since it is probably impossible to *guarantee* that no one would ever be "taken advantage of" because of their inability to deal with commercial uncertainty and risk, or because of their ignorance of how banks operate, or because of their misinterpretation of the law of secured credit etc., all we could do would be to alter the threshold below which protection is denied. But for all we know, that threshold might lie roughly at the right level today.[121] On this point, the most that can be said in favour of those proposing 'reform' on these grounds is that we cannot be certain, since they do not provide any information about how many such "ill-equipped" creditors there might be today. This also means we cannot know how much "protective" regulation should be added to cut down the number of those "exploited" by way of secured credit by (say) one-half.

Nor does it seem to this author desirable for the law to ensure that members of society continue for as long as possible to do what *ex hypothesi* they are not very good at doing. Society has adopted the attitude that individuals are generally not to be prevented from entering the occupation of their choice. However, this same freedom implies one must also face up to the consequences of that choice. So until society decides to abandon the position that the market should be allowed to encourage those not terribly good in their chosen profession to apply their talents elsewhere, surely no such argument would be persuasive in the debate about secured credit. Nothing justifies isolating "unsophisticated" unsecured creditors from plumbers, actors, and soccer players of comparable abilities, so it is submitted that nothing requires them to be shielded from the consequences of their decisions any more than all others.

What is more, it would be undesirable for the legal system to ensure that everyone in this sphere of activity – where risk-taking and innovation are of the essence – operates at the same level of regulation and restriction ("protection") as that which would have to be afforded to those of its participants who (in LoPucki's words) are "at the lowest level of sophistication".[122] Further and very importantly, if the argument is that some business people cannot comprehend how security operates, can they understand and comply with tax and VAT, health and safety, consumer and environmental protection requirements, which are unlikely to be any less complicated? No one would disagree that laws should be as clear and easily understandable as

[121] See Knippenberg, "Essay", p. 1985, for a similar point.
[122] LoPucki, "Unsecured", p. 1919.

possible,[123] but when all is said and done, a complex world will unfortunately still demand complex laws.[124] Those proposing 'reform' to the institution of secured credit on these grounds must surely bear the burden of demonstrating that these issues can be satisfactorily addressed. Until they do, it is respectfully submitted that proposals to modify the institution of secured credit to "protect" actors who enter a business which requires credit to be extended, but who are "unsophisticated" in such matters, who are unable to understand the effects of the relevant laws, who systematically underestimate risks, in short, who are "incompetent" creditors, must be considered unacceptable.

5. 'Non-adjusting' creditors and the Inefficiency Hypothesis

Bebchuk-Fried have given the most systematic statement of the Inefficiency Hypothesis.[125] They argue that "under the rule of full priority, the creation of a security interest diverts value from creditors that do not 'adjust' the size of their claims to take into account the effect of the loan transaction that creates the security interest".[126] Security allows the debtor to transfer to secured creditors some of the insolvency value of such 'non-adjusters'. In return, the secured creditor charges them a lower rate of interest, reflecting the fact that its claim would not now have to rank *pari passu* with those of non-adjusting creditors.

A 'non-adjusting' creditor, then, is one who "cannot or does not adjust the terms of its loan to reflect the effect on its loan of all the arrangements the borrower enters into with other creditors, including the creation of security interests which, under full priority, completely subordinate the nonadjusting creditor's claim in bankruptcy."[127] Four broad categories of 'non-adjusters' are identified. First of course are tort victims, the quantum of whose claims is irresponsive both to whether there is a pre-existing security interest senior to them, and to whether such an interest is created after judgment is given in their favour. Second are

[123] Or that the laws governing the taking of security are not a model of clarity. But then, few laws are.

[124] In the US context, the complexity of the Revised UCC Article 9 (which came into effect on 1 July 2001) is tied directly to the "complexity of the transactions and financing patterns that [it] addresses" by Harris and Mooney, "How successful was the revision of UCC Article 9? Reflections of the Reporters" (1999) 74 Chicago-Kent LR 1357, 1397. For the continuing attempts to make the Article ever more readily accessible, see Del Duca *et al*, "Simplification in drafting -- The Uniform Commercial Code Article 9 experience" (1999) 74 Chicago-Kent LR 1309. One response to the point made in the text here would be that these other laws serve useful purposes; laws allowing security to be taken do not. But anyone taking that position would then have to show why various forms of secured credit have existed, persisted and thrived in all parts of the world across the ages. The various arguments that security is mutually beneficial to all would have to be conclusively rebutted.

government tax and regulatory claims, their size set by statute without regard to a firm's capital structure. Third, voluntary creditors with small claims would rationally charge uniform interests rates without paying heed to whether a particular debtor already has significant senior debt. It may or may not be the case that these uniform rates, by reflecting the average risk they bear in lending to all their customers, cause them to be fully compensated. And finally, prior voluntary claimants who have already lent on a fixed rate basis would not be able to adjust if their debtor subsequently issues secured debt.[128]

Bebchuk-Fried are more at ease than LoPucki accepting that security might be beneficial and efficient as well as merely redistributive (from non-adjusting creditors to debtor and secured creditor) and inefficient. They explain that since the security interest encumbers the collateral and affords the secured creditor both a superior remedy and priority to the proceeds of its realisation, it reduces the borrower's ability to *overinvest* by selling those assets and embarking on an inefficient project. It discourages *asset dilution* by way of transfer of those assets to the debtor's shareholders. It also discourages inefficient behaviour on part of the debtor by increasing the expected costs of non-compliance with value-increasing covenants in the loan contract. Security reduces the costs to the secured debtor of dealing with a default. And finally, it puts off other creditors from rushing for the collateral when the debtor becomes financially distressed. This ensures that the debtor's estate would not be broken up and sold piecemeal to satisfy these multiple claims, and any 'going concern surplus' can be preserved.[129] Bebchuk-Fried are also keen to emphasise their argument does not depend on proof that non-adjusting creditors are "'victimized' by the creation of a security interest".[130] Inefficiencies caused by the (full) priority of secured claims would persist even if all 'non-adjusters' were fully compensated for the loss of insolvency value.

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[125] Again, the argument has been imported into the English context by Finch, and together with the Exploitation Hypothesis, constitutes what she describes as "the core objection to the provision of security"; see "Security", p. 644.
[126] Bebchuk-Fried, "Uneasy case", p. 864.
[127] Bebchuk-Fried, "Further thoughts", pp. 1295-6; see also "Uneasy case", pp. 864-5 and 882-91.
[128] Bebchuk-Fried, "Uneasy case", pp. 882-91.
[129] *Ibid*., pp. 872-6. Adopting the terminology introduced in Chapter I.6, above, the first four of these are ways in which security minimises the motivation costs that would otherwise exist because the debtor's shareholder-managers acted to maximise their own advantage at the expense of others interested in the debtor's undertaking. The fifth illustrates how security could contribute towards reducing the co-ordination costs of all the creditors as a group. It does this by encouraging them not to monitor the debtor excessively for signs of financial distress, and not to take precipitate action in case of such distress: each creditor knows the benefits of any such activity would go, not to them, but to the priority-holding secured creditor.
[130] *Ibid*., p. 865.

Here is how these inefficiencies are supposed to arise. As already noted, Bebchuk-Fried accept that security *might* have effects beneficial for all creditors, secured and otherwise, by controlling debtor misbehaviour. To the extent that it increases the wealth of all the parties, security is of course desirable. But security interests will be granted beyond this point not because of their social benefit, but simply because they allow the debtor to reduce its own financing costs by selling the insolvency share of non-adjusters. On the margins, therefore, the role of security is merely redistributive. Second, security interests would sometimes be used precisely for redistributive purposes when debtor misbehaviour might more effectively have been controlled by use of non-security covenants. Third, the existence of full priority for secured claims leads to the externalisation of tort risk. The debtor can engage in more potentially harm-inflicting activities and take fewer precautions. It thereby also increases its expected tort liability. Without priority over tort claims, its adjusting creditors would raise interest rates to compensate for the effects of having their insolvency claims diluted by tort ones. The anticipation of, and the desire to avoid this would, in turn, create incentives for the debtor to take more precautions in the first place. But since the secured creditor is insulated from having its claim diluted thus, it does not raise its interest rate, and the debtor sees less reason to be cautious. Fourth, the full priority accorded to secured claims diminishes the incentives for the secured claimant to monitor the debtor's activities by imposing covenants and ensuring compliance, since security reduces the claimant's risk of loss. And finally and for the same reason, the secured creditor has less of an incentive to control debtor misbehaviour.[131]

a. The relationship between risk, security, and interest rates

This, then, is the Inefficiency Hypothesis, and we must decide what to make of it. It is submitted the Hypothesis is seriously undermined – at least as it applies to this jurisdiction – by empirical evidence now available. However, the same evidence also calls into question one of the most deeply embedded and seemingly obvious intuitions underlying the debate about security. This is what we must begin by unearthing. It is important to notice the structure of the argument above. Bebchuk-Fried accept that the existence of secured credit does allow the secured creditor to

[131] All these alleged inefficiencies are described in "Uneasy Case", pp. 895-903. Compendiously, all these arguments amount to the allegation that, at least on the margins, the priority of secured credit, instead of reducing the motivation costs of the debtor's management, in fact *create* additional motivation costs both on

control debtor misbehaviour. This benefits all of those with claims against the latter, and therefore maximises social value. The secured creditor-to-be anticipates the lower costs to it of administering this loan in the way described above, *and* of an increase in its share of bankruptcy value, and so lowers the interest it charges. The debtor for its part offers security to enjoy the benefits of this lower interest rate. As the argument is presented, the problem arises only after all the gains from the secured creditor's ability to control debtor misbehaviour have accrued. Beyond this point, the *secured creditor* will lend cheaper on a secured rather than unsecured basis *only* because the priority associated with secured status allows it to obtain a greater part of the debtor's estate, should the latter become insolvent. And the *debtor* still has an incentive to offer security because of the attraction of cheaper loans from the secured creditor. *Now* security is doing nothing but transferring bankruptcy value from one set of creditors to another. The losers in this process can do nothing about it since, *ex hypothesi*, they are unable to adjust the terms on which they lend.[132]

Now the linchpin of this argument, the assumption that does all the work here, is the obvious one that secured credit is cheaper than unsecured credit. Call this the 'rate reduction assumption'. The assumption seems reasonable: after all, having priority does (by definition) improve a creditor's position in its debtor's insolvency compared to what it would otherwise be. So this difference must obviously be reflected in the price to be charged for debt. Of course if there were no difference in rates between secured and unsecured debt, then this argument simply would not work. It is important to understand why. If the assumption holds, secured creditors-to-be are indifferent between being asked to lend unsecured and charging a high interest rate on the one hand, and taking security and reducing the price of their loan on the other. It is the *debtor* that has an incentive to offer security, precisely because it can pocket the difference in interest rates. If there were no difference between borrowing secured and borrowing unsecured, there would from the debtor's perspective be a strong *disincentive* to offer security. We should remember that on Bebchuk-Fried's premises, security has two broad roles. It may facilitate a transfer of bankruptcy value from non-adjusting to secured creditors, but this is consummated only once the debtor becomes insolvent. *While it is still solvent*, however, security allows the secured creditor to restrict the debtor's freedom of action, preventing it from engaging in over-investment, asset dilution, and because of the 'hostage' role of security, extracting from it

its part and that of the secured creditor. This is value-destroying from the point of view of all the relevant parties (including, especially, non-adjusting creditors, who bear the brunt of these costs) taken as a group.

scrupulous compliance with debt covenants. The debtor's shareholder-managers *suffer* from the existence of security, on Bebchuk-Fried's view. So they must be compensated handsomely through a reduction in price of the now-secured loan, if the debtor is to offer security at all.

This strategy of arguing against the priority of secured lending is by no means unique to Bebchuk-Fried. Both limbs of the Exploitation Hypothesis are also premised on the rate reduction assumption. Think back to LoPucki's numerical example.[133] Debtor starts off with assets of $100, and with one creditor C that it owes $100. It then commits a tort, inflicting another $100 worth of harm on T. As things stand at this point, C and T would share *pari passu* in the distribution of Debtor's estate (each getting $50), should it become insolvent. So C would be tempted to raise its interest rate at this point to compensate for the dilution of its claim. (Anticipating this, Debtor might have had an incentive *ex ante* not to commit the tort in the first place.) However, Debtor can grant C security during its own solvency, thereby increasing the latter's share of its estate (back to $100). The involuntary creditor cannot of course raise its interest rates in retaliation. Debtor's shareholders benefit during its solvency, then, since C naturally would continue charging it the old, lower, rate, to reflect the fact that it will still be paid back in full. This is the "subsidy" which results from the "victimization" of involuntary creditors through the "externalisation of tort risk". There would be no point in the debtor's improving C's position in the event of its own insolvency (i.e. by offering security) unless it received something in return. *Mutatis mutandis* for 'uninformed' creditors.[134]

The rate reduction assumption is quite crucial to all major attacks on security, then.[135] And so strongly accepted is it that the defence of the priority of secured credit in this Chapter so far has also proceeded as if it were true.[136] Yet, as the reader would have gathered from the build-up it has just been given, it is now contended there is reason to think the way this assumption

[132] This strategy of argument is obvious in, e.g. Bebchuk-Fried, "Uneasy case", pp. 891-5, and 896-7.
[133] See Section 3, above.
[134] LoPucki, "Unsecured", pp. 1897-9 and 1916-20. See also Finch, "Security", pp. 645-6.
[135] In Finch's case, it can be found explicitly in, e.g. "Security", p. 638: "If both parties are rational and informed..., even the most powerful debtor is likely to be presented with a choice by the creditor -- between a certain interest rate in combination with security and a higher interest rate without security". Implicitly, of course, this assumption is present whenever she relies on any of LoPucki's or Bebchuk-Fried's arguments, or herself makes arguments with a similar structure.
[136] So that defence would stand even if the following arguments could be rebutted. The rate reduction assumption is also accepted (though in the US context, which might make a difference) by two of the most insightful challenges to the Inefficiency Hypothesis, those by Schwartz, "Priority contracts", Section IV, and Schwarcz, "Easy case".

operates in the attacks on security is quite fallacious (at least in the English context). The evidence for this is discussed below. It would be helpful first to set the theoretical context of this relationship between risk, interest rates and security.

Let us start by disentangling two distinct factors that might be at play in determining whether the rate reduction assumption is valid. The first one, which the literature refers to as *financial agency costs*, has already been mentioned. The debtor's management has an incentive to engage in behaviour harmful to its creditors. They might 'overinvest' by putting the borrowed capital in projects with a negative present value, or dilute the existing lenders' claims by borrowing more, or simply by distributing corporate assets to shareholders in the form of excessive dividend payments. Since all these activities increase the prior lenders' risk, those capable of adjusting their rates would have an incentive to demand a higher interest rate at the time the loan is made. Now to the extent that security mitigates *this* risk, it serves as a substitute for a higher interest rate. Very simply put, a secured loan is for this reason likely to be cheaper than an unsecured one, *all other things being equal*. But as already pointed out above, to the extent that *this* factor explains the relative cheapness of secured debt, it is accepted by critics like Bebchuk-Fried to be beneficial to *all* of the firm's creditors, *un*secured as well as secured (since financial agency costs hurt them all).

But the second of the two factors just mentioned might ensures that the relationship between security and interest rates is not always inverse. From the lender's perspective, and focussing for a moment only on unsecured loans, raising interest rates beyond a certain point might well be self-defeating. This is because potential borrowers who *offer* to pay more *ex ante,* may not *end up* paying more *ex post*. Those offering to borrow at higher interest rates might be willing to do so only because they intend to undertake riskier projects, or are over-estimating the success or profitability of their projects, or are simply dishonest. It follows that as the interest rates charged by a lender creep up, the average quality of its borrower would tend to decline. This *adverse selection effect* also means that as interest rates increase, less risky borrowers would drop out of the market, finding credit to be prohibitively expensive (remember that their lower-risk projects also yield lower returns). What is more, rates increased in order to compensate the borrower against the risk of debtor misbehaviour, might in fact generate additional motivation costs, as debtors are pushed into taking excessive risks to finance the higher costs of borrowing. Instead of compensating the lender for its portfolio risk, then, high interest rates might increase that risk. One way of avoiding this problem would be for the lender to 'ration' credit instead of raising rates. Keeping the rates lower would attract better-quality borrowers back into the market. It would also ensure, however, that some good potential borrowers who nevertheless have an *ex ante* risk profile necessitating a somewhat higher rate do not obtain credit.[137]

Introducing security back into the picture, we can now see that it might sometimes substitute, not for higher interest rates, but for refusing credit altogether. Some loans might be made because the lender's *ex ante* risk is mitigated by the priority it would now enjoy in any subsequent insolvency, when without that priority, an 'adequate' interest rate would be beyond the level where the adverse selection and moral hazard problems become acute. Importantly for our purposes, it should be noted that in this situation, the rate reduction assumption turns out to be the rate reduction fallacy. Here, the choice would not be between borrowing at a high rate without offering security, and obtaining a lower rate by offering it. It would instead be that between borrowing (at a relatively high rate) *by* offering security, and not borrowing at all.

To the extent that this analysis holds, we have a way of testing the anti-security Hypotheses. Both predict that for troubled firms which might eventually become insolvent, there should be a difference in the price of secured and unsecured loans made by banks (i.e. creditors which lend both with and without security), secured credit being cheaper. On the other hand, if such a relationship is lacking, then we have reason to doubt the validity of the anti-security attacks, at least as they stand. We would then have to decide whether the ability of security to avoid the adverse selection and moral hazard problems itself creates costs for unsecured creditors.

Now for the relevant evidence, which comes from a recent study conducted by Julian Franks and Oren Sussman (hereafter, 'Franks-Sussman') on behalf of the Working Group on

[137] This discussion draws on the work of Joseph Stiglitz and Andrew Weiss; see e.g. "Credit rationing in markets with imperfect information" (1981) 71 American Economic Review 912, "Credit rationing and collateral", in Edwards, Franks, Mayer and Schaefer (eds.), *Recent Developments in Corporate Finance* (New York, CUP, 1986), and "Banks as social accountants and screening devices for the allocation of credit" (National Bureau of Economic Research Working Paper No. 2710, Cambridge, MA, September 1988).

Company Rescue and Business Reconstruction Mechanisms.[138] Franks-Sussman persuaded three large UK clearing banks to grant them access to private records on 542 companies, all of which had entered the central 'rescue units' of these banks during a certain sampling period. The stated purpose of these units is to "intervene early in the cycle of a company's decline and provide a greater opportunity for rescue and recovery, without necessarily resorting to formal procedures".[139] Each bank employs considerable discretion and its own criteria for deciding which company is sent to these units, based variously on the size of the firm's debt or of its turnover, and on whether it has failed to make important repayments or payments of interest, the state of its balance sheet, its borrowing history, etc.[140] Firms in the unit are kept under close supervision, and might either recover and be sent back to the bank branch, or close their account and take their business elsewhere, or come to be regarded as beyond (informal) rescue and consigned to another of the bank's units (the 'debt recovery unit') and then perhaps to a formal insolvency procedure.[141]

An important test conducted by Franks-Sussman on the data obtained from one of the banks was aimed at discovering the relationship between interest rate spreads and the characteristics of firms as they entered the bank's rescue unit.[142] Their regression analysis treated the interest rate spread charged by the bank as the dependent variable. The independent variables included the total debt of the firm, the length of the banking relationship, whether the firm had previously suffered financial distress, whether the bank had secured personal guarantees (mostly) from the firm's shareholder-managers, the ratio of bank to total debt and of profit to turnover, whether the firm was publicly quoted, and of course the ratio of security value to bank debt. Two of these are particularly relevant for the point at issue. First, the relationship between the ratio of security value to bank debt on the one hand and the interest charged on the loan on the other, while being an inverse one, was the second *least* significant (approximately) of all those tested.

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[138] *Cycle*; the Working Group was set up jointly by the Department of Trade and Industry and the Treasury. See also the revised version of the paper, "Resolving financial distress by way of a contract: An empirical study of small UK companies" (22 October, 2000), available at URL: www.ifk-cfs.de/papers/franks.pdf

[139] *Cycle*, p. 4, and "Resolving", p. 12.

[140] *Cycle, p.* 6.

[141] *Cycle, p.* 5.

[142] There is some reason to be cautious about how far this data can sustain generalisations, given the noticeable "diversity in lending strategies within English banking" also discovered by the authors; see "Resolving", p. 28. The following analysis should therefore be read as based on the best and most current data now available, but (needless to say) always subject to revision as the results of any more extensive investigations become known. Of course this point cuts both ways, so that the generality of the predictions of the anti-security Hypotheses must also be treated with at least as much caution.

In other words, how much of the bank's debt was secured was only marginally related to the interest charged on the loan, *if it was related at all*.[143] Changes in the interest rate were to be explained overwhelmingly by factors other than the proportion of bank debt secured. And second, there was a "highly significant" *direct* relationship (perhaps the second strongest of all the factors considered) between whether the bank had been given personal guarantees for some part of its loan, and the interest it charged on it.[144] The greater the likelihood that a guarantee had been given, the higher the interest charged.

This has dramatic implications for the Inefficiency – and equally, the Exploitation – Hypotheses. For this data at least, it simply is not the case that a debtor can mechanically obtain a reduction in its interest bill by offering security. This should be read together with Franks-Sussman's finding that bank debt was "almost universally secured" through a combination of fixed and floating charges.[145] It does not, then, seem to be a matter of choice for the debtor to *bargain* with its main bank, offering security in return for a lower interest rate.[146] Security *will* be extracted as a matter of course from companies likely to end up in the bank's rescue unit (and therefore those most relevant to the two Hypotheses),[147] and it may *not* lead to any noticeable reduction in interest charges. For such companies, and consistent with the analysis above, the difference between offering security and not offering it does not appear to be that between

[143] The reader would note as crucial the emphasised part of this statement. The relevant t-statistics in *Cycle*, p. 22, Table 11, indicate that there is no statistically significant reason to reject the hypothesis that the regression co-efficients are zero, or in other words, to reject the statement that 'there is no particular relationship, direct or indirect, between the proportion of bank debt secured, and interest rates'. Put very simply, we cannot say, in a statistically meaningful way, that offering security leads to a reduction (or indeed an increase) in interest rates. Compare the findings of the UK Competition Commission, which was told by the main 'clearing groups' of UK banks that one of the eight factors affecting the level of margin was security: "Secured loans *generally* have lower rates.
margins than unsecured ones" (emphasis added); see *The Supply of Banking Services by Clearing Banks to SME's* (HMSO, March 2002), paras. 4.151-4.160. Evidence from both sources is consistent with the combined effect of the agency cost reduction effect (often leading to lower rates, and also explaining the negative sign for this variable in the Franks-Sussman study) and the adverse selection/moral hazard avoidance effect (meaning rates are not *always* lower, especially for firms in distress).

[144] *Cycle*, pp. 21-2, including Table 11. Very importantly, "many of these guarantees will involve directors' personal property"; see "Resolving", p. 15.

[145] "Resolving", p. 14, and *Cycle*, p. 9, Table 4.

[146] Milman and Mond, *Security*, p. 37, have rightly noted that "banks tend to offer little choice over matters of security."

[147] In other words, security (including directors' guarantees, discussed below) is demanded on the basis of a 'pre-loan' appreciation of the loan's riskiness; for the suggestion that this is the very time at which to ask questions about why security is taken, see Mann, "Explaining", p. 637. For symmetry, it can be added that firms (of the appropriate size) are consigned to the banks' 'rescue units' in response to what happens *during* the currency of the loan. This is of course a rough distinction, so that, e.g., security might be taken half way through the duration of the loan because of circumstances which only then become apparent to the lender.

borrowing at lower or higher rates, but more likely that between borrowing and not being able to borrow at all.[148] As explained above, both the Inefficiency and the Exploitation Hypotheses are heavily dependent on the contrary assumption to explain *why* security is asked for and offered. Both must therefore be considered weakened.

That is not all. Suppose we take the interest charged on the bank loan to be related to the bank's assessment of the borrower's riskiness.[149] The discussion above indicates taking security over the latter's assets is by no means the most discriminating way in which the bank responds to this risk (since security is taken anyway from this type of firm, and since the extent to which it covers the loan is not strongly associated with the interest rate). In fact, a more focused method of dealing with risk seems to be to extract a personal guarantee from the firm's shareholder-managers. Only this explains the "highly significant" relationship between the incidence of such guarantees and the rates of interest. The riskier a firm is perceived to be, the higher the interest it is charged (of course subject to the limits set by the adverse selection and moral hazard problems), *and* the more likely its directors are to be required to provide personal guarantees.[150] The finding that the incidence of directors' guarantees seems remarkably more discriminating than that of security over the firm's assets[151] also strongly supports the view that, *amongst* the firms likely to end up in its rescue unit, this is the method the bank uses to separate the riskier from the less risky borrower.[152]

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[148] This has implications quite crucial to the debate about secured credit; see Section 7, below.

[149] This is a very plausible assumption; see e.g. Franks-Sussman, "Resolving", p. 23. Other factors will of course be relevant here as well, perhaps including the competitiveness of a particular market for bank loans; for mixed evidence in support of the relevance of this factor, see Don Cruikshank, *Competition in UK Banking* (HMSO, 2000), pp. 153-4, including fns. 7 and 8.

[150] So here (as, with great respect, on so many other occasions), Goode seems to have been right after all when he observed (well before the Franks-Sussman study), in *Insolvency*, p. 41, that "It is assumed as an article of faith that a creditor taking security will charge a lower rate of interest than one who lends on an unsecured basis… But this is simply not how lending works. Banks charge what they consider the market will bear. A bank does not quote a lower rate of interest *because* it is secured; it takes security because of a perceived risk of non-payment and may charge a *higher* rate because of the risk. Similarly, the mere fact that a loan is unsecured does not necessarily mean that the bank will charge a higher rate" (emphasis in the original, footnote omitted). We now know of course that security is taken as the risk on the loan rises (and higher interest rates would cause adverse selection and moral hazard). For especially risky firms, the interest rate very clearly goes up, and guarantees are demanded from the firm's directors.

[151] Contrast the respective figures in *Cycle*, p. 9 Table 4.

[152] Hudson, a leading critics of security in this jurisdiction, has suggested that many (not all) the problems he had identified in the institution of security would be avoided if security were taken – not over the "inside" assets of the firm – but over assets belonging to the firm's shareholder-managers; this would also retain most of the benefits he thought might be associated with "inside" security; see "Case", pp. 59-60. These arguments were of course made before the Franks-Sussman study. It is intriguing to speculate how he might wish to modify them in view of this 'fused' system.

We should think again about the two Hypotheses we are testing. Both assert that security is offered because the debtor (and here this must mean its shareholder-managers) wishes to sell off the insolvency share of involuntary, uninformed, or non-adjusting creditors (more accurately put, only when this happens do the criticisms implied by the two Hypotheses kick in). So **(a)** the reward they receive in all cases is the reduction in interest rates, and, **(b)** their *insolvency* costs are unaffected. We can see however that both limbs of this type of argument are wrong. As the riskiness of the firm's activities increases, **(a)** the interest charged to the firm may go *up*, and **(b)** the manager-shareholders' private (insolvency-linked) expected costs also *increase*.[153] This evidence shows that regardless of the existence of security, operating riskily and aiming at a strategic liquidation becomes increasingly unattractive, and any incentive to create tortious harm (in the expectation that it could later painlessly be defeated through insolvency) diminishes even further. The Exploitation Hypothesis is therefore deprived of any vestigial plausibility. And there remain neither incentive nor scope for debtors to sell the insolvency share of non-adjusting creditors to a secured creditor in order to pocket the interest payment savings (any such savings being negligible). So the Inefficiency Hypothesis too starts to crumble.

It was noted above that two of the independent variables studied in Franks-Sussman's regression analysis had implications for our discussion. Well, there is also a third one. This concerns the relationship between interest rates and the ratio of bank debt to total debt. Let us think about what we should expect this to be, if the lines of argument we have been considering (derived from the two Hypotheses) led to truth. The way the rate reduction assumption is made implies that the borrower has two options. It can either operate sensibly, not increase the risk of default faced by its creditors, take reasonable precautions to prevent tortious harm, and enjoy a relatively low interest rate on the unsecured loan from its main bank. Alternatively, it can engage in risky activities which increase the variance of its returns and thus its shareholder value, but also simultaneously its chances of facing an insolvent liquidation. It can save money by not taking sufficient precautions against potential tort liability. But it can then issue security to its bank and thus continue to enjoy the same (or in any case, not significantly higher) rates on the loans made to it by the latter. The bank's pricing decision is very simple. In the first scenario, the

[153] Since their personal assets are threatened if their firm becomes insolvent. Their expected costs from these guarantees are a function of, among other things, the product of the probabilities of (i) there being an insolvent liquidation, and (ii) in this case, the collateral being insufficient to meet the firm's liability to the secured creditors. What is more, these costs will loom even larger in the insolvent.

bank anticipates a low probability of default on its loan, and a small pool of other claims with equal priority with its own, and thus charges a low interest rate. In the second, it anticipates a higher probability of default, a large number of other claims, but still the same expected recovery on its loan because of the priority it now has. So it charges more or less the same low interest rate. The number of other claimants simply does not matter to it, as long as it has priority over all of their claims. This is how the rate reduction assumption operates in the two Hypotheses. In view of this, and given the near-universality of security in the Franks-Sussman data set, we should expect no significant relationship between interest rates and the proportion of bank to total debt.

A different prediction emerges from the two Hypotheses for debtors which were more obviously and seriously in trouble before eventually being liquidated insolvent. Here, the secured creditor (in practice, the bank) would have a higher expected rate of recovery in the debtor's insolvency if it had available to it a 'cushion' of value provided by other creditors. This is the bankruptcy value supposedly sold to it through the use of priority by the debtor. The latter is rewarded with lower interest rates. The bigger the cushion, the greater the protection accorded to the secured creditor. It follows that the bigger the cushion, the lower the interest rates charged by it.[154] Now the size of this cushion is inversely represented by the ratio of bank to total debt. The smaller the proportion of total debt that is owed to the bank, the greater is the protection available to it. This is because the debt owed to the priority-holding bank is more likely to be repaid (and repaid in full), the greater the proportion of the debtor's estate derived from value provided by the other, subordinate, creditors. And on the views being explored, it is precisely because the secured creditor expects to be able to appropriate (some of) this value that it would reduce its interest charges. On the strength of the two Hypotheses, then, and to the extent that this contingency could be reflected in interest rates, we should expect a direct relationship here: the smaller the ratio of bank to total debt, the lower the interest charged by the bank. And since this mechanism is supposed to explain much (Exploitation) or at least the objectionable bit (Inefficiency) of the ubiquity of security, this relationship should be fairly significant. So if the Hypotheses have *any* validity, the relationship between the ratio of bank to total debt and interest

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shareholder-managers' eyes than this suggests, since (ii) might be hard to measure from time to time (given the difficulty, e.g., of ascertaining the value of the charged assets and undertaking), so that (i) is likely to be used as a proxy instead.

[154] At least until the point where the secured creditor's risk diminishes to a level where the cost to it of offering lower interest rates outweighs the benefits to it of further risk reductions.

rates should either be direct and significant (as explained in this paragraph), or simply insignificant (as the previous paragraph explains).

Franks-Sussman's findings for this variable were indeed "highly significant" (one of the strongest of all the relationships tested). They were also exactly the reverse of what the anti-security Hypotheses would have us expect! In other words, the *greater* the proportion of total debt that was owed to the bank, and therefore the smaller the cushion of value provided by other creditors (and thus available for appropriation to the bank), the *lower* was the interest rate charged on its loan by the bank.[155] To the extent that the implications of these findings can be generalised, then, secured creditors very clearly do not display predatory intentions towards value contributed by other creditors, at least in the pricing of their loans, Nor, it therefore follows, do they create an incentive for the debtor to 'sweep in' significant amounts of this value in order to sell it to the secured creditor in return for lower interest rates. In fact, as we have just seen, secured creditors seem positively to *discourage* debtors from borrowing too much from other creditors by unambiguously charging them higher interest rates, the greater the proportional value derived from other creditors. This surely leaves little room for doubt. It is submitted this – in addition to all the other evidence discussed in this Chapter – proves that arguments meant to explain the prevalence of secured credit, but based on debtor-secured creditor coalitions extracting "subsidies" from an assortment of involuntary, uninformed, "ill-equipped", and non-adjusting creditors, all just do not hold water.[156] Therefore, very simply, they cannot be used to base suggestions for 'improvements' to the institution of secured credit.[157]

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[155] At pp. 21-2, including Table 11.

[156] Several such arguments are made in the English context by, e.g., Finch, "Security", pp. 644-6.

[157] Even in the US context, where the analysis so far in this Section may or may not apply, Bebchuk-Fried's proposals to restrict the priority of secured credit, based on the arguments discussed here, have not been entirely persuasive. "[H]aving received hardly any support among members of the task force [on bankruptcy issues, comprised largely of bankruptcy specialists, appointed to assist the Drafting Committee to Revised Uniform Commercial Code Article 9] and no support whatsoever from anyone who ever attended a meeting of the Drafting Committee, these proposals were rejected. The proposals were advocated also before the Council of the [American Law Institute] and at a [National Conference of Commissioners on Uniform State Laws] Annual Meeting, where they met with almost unanimous disapproval"; Harris and Mooney, "Revision of UCC Article 9", p. 1359 including fn. 6. Decision-makers and scholars in this jurisdiction surely should not rush to embrace arguments based on a very different legal system, when those arguments have received such a frosty reception in the very jurisdiction where they originated.

b. Monitoring inefficiencies?

A similar rebuttal applies to Bebchuk-Fried's argument that the full priority of secured claims leads to a distortion of the creditor's choice between lending on a secured basis, and demanding (and enforcing) non-security loan covenants. Such covenants are supposed to create an "external" benefit from the point of view of the enforcing creditor: in some circumstances, they might control debtor misbehaviour more effectively, thus increasing the total bankruptcy value for all its creditors. In the debtor's insolvency, this value would of course be shared *pro rata* with other creditors put in the same class by insolvency law. If security is used instead, the reduction in the total costs of debtor misbehaviour would be smaller, but the proportion of that captured by the now-secured creditor a lot larger. So the interest rate reduction it offers in return for secured status rather than rateable distribution is larger than the increased interest charges of any adjusting creditors. This is because the remaining loss in insolvency value is of course borne by non-adjusters. The secured creditor also has less incentive to enforce properly the covenants it has persuaded the debtor to offer, since it derives part of its protection from risk from its priority position. This causes a reduction in the collective (and from the secured creditor's perspective, partially external) benefit derived from an efficient level of control of debtor misbehaviour.[158]

It is submitted that this argument fails, partly because, again, the easy relationship it posits between security and interest rates does not hold. Let us look at it first from the *creditor's* perspective. If it is the case (as assumed above) that the rate of interest charged on a loan is related to its riskiness, then the figures suggest security over the firm's assets is taken almost as a matter of course from firms with a certain risk profile (and thus with a higher probability of ending up in the banks' 'rescue unit') and not in response to any *particular* (debtor specific) risk. So in order to protect itself, and depending on its assessment of the probability of default of a particular debtor, and of its likely causes (especially management-related ones), the secured creditor would still have to set in place mechanisms more accurately responsive to the level of risk. It was suggested above that personal guarantees from the debtor's shareholder-managers appear to be the chosen solution.[159] It is argued now that these would likely be contained in

[158] This, it is hoped, is a workable composite of the arguments made separately in "Uneasy case", pp. 897-8 and 900-3. Several such arguments are also found in Finch, "Security", pp. 649-50, and it is respectfully suggested, are subject to the same criticisms.

[159] Interest rates also go up, as already noted; additional evidence for this comes from the survey results reported in Armour and Frisby, "Receivership", text accompanying fn. 134.

debentures side-by-side with covenants (perhaps including from the guarantors) aimed at curbing debtor misbehaviour.[160]

It is important to understand why the secured creditor would still wish to employ and "enforce" covenants. If, as suggested above, the creditor must still respond more discriminatively to risk despite the (near universal) existence of security in order to increase the expected return on its loan, this is more effectively accomplished by indicating to debtors what would be regarded as risk-enhancing misbehaviour. In practice, this is done not by spelling out what debtors should not do, but by setting 'alarms' which are likely to be triggered in the event that such misbehaviour takes place. Such alarms are set, through the use of covenants in the debenture, by defining 'default' to have occurred e.g. if the firm does not make interest payments on time, does not present accounts for inspection, allows its profitability or turnover to fall below a particular level, loses an important counter-party, etc.[161]Particularly in loans secured with a fixed charge, one would expect covenants requiring that the value of the secured assets, or the income from them, or both, not fall below a certain multiple of the debt secured. So covenants tell debtors what they should avoid, and non-compliance with them tells creditors things are amiss. Appropriate steps might then be taken, perhaps including putting the debtor under closer supervision in a 'rescue unit'. Simply extracting personal guarantees (or other security) is not a substitute for this *bi-directional*, *informational* role of covenants even from the secured creditor's perspective.[162] Unsurprisingly, this analysis is strongly supported by the UK evidence.[163]

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[160] For an example of the sort of arrangement where some form of security exists as an addition to contractual monitoring arrangements, see *Official Receiver and Hickling v Dhiren Doshi* (1.3.2001, Transcript available on Westlaw, 2001 WL 172017), para. 22: here, a factoring agreement contained guarantees from the debtor company and from its directors, extensive contractual rights of set-off, and, *inter alia*, the right to examine the debtor's monthly management accounts. The last seems to have been exercised vigorously (*ibid*.), but, in the event, impotently, given the defendant's "mendacity[,] breathtaking in its audacity and remarkable for its fluency"; *ibid*., para. 19. Further, see below.

[161] *Official Receiver v Doshi* once again provides an interesting illustration; see the discussion of the "trigger figure" in paras. 24 and 86: the trigger figure was the contractually specified length of time within which the debtor was required to make recoveries of what it was owed by its customers. As the Court noted, "Any evidence of difficulty in recovering [from the customers] would necessarily case doubt on the inherent viability of the [debtor's] business. That is one reason why the monitoring of debt turn [accomplished using stipulation of the trigger figure] was such an important control" for the creditor.

[162] In fact, it makes compliance with them more likely; see the argument which follows shortly. See also Franks-Sussman, "Resolving", p. 24, for discussion of the problem of "lazy banking" allegedly caused by excessive reliance on security.

Further and importantly, Bebchuk-Fried's argument would have the *debtor* itself preferring to offer security rather than accepting imposition upon it of loan covenants. This is because (on their assumptions) the bank would face lower costs in relying on its security-based priority to deal with risk rather than monitoring compliance with the covenants to minimise debtor misbehaviour.[164] And it would offer to pass some of these savings on to the debtor (to the benefit of the latter's shareholders). We can now see why this argument also misrepresents the debtor's perspective. We know the debtor is either going to get a rate reduction *precisely* by giving up some of the ability to misbehave which the covenants are meant to control, or will not benefit from appreciably reduced interest charges at all. So it has no reason to prefer security to covenants. In any case, it is unlikely to be faced with that choice in the first place, security being extracted from it regardless as long as it fits a particular risk profile.

Finally on this point (and as already noted), the dichotomy between security without loan covenants, and loan covenants without security suggested by this argument (even if only on the margins) is itself somewhat misleading. There are strong theoretical reasons for thinking the existence of security, far from substituting for loan covenants or for their proper enforcement, actually enhances their effectiveness. One way in which this happens stems from the fact that debtor misbehaviour of certain types is 'observable' but not 'verifiable'. In other words, the creditor can see it when it occurs, but cannot prove this cost-effectively in court. The existence of security enables the creditor to threaten severe harm to the debtor (by seizing the collateral and disrupting the debtor's business), should such misbehaviour occur, without having to prove this in court. This leverage encourages the debtor more scrupulously to comply with loan covenants prohibiting such behaviour by making the latter "self-enforcing".[165] While this ability to threaten harm is not always directly related to the *priority* of secured credit, it is argued here this priority makes the threat more credible by eliminating potential conflicts concerning the method of realisation and distribution of the proceeds, thereby reducing its costs to the security holder. There is also some qualitative evidence from the US that creditors regard security as important (*inter alia*) precisely because it renders loan covenants more effective.[166]

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[163] See e.g. David Citron, "The incidence of accounting-based covenants in UK public debt contracts: An empirical analysis" (1995) 25 Accounting and Business Research 139, especially 144-5.
[164] Why else would the bank rely on its security instead of enforcing covenants properly? This point is derived from, e.g. Bebchuk-Fried, "Uneasy case", p. 902.
[165] Scott, "Truth", p. 1451, including fns. 30-2.
[166] See e.g. Mann, "Pattern", pp. 649-655.

Related to these arguments about the effect of security on the incentives of the secured creditor to investigate and monitor debtor activity are others made (or sometimes reported) by Finch.[167] One dominant general theme seems to run through them all and could fruitfully be examined. Against the suggestion that monitoring by secured creditors might be socially efficient, Finch mentions the possibility that monitoring might be intrusive enough unduly to interfere with management decision-making, and therefore might actually harm the debtor.[168] In addition, the secured creditor will not be interested in improving the profitability of the debtor, since it is concerned only with its own fixed return. Such a creditor (notably, a bank) might lend to numerous debtors and have no incentive to monitor any one of them effectively, and in any case, lending institutions may not have any expertise or specialised trade knowledge properly to assess managerial performance. Creditors might also count as a reason against monitoring the fact that factors other than mismanagement might lead to corporate distress. They might take security precisely in order to protect themselves against such a contingency, rather than as an aid in monitoring. And in any case, even if there is effective monitoring by one creditor, conflicts of interest between different creditors might mean there is no collective benefit.[169]

It is submitted all of these arguments are based *solely* on the (quite correct) observation contained in the last point noted above, that different parties in the commercial world have different interests. What suits the secured creditor will not be exactly coterminous with the interests of other creditors, which in turn will not be identical with what is best for the debtor's shareholder-managers, and so on. This seemingly obvious point has far-reaching implications for Finch's arguments. The fact is that *no matter who* is selected to monitor the debtor, there will inevitably be some conflicts of interest between them, the debtor, and others interested in the debtor's undertaking. So merely to point out that this is true of the secured creditor, as Finch does, is not to distinguish the secured creditor from *any* other party to which monitoring responsibilities might be entrusted. To see what this means, let us assume the secured creditor is not interested in the size of the debtor's profits since it cares only about its fixed returns. This is supposed to have implications for its monitoring incentives. But then, apart from its shareholders, few parties care specifically about the debtor's profits, and if required to monitor, would be faced with the same incentive 'distortions'. Suppose monitoring does wastefully interfere with management. If so, this remains the case regardless of who monitors. Let us assume banks might

[167] "Security", pp. 649-51.
[168] "Security", p. 650 fn. 105.

not have the expertise to judge good from bad management.[170] But if even repeat players like them (with economies of scale in information gathering and accumulated expertise) do not, then no other interested party is likely to either. It also follows that, if they do not have that expertise, then their disinclination to monitor any individual debtor is not a cause for concern. Further, others who would be more likely to monitor since they do not lend to multiple debtors could not have any greater skill than these repeat players at telling apart good from bad management. Let us grant that the realisation that financial distress can be caused by factors other than mismanagement is a reason not to monitor. But then it is equally a reason for all those who reach the same realisation, whether they have security or not. And so on.

The point of this argument is the following. Simply noting divergences of interest between the secured creditor and other concerned parties does not constitute any argument about the efficiency of secured credit, since one could equally pick any other party and point out how its interests diverged from the rest.[171] What is required is a comparison of the extent to which the interests of secured creditors diverge from (whatever is taken to be) ‘the common interest’, with the extent to which other parties’ interests diverge from the same ‘common’ interest.[172] In parallel with that, monitoring will *always* have costs as well as benefits, no matter who carries it out, and these must be compared. To make an argument against the efficiency of monitoring by secured creditors in particular, one would have to find reason to suggest that monitoring was cost-effective all things considered, and further, that it could be carried out at less ‘common’ cost by some party other than secured creditors. Those arguing in favour of the monitoring-based efficiencies of security are saying precisely that the collective benefits of outside monitoring outweigh its costs (not that there are no costs), and that the secured creditor’s ability to carry it

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[169] *Ibid*., pp. 649-51.

[170] Even though the assumptions in this passage are made only for the sake of argument, it has to be said this one is particularly implausible, given the elaborate (and efficacious) mechanisms found to exist in each of the three banks Franks-Sussman collected data from, all meant to provide supervision and support to firms in distress; see e.g. “Resolving”, pp. 11-2, 17, 21, etc. Banks also seem to be very good at deciding when a replacement of management would improve a distressed firm’s chances of recovery, which again contradicts this assumption; see the important findings, *ibid*., pp. 24-5.

[171] This applies equally to trade creditors, employees of the debtor, state agencies, etc.

[172] The only time Finch seems to compare the *relative* monitoring abilities of secured creditors and another party is her comment, in “Security”, p. 650, that “it is rash to assume that those in possession of security are well-positioned to monitor management behaviour. There may, indeed, be circumstances in which unsecured, but well-informed, trade creditors may be better placed to monitor” (footnote omitted). Whatever these circumstances might be, their existence is not supported by the data collected by Franks-Sussman; e.g. see “Resolving”, pp. 21-2 (“trade creditors may possess less information than the bank”) and p. 26 (none of the formal insolvency procedures for the 109 firms in one data sub-set was initiated by trade creditors).

out better than other interested parties provides a reason to consider secured credit efficient. Those disputing these propositions would also have to address the argument on these terms. However, some of Finch's arguments seem to suggest monitoring might not be value-enhancing regardless of who carries it out, others that entrusting this responsibility to security holders leads to greater costs than would be the case if the latter's interests were identical with those of all other parties. With great respect, it seems to this author that as criticisms of *security*, in a world where secured creditors are *not alone* in having interests which diverge from the 'collective' ones, they all miss their mark.

6. Informal 'rescues', trade creditors and the bank's share

In the arguments in the previous Section, considerable reliance has been placed on certain of the findings of the recent Franks-Sussman study. As argued above, the study goes a long way to disproving crucial assumptions underlying the most important existing attacks on the priority of secured credit, as well as some of the predictions that can be derived from them. But the same study also highlights an aspect of the way banks operate in this jurisdiction that might be thought to provide new ammunition to critics of security. This is what this Section considers.

As already noted, Franks-Sussman discovered an extensive and elaborate process of 'intensive care' operated by all three of the banks they studied for firms that were taken to be heading for trouble. Firms were consigned to these 'central rescue units' based on the bank's own criteria, and subject to considerable discretion in credit officers at individual branches. They remained there for an average of seven and a half months.[173] There could be one of three outcomes of this process. The firm might be 'turned around' (rescued) and returned to its bank branch. Or it could be sent to a 'debt recovery unit' for the initiation of a formal insolvency procedure. Or finally, it could repay all its loans to the bank, terminate the banking relationship, and presumably re-bank elsewhere.

The discovery which interests us now is that, while in the 'rescue unit' and subject to close supervision by specialised bank officials, the troubled companies paid off, on average, between 30-40% of their bank debt. At the same time, the debt owed to trade creditors *increased* by between 10-30%.[174] This was the case overall, both for firms which were eventually rescued and 'returned to branch', and those which were sent to the 'debt recovery unit' for formal insolvency

[173] "Resolving", p. 11.

proceedings. The picture was quite similar if the latter were considered in isolation. For one of the banks, Franks-Sussman found that "the bank never extends further loans to a company that is placed eventually in bankruptcy… although the trade creditors do so quite often."[175] On average for this bank, bank credit shrank by almost 14% and trade credit grew by over 11% while the company was in the 'rescue unit'. Given that in the insolvency proceedings that followed for these companies, the bank would have priority over trade creditors, this amounted to "almost a direct transfer from the trade creditors to the bank." This despite the fact that, as the authors noted, "trade creditors are typically small, undiversified, and highly exposed to the risk of default. Unlike the bank, they have no comparative advantage in bearing these risks."[176]

It would not be surprising if some critics of security seized upon these results as proof, at last, for one or other of the anti-security Hypotheses. Surely security is being used, very simply, to siphon away value from trade creditors? The temptation to use these figures to paint -- with a broad brush -- a picture of exploitation on part of secured creditors might well be strong. It is submitted this temptation is best resisted if the aim is instead to acquire an *accurate* picture of these figures. The first point to note is the obvious one that the movement of funds from trade creditors to the company in the rescue unit, and from it to the bank, as depicted in the previous paragraph, is based on *averages* across the client firms of this particular bank. This is significant here because these averages hide what in fact are the "great variations in the record of debt repayments" to trade creditors and the bank during the time the firm was under bank supervision. This is obvious, for example, from a comparison of firms arranged with reference to the amount of debt outstanding at the time of entry into the 'rescue unit'. For companies in the bottom quartile, 58.7% of bank debt was indeed repaid on average. However, this figure decreases to 18.2% for those in the next quartile up. For companies in the top quartile, bank debt actually *increased* by 29.1% while the firms were under close scrutiny by bank officials.[177] So the first conclusion to be drawn is that security is not accurately regarded as merely a mechanism for appropriating value provided to the troubled firm by trade creditors. In fact, as noted, there are very significant differences in bank strategy in dealing with firms of different sizes.[178] For larger

[174] "Resolving", pp. 20-1, and Table 4.
[175] "Resolving", p. 21 and Table 5.
[176] *Cycle*, p. 19 Table 10, pp. 18 and 16.
[177] *Cycle*, pp. 10-1, including Table 6 Panel B.
[178] Recall that Franks-Sussman use the amount of total debt outstanding as a proxy for firm size; see *Cycle*, p. 21.

firms, the (security-holding) bank actually injects additional value into the firm, which amounts on average to a third of what it was originally owed.

Next, we should note that there is a fairly straight-forward correlation between the repayment of the troubled firm's bank debt, and the sale of assets by the firm itself. Almost half the firms in the 'rescue unit' reported "significant asset sales in the rescue process". In interpreting this data, it is important to keep in mind both the priority-based nature of security, and the fact that the 'absolute priority rule' (which requires senior creditors to be paid off before junior claimants get anything) is quite firmly entrenched in this jurisdiction. Given these factors, the finding that the firms which sold off assets usually applied most of the proceeds to pay off their bank debt should come as no surprise.[179] If any assets become available during the rescue process, the bank as senior claimant obviously has the first right to them. The important thing to note here is that this is merely a manifestation of the nature of security. It is not, by itself, evidence that security is exploitative. Critics of the priority of secured lending have to say something more than that secured creditors have priority! The data so far mentioned supports only the latter proposition. It also shows once again that the relationship between value provided by trade creditors and that withdrawn by the security holder is not as clear-cut as the average figures mentioned above misleadingly suggest. Much of the repayment of bank debt (though certainly not all) can be attributed to the sale of assets, rather than to the appropriation of value injected by trade creditors.

The obvious question then is: why the apparent beneficence towards larger distressed companies, and in turn towards their trade creditors, as noted above? Further analysis carried out by Franks-Sussman provides an interesting insight. A "striking explanation" for the differences in repayment of bank debt is "the incidence of managerial turnover". The data shows that firms which owed the bank more (and were thus presumably larger) were more likely to replace an important member of the managerial team. For such firms, the bank contracted its debt by a mere 1.2%. Smaller firms changed their management much more rarely, and the bank contracted its debt to them to a far greater degree, at 28.3%.[180] This is consistent with the point made in Section 3 above, that managers of smaller firms, who also own most of the equity in it, would have huge undiversified pecuniary, and undiversifiable non-pecuniary, investments in the firm. It simply

[179] *Cycle*, pp. 10-1, including Table 6 Panel B.
[180] *Cycle*, p. 11, including Table 7.

does not make sense for them to let go of control of the firm, since the costs to them of doing so are great. They prefer to remain at the helm even when that increases the probability their firm would be unable to survive a particular crisis. This should be read together with the finding that the higher the probability that a manager would be replaced, very significantly greater is the chance that the firm would be successfully rescued, of course to the benefit of all including trade creditors.[181]

All this shows that any conclusion that the bank simply uses its security to appropriate value from trade creditors would be crude and inaccurate. In reality, the position seems to be that the bank employs the leverage provided to it by security "to encourage (or force) distressed firms to undergo restructuring, that includes downsizing and managerial replacement. [Both these factors appear] to be significantly [and inversely] related to the size of debt repayments demanded by bank". They are also significantly (and positively) related to the probability of a successful rescue.[182] All the concerned parties, including trade creditors, are much better off if their debtor recovers than if it is liquidated.[183] An overwhelming proportion of attempted rescues (around 75%) succeed without formal insolvency proceedings.[184] All this happens in the bank's 'rescue unit' under close supervision by its officials, and as noted, is made possible by the leverage provided to the bank through its priority position. The bank's officials of course monitor the firm in the unit and gather data about it, then use it to encourage the firm (in general, successfully) towards a turn-around. They use this same data, it seems, to ensure the debt owed to the bank is paid off first when the firm is not likely to recover, even while the less-informed trade creditors continue to pump value into the sinking firm.

This brings us back to the points made in the previous Section. One of the costs of the elaborate monitoring done by the banks of the distressed firm is the chance that if the firm does not recover, the bank would be paid even at the expense of the firm's trade creditors. But it should be emphasised this by itself is *not* an argument against either the efficiency or indeed the fairness of the priority of security, since no one, to this author's knowledge, has suggested that

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[181] *Cycle*, p. 23 including Table 23.
[182] *Cycle*, pp. 24 and 23.
[183] For arguments in support, see below, and also Schwarcz, "Easy case"; for data, see Franks-Sussman, *Cycle*, e.g. p. 18.
[184] *Cycle*, pp. 2 and 24; "Resolving", pp. 4 and 30, etc. This, as well as the incidence of 'going concern' sales in receivership, compares very favourably with more 'pro-debtor' regimes like the US; see

outside monitoring of distressed firms does not have costs. The point is that this same monitoring also seems to bring the great benefit to all, including trade creditors, of a very significant chance of successful rescue of the debtor. To make an argument against security, then, one would have to conclude either (or both) of two things. First, one would have to show that the removal or reduction of the priority of secured lending would not impede the secured creditor's ability to *monitor* and *influence* the debtor. Alternatively, it would have to be demonstrated that the benefit of an increased chance of successful rescue associated with this monitoring is outweighed nevertheless by whatever harm results from it in case of that minority of firms for which this monitoring does not lead to rescue.[185] Till such an argument is made (and made successfully), it is submitted the Franks-Sussman study cannot be used in support of either of the anti-security Hypotheses. This suggestion is reinforced by the important fact that, as discussed above, the study shows secured creditors (in particular, the very bank whose strategy is discussed in this sub-Section) seem to price their debt in a way which very clearly belies both the assumptions and the predictions of them both.

But do we have to leave this debate in this rather inconclusive state? Must we wait till data is available to decide the questions just posed, before answering the question of whether the priority of secured credit is desirable, all things considered? Fortunately, we can do somewhat better.

7. Beginning the affirmative case for the priority of secured lending

The burden of the argument so far has mostly been to show what security does *not* do. It has been argued it does not facilitate the exploitation of involuntary or 'uninformed' creditors. Nor does it create inefficiency through its ability to transfer insolvency value from 'non-adjusting' to secured creditors and debtors. It would be natural at this point to ask what its role really is. *That* debate seems interminable, as is obvious from the partial list of relevant citations given above in a lengthy footnote in Section 1. The issue will not of course be settled in this Chapter. Be that as it may, this Section takes the argument further, utilising the evidence from this jurisdiction to

"Resolving", p. 31. Interestingly, only in Sweden -- which also has a floating charge -- is the rate of 'going concern' sales higher; see *Cycle*, p. 3 and "Resolving", p. 31.

[185] And for this to be a *fairness*-based test, both the benefit of an increased *chance* of rescue, and any additional expected harm resulting from the secured creditor's hold over the firm, would have to be measured from an appropriate perspective. It has been suggested in previous Chapters that this perspective is best captured by the choice position of the Authentic Consent Model; see esp. Ch. III, above.

suggest the priority of secured credit, by reducing the probability of the debtor's insolvency in the first place, is likely in general to be universally value-enhancing. That priority would therefore be acceptable to all the parties negotiating in Dramatic Ignorance in the choice position of the ACM, and thus part of any rational scheme of fair co-operation amongst equals in the corporate realm.

The argument, in outline, is the following. Companies borrow on a secured basis in two situations. There are, first, those which *could* borrow without offering security. These companies have strong incentives *not* to offer security. They will pledge collateral only when this significantly reduces their risk of insolvency. Other companies are faced with the choice between either offering security, or not being able to borrow at all. This being the case, security is almost always offered for 'new money'. For such companies, this new money means the difference between solvency and insolvency. All creditors, including preferential, trade, and any 'involuntary' creditors, are far better off if their company survives, than if it is liquidated insolvent. It follows that secured credit, by improving the probability of the debtor's survival, is value-enhancing from their perspective in both situations.[186]

In the first situation, then, we should begin by noting that companies in a position to borrow on an unsecured basis have very strong incentives not to borrow secured. Evidence (from this jurisdiction and the US) that the strongest companies very rarely (if ever) borrow on a secured basis has already been mentioned in Section 3(a) above.[187] As noted there, this fact is universally acknowledged, including by the leading critics of security. Nor is this some unexplained empirical anomaly. We have strong theoretical reasons for supposing firms would rather borrow unsecured than secured. We can understand these by first asking why firms issue secured debt. The only reason routinely mentioned is that it would allow them to benefit from reduced interest rates. But on this basis, the healthiest firms have little incentive to issue secured debt. This is because the reduction in interest rates that security supposedly brings is said to be

[186] This argument is adapted from Schwarcz's compelling analysis in the US context; see "Easy case".
[187] In the case of such companies, security would be offered only for non-recourse loans, where the lender's rights of recovery are limited to the proceeds from the asset or project being financed. It is obvious that here, the overall credit-worthiness of the borrower matters much less than the riskiness of the project itself. So when applied in this context, the arguments which follow should be interpreted as referring to the viability of the particular project being funded thus, not to the overall viability of the firm.

overwhelmingly dependent on the probability of default on the loan.[188] Now, the healthier the firm, the less likely it is to default. It follows that the healthier the firm, the less appreciable will be the interest rate difference for it to borrow on a secured basis, and the smaller the incentive for it to do so.[189] Healthy firms would only borrow secured (rather than unsecured) in order to benefit from such differences if the benefit from doing so still outweighed the costs.

We should remember, though, that there *are* costs associated with secured debt, and that these can be substantial. Three of the most important categories of such costs are identified here. First, as emphasised above, the creditor with security has a far greater influence on debtor behaviour than the same creditor without, and it can demand more scrupulous compliance with loan covenants. The debtor's managers lose their freedom of action by issuing security, and with it, their ability to add to the variance of the firm's returns and thus to its shareholder value. Now there is of course a partial asymmetry in the way this loss is viewed by the debtor's shareholder-managers, and by all others interested in the debtor's undertaking. It has been noted time and again that controlling these agency costs is value-enhancing for the latter, because lowering the variance of the firm's returns also lowers the chances that it will be rendered insolvent. However, the shareholder-mangers, who would capture the upside from the additional variance, would consider the security-holder's ability to prevent them doing so as a reason against granting security.

Second, firms would prefer to keep *unpledged* collateral at their disposal till they really are in financial distress. The reasons for this have also been touched upon above. Distressed firms find it harder to persuade creditors to lend, since the latter perceive the high risk of default. Given that degree of risk, even critics of security accept that "the interest rates necessary to compensate [lenders on an unsecured loan would be] far above customary and legal levels [more accurately, as already explained, above levels where the adverse selection and moral hazard problems associated with high rates become acute]. Creditors [would not then] charge higher rates; they [would simply] refuse to lend."[190] It follows that "existing firms with unpledged security are more likely to have access to external finance to help them trade through difficulties"

[188] See e.g. Finch, "Security", pp. 638-9: "The rational creditor will set the difference in rates after calculating the extra risk of non-repayment that a lack of security brings."
[189] Finch herself notes this at "Security", p. 639, but does not seize on the implications for her argument which are drawn out here.
[190] This comes from LoPucki himself, "Unsecured", p. 1935, fn. 181. This factor is of course crucial in the second of the two situations where security is deployed, and is further discussed below.

by *only then* offering their assets as collateral.[191]In addition, firms with growth possibilities would wish to keep free collateral in order to avoid the 'underinvestment' problem. They might find it difficult at a later date to finance a profitable project using outside funds, given that if insolvency then occurs, the returns from the new venture might go in part or fully to pay off pre-existing creditors. Being asked to subsidise these creditors in this way puts off potential new lenders from providing funds. The ability to attract new funding by offering later creditors a higher priority is one way of overcoming this problem.[192] In both the situations just mentioned, 'using up' collateral prematurely, when it was still possible to borrow unsecured, merely to enjoy any tiny (more likely, non-existent) interest rate benefits would make little sense, and certainly would not be a rational strategy.

Finally, and following from the observations above that strong companies do not often borrow on a secured basis and that any security-based interest rate differences are only going to be important for risky firms, encumbering most of one's assets could be a signal that creditors do not consider this debtor a safe enough risk to lend to it unsecured.[193] We have already considered evidence above that in this jurisdiction, when creditors' perception of the firm's riskiness increases, the interest rate charged on loans to it goes up, *and* the firm's shareholder-managers are often asked to provide personal guarantees. Other counter-parties might also seek to tighten up their terms, insisting for example on trading on a cash-on-delivery basis. Once again, then, pledging the firm's assets is unlikely to be taken lightly by its managers, since it brings disadvantages both for them and their firm.

For all these reasons, firms able to borrow unsecured will only offer security where there is a significant *ex ante* risk of managerial misbehaviour, and therefore a significant risk of insolvency. Only then would the existence of security lower the risk of insolvent liquidation sufficiently to cause the lender to offer a rate reduction on a secured loan large enough to outweigh these costs. The most obvious example of the sort of firm in this position would be one with large growth potential, whose managers might be perceived to have a greater incentive, once

[191] Bank of England, *Sixth Report*, p. 26, including fn. 32. See also Schwarcz, "Easy case", p. 450, including fn. 102 (explaining the parallel notion of 'financial slack', familiar in the finance literature).
[192] See the classic Myers, "The determinants of corporate borrowing" (1977) 5 J. Financial Economics 147. For a useful recent discussion in the bankruptcy context, see Triantis, "Financial slack policy and the laws of secured transactions" (2000) 29 J. Legal Studies 35.
[193] See Schwarcz, "Easy case", p. 446, including the references in fn. 93. This will of course not be the case in markets where security is ubiquitous.

the loan has been made, to engage in negative net present value projects. Managers could use security as a bond to obtain cheaper finance.[194]

Moving on to the second situation where security will be deployed, there is substantial evidence that for many of the companies borrowing secured, the choice is one between doing so and not being able to borrow at all, *not* that between borrowing unsecured on higher rates and secured on lower ones. The Bank of England has noted that “Ready access to finance when needed is often a more compelling consideration for small firms than its actual cost”, and that “the availability of debt finance to small firms is affected by the size and value of those assets which can be taken as collateral”.[195] A survey of its members by the Institute of Directors found that more than half of those “whose plea for finance had been dismissed by their bank attributed the bank’s decision to their lack of collateral”.[196] And we have already noted above that the Franks-Sussman study found that firms which eventually ended up in the banks’ ‘rescue units’ had almost universally borrowed on a secured basis. In view of the evidence discussed above, any suggestion *these* firms could have bargained with their bank to borrow unsecured by offering a higher interest rate would be simply incredible.

This analysis leads us to postulate that there will come a time when some companies wishing to gain credit will either have to offer their assets as collateral, or do without credit altogether. Not all firms will then offer security; some would prefer to find other ways of raising money (e.g. through equity injections), or would go without additional funds at that point.[197] So for firms which do end up borrowing on a secured basis, the choice they would have faced would

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[194] This is consistent with UK evidence; see Lasfer, “Debt structure”, pp. 15-6: “firms with high growth opportunities are likely to use leasing, [and] secured debt”, and that “growth opportunities are not financed with subordinated loans, [or] unsecured… debt”. Lafer also points out that larger firms, even if they have high growth potential, are less likely to offer security.

[195] See Bank of England, *Sixth Report*, pp. 25 and 26: (footnote omitted).

[196] Wilson, *Bank Finance* (IOD, London, 2000), pp. 4, 13 and 15. That collateral was perceived to be so important to the banks’ lending decisions was in fact one of the leading complaints by the respondents; see p. 12. It must be kept in mind, however, that almost two-thirds of the same set of respondents reported they had never been refused extra finance by their bank, and that this was true for 77% of those who considered their firm to be involved in high technology (a sector where firms generally have little collateral to pledge). Tellingly, none of the respondents whose request for funding had been turned down by the bank felt the reason was that they themselves had a poor business plan! See *ibid*., pp. 12-3. Members of the Federation of Small Businesses were somewhat more successful in obtaining finance; 72% of them have never been refused finance by their bank; see FBS, *Small Businesses’ Finance and the Economy: Survey of FSB Members* (London, 1998), p. 87.

[197] Remember that during the 1997-9 period, 60% of SMEs did not seek *any* external finance at all; see BOE, *Finance: Eighth Report*, p. 23.

likely have been even starker. It would have been one between offering security or going into insolvent liquidation. The reason is easy to understand. Firms would only borrow on a secured basis when they could not borrow unsecured, *and* the value to them of new funding exceeded the costs identified above. This is only likely to be the case when they face a serious threat to their continued survival. Only then would the opportunity cost of having unpledged assets (held precisely so as to be available in a crisis), any reputational costs of offering security, the costs of surrendering some freedom of action to a creditor, etc. are likely to be outweighed by the expected costs of impending insolvency. We can speculate about the type of company likely to find itself in this situation. Most obviously, this would be the case for companies on the brink of or already in financial distress. It is also likely to be the case with some start-ups which have no established track record and therefore a lesser chance of persuading a bank of the competence of its management and (less importantly) the viability of its business plans.[198] Both types of firm are likely to be faced with a credit crunch and a looming liquidity crisis. And there is support for the proposition that the lack of liquidity is a leading cause of insolvency.[199] Loss of long term finance, lack of working capital and a poor cash flow have been consistently identified as among the main factors in company failure in successive Surveys by the Association of Business Recovery Professionals (formerly, SPI).[200] And the Bank of England has noted the more direct finding that "the availability of collateral does not impact on the birth of new firms, but on [their] survival rates".[201]

So firms unable to borrow without pledging collateral are likely to borrow secured only when their survival depends on being able to find fresh funding. This should be read together with evidence from the US that the availability of fresh funding for distressed firms raises both the expected recovery rates for unsecured creditors, and the chances of the firm itself being rescued successfully.[202]

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[198] ABRP, *9th. Survey*, p. 7, provides evidence that younger firms are "far more prone to failure than established businesses".
[199] In the US context, see the illuminating discussion in Schwarcz, "Easy case", pp. 445-9, including fns. 87, 102 and 104.
[200] See *9th. Survey*, p. 13.
[201] *Sixth Report*, p. 26.
[202] See the interesting paper by Maria Carapeto, "Does debtor-in-possession financing add value?" (Unpublished, City University Business School, February 2001). The reader should also recall that 75% of firms in the banks' 'rescue units' are successfully turned around.

We can now see why the availability of secured funding is actually value-enhancing for *all* of the firm's creditors. All creditors are much better off if their debtor either (a) lowers the probability of ending up insolvent, or even more strongly, (b) recovers from financial distress. This is dramatically brought out by considering the following calculation.[203] Let U = the expected value of unsecured claims, p = the probability that the debtor would be liquidated insolvent, and F = the actual, full value of unsecured claims. Suppose also that if the debtor is liquidated without secured credit ever being issued, unsecured creditors would get a (very generous) 80 pence on the pound.[204] If the debtor becomes insolvent after having issued secured credit, unsecured claimants would (pessimistically) get nothing.[205] In either case, if the debtor survives, unsecured creditors are paid back in full. Finally and in line with the analysis above, assume that if secured credit is not available *when it is most likely to be used* (i.e. when the debtor suffers a high risk of ending up insolvent), the probability of the debtor being liquidated insolvent is (a relatively low) 60%. If secured credit is then issued, it falls moderately to 40%.[206] The expected value of unsecured claims is then given by the equation:

Expected value of unsecured claims = probability of insolvent liquidation multiplied by the return on unsecured claims in debtor's insolvency + probability of rescue multiplied by the return on unsecured claims if debtor is rescued.

If *no* secured debt is issued, the equation can be solved as follows:

U = p (0.8 x F) + (1-p) F

= 0.6 (0.8 x F) + (0.4 x F)

= 0.52 x F

On the other hand, if secured debt is issued, the outcome is:

U = p (0) + (1-p) F

= (0.4 x 0) + 0.6 x F

= 0.6 x F

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203 Adapted from Schwarcz, "Easy case", pp. 473-4.

204 The generosity of this figure can be judged from the fact that it is higher than the average of 77% that *secured* creditors presently get; see Franks-Sussman, "Cycle", p. 3.

205 This is pessimistic because the figure covers preferential creditors, who currently get an average of around 27%; see Franks-Sussman, *Cycle*, p. 3.

So even on these very conservative figures which assume a relatively low probability of insolvent liquidation if the high-risk firm does not borrow on a secured basis, a very moderate decrease in this probability if secured credit is issued, and fairly extreme figures for the return on unsecured claims, the conclusion is still that all unsecured creditors are *better off* because some creditors are induced to lend by being offered priority, when they would not lend if priority could not be offered to them. So secured credit enhances the expected value of *all* claims (preferential, trade, involuntary, 'uninformed', 'non-adjusting', etc.) by reducing the risk of the debtor's insolvency.[207] It follows that parties put in Dramatic Ignorance and asked to judge the acceptability of according priority to some claims would recognise this as a sufficient generic reason to approve of that priority. They would do so in recognition of the fact that doing so serves the *overall* interests of them all, even though it does not serve the *post*-insolvency interests of some of them.[208]

It should also be pointed out that this argument does not depend at all on many of the 'traditional' justifications of security, e.g., that it is fair from the point of view of unsecured creditors because they would have notice of its existence, or that the law should not restrict the property rights of debtors in their assets or the freedom of contract of debtors and potential secured creditors.[209] Nothing in this argument turns on taking any position on these issues.

Ironically, the possibility that security might make unsecured creditors better off by improving the debtor's chances of survival is noted by Finch herself, but apparently dismissed on the grounds that it would be relevant only when "suppliers of capital [are allowed] to 'jump the queue' ahead of other creditors in identifiable troubled times (e.g. in formal protection periods) -- but [granting this priority] is unlikely to be efficient in more comfortable corporate circumstances".[210] We should note the reference to "comfortable corporate circumstances". The argument in this Section has been that the debtor has nothing to gain (in terms of interest rate reductions) by issuing security in such circumstances, and very much to lose (in terms of freedom

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[206] It should be obvious these figures are very severe indeed towards the argument being made. The eventual conclusion would be even clearer if the probability of failure without credit was assumed to be higher, or the improvement in that probability greater if secured debt was issued, or both.
[207] It is for this reason that, as noted by Jan H. Dalhuisen, *Dalhuisen on International Commercial, Financial and Trade Law* (Oxford, Hart, 2000), 661, "It is accepted everywhere that... financiers can negotiate a higher ranking for the liquidity they provide."
[208] See the similar point made in Ch. IV.5.
[209] See e.g. Finch, "Security", pp. 660-3.
[210] "Security", p. 646 (footnote omitted).

of action, opportunity and reputational costs, etc.). Security will *only* be issued in "identifiable troubled times", or when the debtor's risk of insolvency is otherwise high, so it is *always* likely to be "efficient"!

There is however one other possibility which has not yet been considered. Suppose the debtor has no secured debt, and gets into difficulties. Its main bank demands security, not by offering it more credit (or sufficient credit to bring about an improvement in the debtor's chances of survival we stipulate to be 'appropriate'), but by threatening to send it into liquidation straightaway if security is not given for already outstanding debt. It would be very surprising if this never happens in the real world today.[211] This is the point where the analysis in this Section ties into the suggestions made at the end of the previous one. It is in the situation now being considered that the *only* benefit (if any) to the debtor's unsecured creditors comes from the increased ability of the bank to monitor and influence the debtor, thereby improving the latter's chances of recovery. So the two questions given at the end of the last Section are relevant only to that sub-set of situations where security is given for no (or insufficient) new value.

However, we should note the following point. Even if it were concluded, in this situation, that the expected costs to unsecured creditors of being deferred to secured creditors in their debtor's insolvency are greater than the expected benefits of the improved chances of avoiding insolvency flowing from the increased control of debtor behaviour *alone* (as explained in the previous Section), this still would not by itself be an argument for restricting the priority of secured lending. We would then have reason to suppose priority was being demanded by one creditor here simply to improve its own position at the expense of others, in other words, to secure a preference for itself. But then, this ought to be dealt with just like any other attempt to engineer such a preference. So we would have an argument for strengthening the legal provisions against voidable preferences (and perhaps those against transactions at an undervalue), so as to bar the offering of security except for appropriate new value. In effect, there would then be a good reason for reconsidering -- and perhaps reversing -- either or both parts of the decision in *Re MC Bacon Ltd. (No. 1)*.[212] An obvious reform would be to extend in an appropriate way the

[211] At the same time, however, it would be quite astounding if this were the only or dominant situation where security was demanded and offered, so that secured credit *rarely* improved the debtor's chances of recovery.

[212] [1990] BCC 78. The two parts referred to are the propositions that, first, the giving of security for past value can never constitute a transaction at an undervalue for the purposes of s. 238 of the Insolvency Act, and second and more directly connected with the text of the statutory provision itself, that there is no

effect of section 245 of the Insolvency Act, which invalidates floating charges granted for ‘past value’, to cover fixed charges as well.[213] It seems to this author that any more general tampering with the priority of secured credit needs stronger justification than is currently available.[214]

8. Conclusion

This Chapter has examined the main attacks on the priority of secured credit, with a view to determining whether a priority-based system would be acceptable to all the relevant parties treated as equals. The supposed exploitation of involuntary (especially tort) creditors was the obvious starting point. It was argued that the possibility of such exploitation is very remote. For large firms which have the ability to acquire significant involuntary credit (for example by inflicting tortious harm), there is evidence that little or no secured debt is issued, and such involuntary creditors are paid off. For smaller firms which do issue security, the alleged benefit of reduction in interest rates obtained by doing so is likely to be greatly outweighed by the costs of liquidation to their shareholder-managers. A ‘representative’ numerical example was discussed in order to bring out the implausibility of the Exploitation Hypothesis. Empirical data was also examined to test the predictions of the Hypothesis, each one of which it seems to contradict.

Attention was also given to the claim that security creates a subsidy extracted by coalitions of debtors and secured creditors from “uninformed” or “ill-equipped” or “unsophisticated” creditors who systematically underestimate the risk associated with their loans and therefore under-price them. Such arguments seem to pay insufficient attention to the purging effects of the market, which encourages creditors either to learn how to price loans properly, or be driven out of business. The implications of the suggestion that naturally “unsophisticated” creditors be “protected” from the effects of the priority of secured credit were also brought out and examined.

The Chapter also investigated claims that the existence of ‘non-adjusting’ creditors leads to several types of inefficiency, mainly to do with the monitoring implications of substituting the protection it offers in place of the extraction and enforcement of non-security covenants. It was suggested that empirical evidence from this jurisdiction casts doubt both on the assumptions on

voidable preference for the purposes of s. 239 of the Act unless the debtor is motivated by a “desire” to prefer the creditor to whom security is granted.

[213] For an interesting discussion, see Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet & Maxwell, 2001), 603-11.

which these arguments (and the others noted above) are based, and on the predictions that can be extracted from them. Most notably, the assumptions that it is up to the debtor to offer security, and that if it does, the interest rate it is charged would go down while the insolvency costs of its shareholder-managers remain unaffected, all were found to be false. The basic prediction of the anti-security Hypotheses that there would either be no significant relationship, or a direct one, between the proportion of the total estate derived from value provided by the secured creditor and the interest rate it charges, is strongly belied by the evidence available.

Finally, issues concerned with the informal 'intensive care' provided to distressed firms by security-holding banks were examined. It was argued that the features of the provision of intensive care can not be used to support the claim that the priority of secured lending allows the exploitation of any other group of claimant. In view of all these arguments and data, we can conclude, as did Schwartz in the US, that in this jurisdiction too, "the case for restricting the secured debt priority in bankruptcy has yet to be made."[215] The argument in this Chapter concluded with a demonstration that the priority of secured credit is likely to be value-enhancing for all unsecured creditors. Recognising this as a relevant generic reason,[216] parties bargaining within the framework of the ACM would opt to allow it to exist. In other words, such priority would be part of any rational scheme of fair co-operation amongst relevant parties conceived of as equals.

[214] For a parallel comment in the US context, see Schwarcz, "Easy case", p. 434.
[215] Schwartz, "Priority contracts", p. 1398.
[216] See Ch. III.4.

Chapter VI: The Wrongful Trading Provisions

1. Introduction

Section 214 of the Insolvency Act 1986 provides that if, at some time before the commencement of the company's winding up, a director knew or ought to have concluded that there was no "reasonable prospect" of avoiding insolvent liquidation, he would be liable for wrongful trading,[1] unless from then on, he took "every step" to minimise loss to the company's creditors that he ought to have taken. The standard by which he is to be judged is defined by reference both to his actual knowledge, skill and experience, and to the expertise reasonably to be expected of a person carrying out the same functions as him in relation to the company.[2]

Section 214 arose out of frustration at the perceived failure of the rules against fraudulent trading. The Cork Committee reported that the existing law did not provide sufficient incentives to directors of insolvent companies to take steps to prevent further loss to their company's creditors.[3] Not only was the drafting of the rules infelicitous,[4] but the requirement to show dishonesty on part of the debtor's managers to the criminal standard proved unduly onerous.[5] The Cork Committee recommended that any person involved with the management of the company be made personally liable for the company's debts if he allowed such debts to be incurred, there being no reasonable prospect of repaying them. The directors would be under a duty to place their company under receivership, administration or liquidation if at any time they considered it to be insolvent, on pain of being liable for wrongful trading. A claim for wrongful trading would be available to the company's creditors or members, its liquidator, administrator or receiver, if

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[1] The term appears, not in the section itself, but only in the marginal notes. It is in this potentially significant way that the section is wider than Cork's proposals (see below); the debtor need not be trading for its directors to be rendered liable under s 214.

[2] For a discussion, see Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet & Maxwell, 2001), 621-34; more generally on directors' duties with respect to their company's creditors, see *ibid*., pp. 640-56.

[3] *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982), hereafter, the Cork Report, Ch 44.

[4] See F. Oditah, "Wrongful Trading" [1990] LMCLQ 205, 206.

[5] *Ibid.*; see *Re Patrick & Lyon Ltd* [1933] Ch 786. But as Prof. D. D. Prentice points out, the courts shifted their position after the publication of the Cork Report, rejecting the so-called "sunshine doctrine" and making it somewhat easier to prove fraud; see "Creditor's interests and director's duties" (1990) 10 OJLS 265, 265 fn 5.

the company was in a formal insolvency proceeding (administration, receivership or liquidation).[6] These strong proposals were watered down by the Department of Trade and Industry[7] before being enacted as what is now section 214 of the Insolvency Act 1986.[8] The action is available only to the liquidator when the company is in insolvent liquidation, and only directors can be made subject to it.[9]

Using these provisions as an example, this Chapter addresses a well-known proposition, derived from the economic analysis of insolvency law generally, and from the Creditors' Bargain in particular, that insolvency law should not disturb the relative value of the pre-insolvency rights of the parties it affects. Recall from Chapter II, above, the basic premise of the Bargain model, that the rules of insolvency law are justified only to the extent that they could be shown to be acceptable to all the creditors bargaining *ex ante*. It follows that the coercion inherent in insolvency law (e.g. in the automatic stay on the individual pursuit of unsecured claims) must necessarily be limited to what would be selected by the creditors themselves at the negotiation stage.

Now, those writing in the Bargain tradition argue that the hypothetical bargain would be concluded with the sole purpose of overcoming the common pool problems discussed in Chapter II.2, above. Insolvency law is nothing more than a collective debt-collection system which exists for the benefit of all the creditors (as a group) of an insolvent debtor.[10] It follows, they suggest, that the special insolvency rules for the preservation and distribution of the insolvent's assets, which are necessitated by the collective nature of the mandatory insolvency forum, should not disturb the *relative* value of the pre-insolvency rights of all the parties they affect.[11] Not only would such a redistribution -- being unrelated to the solution of any common pool problem -- not form any part of the hypothetical Bargain, it would also create perverse incentives. Put

[6] Cork Report, paras 1781 - 1806.
[7] *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984).
[8] This weakening of the proposals has been criticised; see, e.g., C. Williams and A. McGee, "Curbing unfit directors -- Is personal liability an empty threat?", Insolvency Lawyer, Feb 1993, p 5.
[9] Including shadow directors; see IA, s 251.
[10] That this is *one* of the purposes of insolvency law is a commonplace; see e.g. Keay, *Liquidation*, p. 333: "liquidation is a form of collective enforcement of debts to the benefit of the general body of creditors", citing *Re Lines Bros. Ltd.* [1983] 1 Ch 1, 14.
[11] One way that the relative value of pre-insolvency rights could be upset would be for the special insolvency law regime to create rights in some parties which did not exist under the general law; see Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, MA, Harvard Univ. Press, 1986), 22 and

differently, it would increase the creditors' motivation costs. For example, those in whose favour insolvency rules redistribute would have an incentive to rush the debtor company into the collective forum, even if the debtor's business is viable and it could be brought back to profitable trading if given the chance. So while the mandatory forum exists to counter the adverse effects of selfish individual behaviour, any redistribution of rights would in fact end up encouraging parties selfishly to invoke the special (redistributive) rules in a way detrimental to the collective interests of all the parties affected.[12]

The aim of this Chapter is two-fold. First, it addresses the question of acceptability to the relevant parties. The burden of Chapter II, above, was to show that the Creditors' Bargain does not provide any justification within its framework for rules which could be argued to be acceptable to the creditors negotiating *ex ante*.[13] Be that as it may, it remains the case that laws should be legitimate, not merely coercive, and an obvious way in which they might be legitimate is by being reasonably shown to be equally acceptable to all those subject to them. So this Chapter asks if obligations of the sort created by section 214 would be acceptable to all the relevant parties treated as equals. Contrary to the opinion of most Law and Economics theorists,[14] it will be suggested that the answer must be in the affirmative. The argument will be that the wrongful trading provisions help control *agency problems*, which create motivation costs for the parties taken together. Parties bargaining in the choice position of the ACM, wishing to provide a mechanism to reduce these costs, would therefore agree to such obligations. The analysis also throws light on the structure of the wrongful trading provisions and their limited role. It will be argued that the section 214 duty is not likely to be equally relevant for all types of companies. The analysis also brings out important parallels between the role of security, and that of section 214 itself.

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93. But Jackson also cautions, in the first sentence of Chapter 3 of *Bankruptcy*, 68, that "Bankruptcy law... should focus primarily on values, not rights."

[12] Jackson, *Bankruptcy*, p. 21; further, see Section 2, below.

[13] Another crucial implication of that discussion should be noted at the outset. It was argued in Ch. II.6, above, that if the Bargain model yielded an accurate description of reality, there would be no switch from an individualistic to a collective system for dealing with the affairs of an insolvent firm. It follows that, to the extent that s. 214 is a means of buttressing the collective liquidation regime (as the argument below suggests), its analysis too can receive no illumination from the Bargain model.

[14] To take a specific example, B R Cheffins, *Company Law: Theory, Structure, and Operation* (Clarenden Press, Oxford, 1997), (hereafter, Cheffins, *Company Law*), 537-548, argues that a s 214-type duty would not be offered and accepted by the interested parties in a hypothetical bargain.

Second, this Chapter argues that the wrongful trading provisions are redistributive in precisely the way objected to by the leading Law and Economics theorists. However, an examination of the incentives they create show that, to the extent to which they are effective,[15] these provisions serve to reduce some of the motivation costs which would otherwise arise because of the actions of the managers of certain types of firm.

The Chapter begins by explaining why commentators in the Law and Economics tradition object to the redistribution of pre-insolvency rights within the collective insolvency forum. It is then shown that the wrongful trading provisions are redistributive. Nevertheless, it is argued they would be acceptable to the relevant parties bargaining, not within the incoherent and normatively empty Bargain model, but in the choice position of the ACM. Some of the inherent limits on the effect of section 214 are then brought out. Finally, the incentives created by it are considered.

Let us begin with a word about terminology. The terms "manager" and "director" are used interchangeably in this Chapter to refer to the top decision-makers in the firm's hierarchy. It has rightly been noted that "Directors, despite what company articles say, do not manage listed companies. Instead, the board, in accordance with the articles of association, delegates its managerial powers to full time executives."[16] A couple of points should be noted here as relevant to the argument which follows. First, whatever the case with listed companies, the analysis below suggests the section 214 duty is most relevant to companies whose directors themselves own a substantial chunk of the firm's equity. In such companies, there is unlikely to be any clear-cut distinction between directors who sit on the board, and managers who are entrusted in reality with the day to day running of the business. Further, even when a director has justifiably delegated some of his managerial functions, he retains a residual duty of supervision and control, and has a continuing obligation, individually and along with the rest of the directors, to maintain

[15] This qualification is important. Commentators have increasingly converged on the proposition that "section 214 has not lived up to its early promise"; see Keay, *Liquidation*, p. 631, and the sources cited at pp. 630-4. It will be argued here (see in particular Sections 5 and 6, below) that many of the criticisms of these provisions can be deflected simply by reaching a better understanding of their structure, role and effect. It does not follow, however, that *none* of the alleged shortcomings of the section are real. This Chapter seeks a better understanding of the provisions precisely because it acknowledges that they have not lived up to their early promise. An appreciation of what purposes, ideally, the provisions should be attaining will, it is submitted, allow us to make more informed judgements about how the provisions should be amended to make them better able to attain those purposes. This Chapter seeks to take that first step, to identify those purposes and importantly, show why their attainment may justifiably be sought both as a matter of fairness and of efficiency. The task of recommending modifications to the provisions is not addressed here; on that, see *ibid*.

a sufficient knowledge and understanding of the company's business.[17] A failure on his part to do so will cause him to be liable for any wrongful trading which might take place.[18] Finally, in a firm where there is a clear distinction between directors and lower-level managers, if the directors "delegate" their decision-making powers to a manager to such an extent that they could be regarded as being accustomed to act in accordance with the latter's instructions, then the latter renders *himself* a shadow director,[19] and thereafter is directly subject to the strictures of the wrongful trading provisions.[20]

[16] Cheffins, *Company Law*, 603-4.
[17] See e.g. *Re Barings plc and others (No 5); Secretary of State for Trade and Industry v Baker and others (No 5)* [1999] 1 BCLC 433, and *Re Landhurst Leasing plc* [1999] 1 BCLC 286.
[18] IA, s 214(5); see e.g. *Re Brian D Pierson (Contractors) Ltd* [1999] BCC 26.
[19] IA, s 251.
[20] As to shadows, see Section 5, below.

2. What is wrong with redistribution?

It is important to the argument in this Chapter that the wrongful trading provisions are redistributive. This calls for a more precise understanding of what redistribution entails in this context. The objection to redistribution by Law and Economics theorists is not on the basis that such a redistribution is unfair because it forces an unjustifiable transfer of wealth from one party to another.[21] If the redistribution takes place because of settled rules and according to certain principles, then an *ex post* redistribution is not, they argue, redistribution *ex ante*. Parties contract 'in the shadow of the law', in full view of their post-insolvency rights. Those nominally 'losing out' as a result of insolvency re-allocation would therefore charge a bit more from the start for their goods, services or credit to reflect that added risk. Similarly, the beneficiaries of the insolvency regime would charge somewhat less. The objections to redistribution focus rather on inefficiency costs.[22]

The academic progenitors of the debate on the undesirability of insolvency redistribution start by isolating two distinct questions.[23] It is argued that a firm faces two types of decision throughout its existence. The *first* is termed the "deployment question". The issue here is how best to put the firm's resources to use, and the response plausibly suggested is that its assets should be deployed so as to maximise the returns on them.[24] It does not really matter who gets what share of these returns, whether it be creditors, shareholders, tort victims or employees. It is in the collective interest of all as a group for the firm to extract the maximum advantage from the

[21] It is not clear whether some commentators in *this* jurisdiction do in fact urge this as one of the reasons against redistribution. See e.g. F. Oditah, "Assets and the treatment of claims in insolvency" (1992) 108 LQR 459, 472: insolvency law should not pursue redistributional goals by destroying security-holders' priority, *inter alia*, because "... a secured creditor has already *paid* for his priority through receipt of a lower interest rate. On the other hand, unsecured creditors have already *been paid* for allowing this priority through receipt of a higher rate of interest" (emphasis in original). Admittedly, the text is ambiguous, since Oditah goes on in the same paragraph to talk about perverse incentives. But see Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, London, 1991), 18, where a similar justification for security is given without any explicit reference to perverse incentives.

[22] B. E. Adler, "Bankruptcy and risk allocation" (1992) 77 Cornell LR 439, 464. The assumption of this argument, that parties have significant control over the terms on which they interact with others, should be noted. It has repeatedly been suggested in previous Chapters that this might not be equally true of all types of parties (e.g. certain employees).

[23] The argument summarised in the following paragraphs is from Jackson, *Bankruptcy*, Ch 2, unless otherwise stated.

[24] It does not matter to the substance of the argument whether what is maximised is the monetary returns, or more abstractly, the utility, howsoever defined, to be derived from them; *ibid.*, 23 fn 4.

deployment of its assets. The *second* and quite distinct question is labelled the "distributional question". This is where one must decide how best to split up the returns earned by the firm.[25]

The opposition to redistribution is based on the premise that only the first question is properly addressed by the distinct rules of the specialised insolvency forum.[26] Simply put, the need for such a forum arises only because of the existence of the common pool problem at the time that the firm is in distress. At this stage in the firm's life, there is a danger that precipitate individual action would be harmful to the common good of all concerned, and to preserve and maximise the common pool of assets, insolvency law steps in to curtail individual freedom of action.[27] Insolvency law steps in to provide a solution to this deployment problem. But there is simply no reason for special insolvency rules to provide answers to the distributional question.[28]

What is more, it is argued, trying to address the distributional question through distinct insolvency rules positively undermines their effectiveness as a mechanism for dealing with deployment issues. As noted, the specialised insolvency forum is regarded as having been created to counteract selfish individual action which would deplete the common pool. But if parties find they have rights in this forum which they do not have under the general law, they would have a perverse incentive to engage in precisely the selfish value-destroying actions the rules of insolvency law are formulated to prevent. The insolvency regime itself might be invoked strategically to capture the advantages available only under its rules. Conversely, incentives come into existence to anticipate the moment when the regime would take over, and to try to opt out of it in order to avoid having to give up non-insolvency rights. All this jostling for individual advantages leads to the very costs the insolvency regime was introduced to minimise. In trying to address distributional questions, then, the re-allocative insolvency system falls short even of its deployment goals. In the terms appropriate to this thesis, the charge is that insolvency law sets out to minimise the co-ordination costs of all the creditors of an insolvent debtor, but by introducing redistributive rules, ends up creating unjustifiable motivation costs instead.

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25 Notice the symmetry, respectively, with the notions of immunity and priority, employed and defended in previous Chapters. The position advocated in this thesis coheres so far with the insight offered by Law and Economics scholars. But the two diverge hereafter, as becomes apparent in the following text.
26 Needless to say, this proposition is rejected in this thesis; see e.g. Ch. IV.5, above.
27 See Ch. II, above; see also Section 1, above.
28 Jackson, *Bankruptcy*, 24-7; D. G. Baird, "Loss Distribution, Forum Shopping, and Bankruptcy: A reply to Warren" (1987) 54 Univ. of Chicago LR 815 (henceforth, Baird, "Forum Shopping"), 817-9.

Opponents of redistribution point out that having in the insolvency forum an alternative method of vindicating claims (in addition to non-insolvency debt-collection mechanisms) is expensive, and this expense must be justified by having reference to the reason for which that additional method exists. That reason is to be found, *via* the notional Creditors' Bargain, in the need to preserve the going concern, to deal with the existence of risk aversion, and to minimise monitoring and transaction costs.[29] That reason is undermined if insolvency law creates new rights which do not exist under the general (non-insolvency) law. The only way to avoid this result seems clear:

> [I]n its role as a collective debt-collection device, bankruptcy law should not create rights. Instead, it should act to ensure that the rights that exist are vindicated to the extent possible. Only in this way can bankruptcy law minimize the conversion costs of transferring an insolvent debtor's assets to its creditors.[30]

This, then, is the basic argument against insolvency law carrying out any redistribution, and the discussion also fleshes out the notion of redistribution. In this context, a rule of insolvency law is redistributive if it confers a right on a group of claimants which they would not have as a matter of non-insolvency law. Crucial, for the purposes of this Chapter, is the question of how to determine what is available to the insolvent's creditors. The proponents of the Bargain model take this to be a distributional question, so it is a matter for the general (non-insolvency) law. In answering it, the proper perspective is said to be that of "an unsecured creditor attempting to execute on a particular asset or to assert a security interest in it".[31] If the general law denies him access to something, insolvency law should promise him no more:

> If unsecured creditors cannot execute against an asset as a matter of nonbankruptcy law, then that property has no value to them and should not be considered to be... property of the [insolvent firm's] estate.[32]

To determine whether section 214 is redistributive, then, a comparison must be made between the positions of the beneficiaries of the rule before and after the debtor firm becomes

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[29] See Ch. II, above.
[30] Jackson, *Bankruptcy*, p 22; see also, Baird, "Forum Shopping", pp 825-6.
[31] Jackson, *Bankruptcy*, p 93.
[32] *Ibid*. As a preliminary matter, it should be noted that English corporate insolvency law does not adhere to this supposed restriction on its ambit; see e.g. Keay, *Liquidation*, p. 543-4, who, noting the role of IA, ss. 238-241, 244-6 and 423, observes that "the range of assets available for satisfying the liabilities of the company is far more extensive in the case of a company which is insolvent than of one which is not." On Jackson's definition (mentioned in the text here), then, all these provisions have redistributive effect.

subject to the distinct insolvency regime. The provision is redistributive if it gives to those whose interests it serves a claim against assets they would not have under the general law.

3. Are the wrongful trading provisions redistributive?

It is clear, after the Court of Appeal's judgment in *Re Oasis Merchandising Services Ltd.,*[33] that it is the firm's general body of creditors together which stands to benefit from any recoveries under section 214. The reasoning which led to this conclusion is very relevant. In this case, the liquidator had purported to assign the fruits of a section 214 action to a specialist litigation support company, the assignees promising in return to fund the action. This was challenged. It was common ground that the agreement was champertous, and the dispute centred around whether the power conferred on the insolvent company's liquidator[34] "to sell any of the company's property" applied to validate it.[35] The Court held that it did not, since a distinction was to be drawn:

> between assets which are the property of the company at the time of the commencement of the liquidation... including rights of action which arose and might have been pursued by the company itself prior to the liquidation, and assets which only arise after the liquidation of the company and are recoverable only by the liquidator pursuant to statutory powers conferred on him.[36]

Only the former category of asset was covered by the statutory exception. But recoveries under section 214 fell within the latter category. Not only was it the case that the assets recovered as a result of a successful section 214 action did not form part of the debtor's estate at the point where the special insolvency regime took over. In fact, the very right of action under section 214 did not exist till that moment. The company never itself had that right while solvent (and governed by the general law), or at any other time. This explains why it could not have created a charge over any recoveries.[37] It followed that anything squeezed out of directors would go to augment the pool of assets available for distribution to preferential and unsecured creditors. That did not mean of course that any of the company's creditors could have proceeded directly against the company's directors at any time. The right of action created by section 214 inhered exclusively in the liquidator, arising only under the rules creating the distinct insolvency forum. The Court of Appeal highlighted the contrast by noting that recoveries under s. 212 of the

[33] *Sub nom Ward v Aitken & Others* [1997] 2 WLR 764; pet diss [1997] 1 WLR 1197 (HL).
[34] By IA, Sch 4, para 6.
[35] *Re Oasis, supra,* p 770-B.
[36] *Ibid.,* p 773-D, E.

Insolvency Act 1986 for misfeasance in the company's affairs *could* be charged by debenture, since the section provided a summary method of vindicating rights available to the company *before* the winding up.[38] It is clear, then, that under section 214, the insolvent firm's general creditors are being given benefit of a right, held and exercised in their favour by the liquidator, which does not exist under non-insolvency law, and they gain access under that right to the personal assets of the debtor company's directors, which assets were immune to their claims before the debtor entered the special insolvency forum.

That is not quite the end of the matter. As pointed out above, section 214 creates a duty on directors,[39] once there remains no reasonable prospect their company would avoid insolvent liquidation, to take steps to minimise loss to the company's creditors. This duty is not owed to individual creditors, since there does not seem to be an obligation to minimise harm to any one of them but only to them as a group, and since the right of action under the provision is not vested in them.[40] The action cannot be brought if the company is not in insolvent liquidation, and it can not be brought except by the liquidator. The duty could be owed either to the insolvent company itself, or it could be owed to the creditors and mediated through the company. In either case, the question arises whether this duty, though nominally a new one available for vindication only once the company is in insolvent liquidation, is merely a recast of a duty under general non-insolvency law owed by the directors to the company itself, or to its shareholders. If that were the case, then section 214 would not be substantively redistributive.

The argument might look something like this. It is trite law that the directors of a healthy company are under a duty to protect and uphold the interests of the company, and that of course includes having regard to the interests of the company's shareholders. The general law imposes obligations on directors to manage the company's affairs in the interests of shareholders as a whole.[41] The directors are required to protect the collective interests of both current and

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[37] *Ibid.*, p 773-G.
[38] *Ibid.*, p 773-F.
[39] Imposed, not by directly spelling out its contents, but by setting out the defence to an alleged breach -- by s 214(3). See the *obiter* comments by Knox J in *Re Produce Marketing Consortium Ltd.* [1989] 1 WLR 745, 751-B - 751-G.
[40] It seems to follow that recoveries under s 214 should not be earmarked for some only of the insolvent's general creditors, but should be available for distribution to all; see D. Prentice, (1990) 10 OJLS 265, 272-3, and *Re Purpoint Ltd* [1991] BCLC 491, *per* Vinelott J, *obiter*.
[41] *Piercy v S Mills & Co* [1920] Ch 77; *Hogg v Cramphorn Ltd* [1967] Ch 254; *Bamford v Bamford* [1970] Ch 212; *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62. The statement in the text must be

prospective shareholders,[42] and to this end they must positively direct their efforts.[43] But "[the directors'] loyalty needs to change when there is a change in the residual owner, the person who gains or loses from any change in the fortune of the firm."[44] Now when insolvency threatens, legal doctrine recognises that the company's creditors replace its shareholders as the "owners" of the company, and therefore, it is to them, *via* the company, that directors' duties are owed:

> In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of the directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors, pending either liquidation, return to solvency, or the imposition of some alternative administration.[45]

It might be argued that section 214 merely reconfirms the switch of loyalty required of the directors of a troubled company, crystallising the content of the duty. The obligation to act in the collective interest of the shareholders metamorphoses into a duty to take every step to minimise harm to the company's creditors as a group. The directors pay from their own pocket for loss done in breach of the fiduciary obligations imposed by the general law to shareholders *via* the company, and they pay similarly for breach of the duty to creditors imposed by section 214. The latter provision is not redistributive since it imposes no new obligations, and makes available nothing not already at risk. All this section does is to confirm the change in identity of the recipients of the benefit of directors' duties.[46]

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qualified; s 309 of the Companies Act 1985 imposes a subsidiary obligation on directors to have regard to the interests of the company's employees.

[42] But the current shareholders' rights trump those of someone making a take-over bid for the company, and who might eventually become a shareholder; see *Heron International Ltd v Lord Grade and Associated Communications Corporation plc* [1983] BCLC 244; *Re a Company* [1986] BCLC 382.

[43] For examples, see *Rackham v Peek Foods Ltd* [1990] BCLC 895 and *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626.

[44] D. G. Baird, "The initiation problem in bankruptcy" (1991) 11 International Review of Law and Economics 223, 228-9. See also Steven Schwarcz, "Rethinking a corporation's obligations to creditors" (1996) 17 Cardozo LR 647, especially pp. 666 and 668.

[45] *Kinsela v Russell Kinsela Property Ltd (in liq)* (1986) 4 NSWLR 722, 730, per Street CJ; quoted with approval by Dillon LJ in *West Mercia Safetywear Ltd (in liq) v Dodd and another* [1988] BCLC 250, 252-3. See also G. Morse (principal ed.), *Palmer's Company Law* (Sweet & Maxwell, London, 1992) (25th. ed.), para. 8.506, and the authorities therein cited.

[46] F. Oditah considers a similar argument in "Wrongful trading" [1990] LMCLQ 205, 217-8.

This argument is superficially attractive but ultimately unpersuasive. First, it is difficult to reconcile with the Court of Appeal's decision in *Re Oasis*,[47] and the clear distinction drawn between the vindication of a pre-existing right under s. 212, the fruits of which are capable of being charged by the company, and the creation of a wholly new cause of action which does not exist till the company enters insolvent liquidation, and which therefore the company can not deal with at all. Support for this is found also in the decision, apparently reached independently,[48] by Chadwick J in *Re Howard Holdings Inc.*.[49] It was held that:

> [O]n a true analysis of s. 214 of the *Insolvency Act* 1986, the court is not enforcing any liability owed by directors or former directors to the company... The section is not concerned to enforce some past or existing liability. It enables the court to impose a new liability to contribute, in circumstances in which that is just and appropriate.[50]

But second, it is difficult to see the duty imposed by section 214 as analogous or equivalent to any duty which could exist outside of insolvency. Remember that the section imposes what could be called *terminal obligations*. These arise only when there are no reasonable prospects of the company avoiding insolvent liquidation, and they disappear into the ether if perchance the company does recover. The very background against which they operate is that of the company having died as a commercially viable entity while incapable of satisfying all outstanding debts. Most of the deceased's creditors would have to suffer some loss. It is in this context that the directors are required to take every step they ought to take to minimise this loss. In many, if not most cases, this would effectively require the directors to relinquish control, either by asking a court for an administration or winding-up order, or by inviting a secured creditor to appoint a receiver.[51] It is obvious this would seldom be appropriate (or even possible) while the company is solvent. In any case, directors of healthy companies are not always concerned to maximise the gains in the short run, and valid strategies might entail a levelling of returns on the company's investments or even some losses while it battles for market share, say:

> So long, at least, as the company seems likely to continue as an independent entity, there would seem to be no reason in principle why the directors, in adopting their business policies, should be required by law to favour those shareholders who wish to sell their

[47] [1997] 2 WLR 764, *supra*.
[48] The judgment, delivered on 6 June 1997, and therefore after the Court of Appeal's decision on 9 October 1996 in *Re Oasis Merchandising Services Ltd*, makes no reference to the latter case.
[49] [1998] BCC 549.
[50] at 554G.
[51] See e.g. *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984), *supra*, para 12; R. Goode, *Insolvency*, pp 472-3. In a recent White Paper called *Insolvency - A Second Chance* (The Stationary Office, 31 July 2001), the Government proposes to remove from most of those secured creditors who can appoint administrative receivers the right to do so, as well as the right to block the appointment of an administrator.

shares now or in the short term, as against those who see themselves as long-term holders.[52]

Under section 214, on the other hand, the only concern would generally be with short-term performance, the only aim would be to increase the immediate value of the company's assets or to halt a fall in that value, and all decisions would be judged with reference to that. The contrast could hardly be greater. The point is not only that the obligations imposed by section 214 exist only in insolvency, but that, because of their terminal nature, they are *incapable* of existing except when the company is on its deathbed.

Finally, it is difficult to argue that the section seeks to preserve the relative values of the rights of various claimants. Most importantly, by creating a potential liability in directors which did not exist before, section 214 actually *upsets* relative values as between them and the firm's creditors. Beyond this point, creditors are protected against loss which could reasonably have been avoided. But this is only at the expense of the directors, who lose the protection of limited liability with respect to this loss.[53] The loss of this protection constitutes an *ex post* diminution in the value of the bundle of rights with which the directors enter the insolvency forum. Even as between creditors, the section simply does not concern itself with relative values. To confirm this, it need only be asked whether directors challenged under it would be able to escape liability by showing that there was a strictly proportionate increase in (avoidable) loss to all the creditors once the company entered the insolvency forum. Conversely, it is unlikely the liquidator would be able to succeed in challenging a director under section 214 on the basis that, while the steps taken by the latter decreased loss to all categories of creditor, the decrease in that loss was greater for some than for other creditors. It can safely be concluded, then, that section 214 is redistributive in the sense outlined above, and is not concerned with preserving relative values of pre-insolvency rights.[54]

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[52] P L Davies, "Directors' fiduciary duties and individual shareholders": Ch 5 in E McKendrick (ed*),* *Commercial Aspects of Trusts and Fiduciary Obligations* (Oxford University Press, Oxford, 1992), 87.

[53] That s 214 pierces the corporate veil has been recognised both judicially and academically. For example, see *Yukong Lines Ltd of Korea v Rendsburg Investments Corp of Liberia and Others (No 2)* [1998] 1 WLR 294, 306-A, *per* Toulson J quoting Lord Cooke delivering the 1997 Hamlyn lecture; Keay, *Liquidation*, p. 622; B. Pettet, "Limited liability -- A principle for the 21st. century?" (1995) 48 CLP 125, 149, and C Williams and A McGee, "Curbing unfit directors -- Is personal liability an empty threat?", Insolvency Lawyer, Feb 1993, p 5.

[54] See also the decision of the House of Lords in *Winkworth v Edward Baron Development Company Ltd* [1986] 1 WLR 1512, 1516-F, where Lord Templeman, with whom the rest of their Lordships agreed, stated *obiter* and without citing any authority that "A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its

4. Motivation costs and the wrongful trading provisions

We can now ask whether, despite being redistributive, obligations similar to those imposed by section 214 would be voluntarily accepted if all the relevant parties treated as equals could be allowed to bargain with each other.

Let's start with an introduction to the notion of agency costs, which constitute a well-known type of motivation costs.[55] Lawyers are of course familiar with the legal concept of agency. In the economics literature, an agency relationship is defined much more broadly as existing whenever "there is an arrangement in which one person's [the principal's] welfare depends on what another person [the agent] does".[56] Agency costs will arise whenever both parties are concerned to maximise their own utility, and this being so, "there is good reason to believe the agent will not always act in the best interests of the principal".[57] The principal can try to overcome this problem by designing a set of incentives which bring together the agent's interests and his own. The principal can also divert resources to checking on and controlling the agent's activities. The costs of these efforts are referred to as monitoring costs. In certain circumstances discussed below, the agent himself would have an incentive to offer guarantees against his own misbehaviour, perhaps by providing for mechanisms which would compensate

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property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors." Now, if this duty exists even when the company is solvent, it might again be argued that s 214 merely sharpens this pre-existing duty rather than creating a new one. But on the facts, it is clear the *Winkworth* duty arose when the company's directors appropriated £115,000 from its bank account to finance the acquisition of their own shares in the company (at p 1516-F) at a time when its potential liabilities (including over £100,000 in corporation tax; see p 1513-G) exceeded its assets. It is also clear the directors' obligation was perfected only when the company "probably belatedly" went into liquidation, till which time any breach of the *Winkworth* duty could have been ratified by the director-shareholders (per Lord Templeman, at pp 1514-H and 1516-G). So the creditors' rights existed only within the special insolvency regime. Finally and in any case, the *Winkworth* duty seems one of avoiding misappropriation of the company's assets for the directors' or shareholders' benefit at a time that the company is balance-sheet insolvent. This is quite different from the obligations imposed by s 214, where misappropriation would not generally be an issue. It is also to be noted the *Winkworth* decision has been less than well-received; of the *dicta* cited here, it has been suggested that it "is probably right to dismiss remarks such as these as little more than so much hot air" (L. Sealy, "Personal liability of directors and officers for debts of insolvent corporations: A jurisdictional perspective (England)", in J. Ziegel (ed.), *Current Developments in International and Comparative Insolvency Law* (Clarendon, Oxford, 1994), 485, at 487.

[55] Most relevant here is M. C. Jensen and W. H. Meckling, "Theory of the firm: managerial behavior, agency costs and ownership structure" (1976) 3 J of Financial Economics 305 (henceforth, Jensen and Meckling, "Theory of the firm ").

[56] Pindyck and Rubinfeld, *Microeconomics*, at 632. See also Jensen and Meckling, "Theory of the firm", at 308.

the principal at the agent's expense, if the latter does misbehave. Such activities are generically called bonding. Finally, and despite the existence of monitoring and bonding mechanisms, it is suggested there would still be some divergence between the decisions the agent ought to take in order to maximise his principal's utility, and the decisions he would in fact take.[58] This loss in utility is referred to as the residual loss. Agency costs are then defined as the sum of monitoring and bonding costs and the residual loss.[59] It is to be noted that all references to agency in this Chapter are to this -- and not the legal -- notion of agency.

Let us look again at the typical (and grossly over-simplified) structure of a limited liability firm. Shareholders provide the initial capital in return for a contingent but unlimited residual claim on the firm, and decision-making and day-to-day oversight are entrusted to the company's managers. Creditors lend a certain amount at a price, with the promise of repayment over a specified period. Note that the managers are under legal obligations to further the interests of the company, which effectively equates to the interests of the shareholders as a group while the firm is solvent.[60] With this in mind, assume for the moment that managers act on behalf of shareholders in administering the firm, and that there is an identity of interests between them.[61] It should be obvious that the existence of debt in the firm's capital structure creates agency costs. The welfare of creditors lies in being paid interest over the pendency of the loan, and of having the capital repaid in full at the loan's maturity. But once the debt contract is concluded, the money is dealt with by the firm's managers, who wish to benefit a totally different class of claimant. In trying to maximise the shareholders' collective utility, managers rationally have an

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[57] Jensen and Meckling, "Theory of the firm", at 308.
[58] This is because "the cost of full enforcement of [monitoring and bonding] contracts exceeds the benefits"; see E. F. Fama and M. C. Jensen, "Agency problems and residual claims" (1983) 26 Journal of Law and Economics 327, at 327.
[59] Jensen and Meckling, "Theory of the firm", at 308.
[60] There is a timely and valuable reminder of this orthodoxy in the DTI's Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report, Volume 1* (HMSO, July 2001), 345; for a more detailed discussion, see the Steering Group's *Developing the Framework* (HMSO, March 2000), 19-47.
[61] The assumption is reasonable, obviously for managers of closely-held firms, but to a degree, even for those of publicly-held ones. See Cheffins, *Company Law*, 522: "In public companies, this alignment [of shareholder and manager interests] can occur because of a combination of contractual terms (e.g., managerial remuneration packages) and market factors (e.g., the market for corporate control)" [footnote omitted]. But it would be useful to remember the common economic assumption that as rational persons, managers would actually seek to maximise their own utility. To the extent to which this is true, this creates conflicts (and therefore motivation costs as) between them and shareholders. So the assumption made in the text here is relaxed in the next Section, when the differences between openly- and closely-held firms is considered, and in the final Section of this Chapter, where the incentives created by s 214 are examined.

incentive to deviate from the course most likely to maximise utility to creditors. Note that this incentive becomes more potent as the firm teeters on the brink of insolvent liquidation:

> As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehavior. But once the business environment deteriorates, the [firm's decision-maker] is increasingly influenced by a "high-roller" strategy. The poorer the prospects for a profitable conclusion to the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct.[62]

At least three different forms of creditor/manager agency costs are relevant to the argument here.[63] The first, labelled asset substitution, arises because, after the debt contract has been entered into, managers have an incentive to increase the riskiness of the relevant part of the company's business, choosing to opt for a strategy which promises to pay more but with a smaller probability. Since debtors are limited to their fixed claims, any increased returns are captured wholly by the shareholders, but losses are shared by the creditors as well. Crucially, the incentive to substitute is heightened when the firm becomes financially distressed. If it enters insolvent liquidation, shareholders would simply drop out of the picture. There is every reason for managers, acting in the shareholders' interests, to venture the firm's resources on increasingly desperate strategies, gambling on the possibility that the firm would recover. At the very least, in a bid to stave off liquidation, managers might sell off the firm's less essential physical assets (e.g.. "nonspecific equipment that comprises excess capacity"), using the money to buy employee hours, which are valuable only if the firm recovers.[64] Physical assets previously available to meet creditors' claims no longer remain in the company's ownership.

The second type of cost arises because once managers have committed a firm to a particular debt contract, they have an incentive to offer equal or higher priority to another creditor. This dilutes the original lender's claim, forcing him to compete with, or be subordinated to, the new lender. Again, this conflict intensifies when the firm is in trouble. "Management might, for example, have the debtor borrow from a later secured creditor to meet payroll in an

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[62] Scott, "Relational theory", at 624.
[63] For an overview, see J. Drukarczyk, "Secured debt, bankruptcy, and the creditors" bargain model" (1991) 11 International Review of Law and Economics 203, 205-7 (hereafter, J. Drukarczyk, "Secured debt"), Rao, Sokolow and White, "Fiduciary duty *a la Lyonnais*: An economic perspective on corporate governance in a financially-distressed firm" (1996) 22 J. Corporation Law 53, especially pp. 56-8, and Scott, "Relational theory", 919-921.
[64] B. E. Adler, "An equity-agency solution to the bankruptcy-priority puzzle" (1993) 22 J of Legal Studies 73 (hereafter, Adler, "An equity-agency solution"), 82.

attempt -- foolish from the investors' collective perspective -- to keep the firm in business long enough for a possible but unlikely reversal of fortune."[65]

A third category of cost arises because managers possess more, and more accurate, information about the firm's prospects and the riskiness of its strategies, than creditors.[66] Yet again, this is critical when the firm is having difficulties. Creditors need reassurance this information would be used to decide in the collective interest when the firm should be made subject to the collective insolvency proceedings, but managers have an incentive to withhold it for precisely that reason. They serve the sectional interests of shareholders. To allow the firm to enter the insolvency forum is to lose the chance of preventing the shareholders' equity becoming worthless.[67]

How might the relevant parties deal with this in the real world? Here is one argument which, for reasons to be given shortly, will later be shown to be defective. It might be said that some far-sighted creditors in some (perhaps all) real-life transactions would realise *ex ante*, before lending anything, that doing so would give rise to the agency costs described above, managers striving to act in the shareholders' interests and to the creditors' detriment. Now these creditors could contract for the right to monitor managers' actions.[68] Monitoring would then be carried out during the pendency of the loans to the point where the additional advantage from monitoring any further equals the additional cost of the monitoring activities.[69] It is important to realise, though, that as long as these creditors anticipate the existence of these additional costs, they take them into account when deciding what to charge the firm for their loans. So monitoring costs are passed on to the firm, and to those who have bargained for a residual claim on it. It is the firm's shareholders and not its creditors who suffer these costs, since more of the firm's income goes to service its debt, and less remains for disbursement to the residual claimants.[70]

How would creditors monitor the managers' activities? They would bargain, for example, for the right to have the firm's accounts audited by independent experts, to include explicit

[65] *Ibid.*, at 80.
[66] J. Drukarczyk, "Secured debt", at 206-7.
[67] Other types of agency costs include asset conversion and under-investment; *ibid*.
[68] For major qualifications to the points made here and in the next paragraph, see the text which follows.
[69] Any further attempt to control the managers' behaviour would simply not be cost-effective; Jensen and Meckling, "Theory of the firm", at 338.
[70] For a formal proof, see *ibid.*, 338-339.

contractual terms restricting managers' freedom of action, to nominate directors to the board, and to arrange for the firm's control to pass to those owing allegiance to them, once insolvent liquidation is inevitable. But shareholders might want managers to have independent accounts prepared in any case for their own inspection. It would also be cheaper for shareholders simply to accept that in case the firm becomes seriously troubled, the *existing* management should be required to protect the interests of creditors. Note that anticipating the specific steps required of the managers of a troubled firm in all circumstances would be expensive for creditors and shareholders bargaining *ex ante*. Managers themselves, actually faced with the particular circumstances of their firm, would presumably be best placed to ascertain what needed to be done, and shareholders would offer at the bargaining stage to put them under an open-ended duty.[71] To put it differently, it is in the shareholders' own interests to require managers to bond themselves broadly to the creditors when there is no reasonable prospect of the firm avoiding insolvent liquidation. Whether it is the creditors who monitor managers, or the managers who bond themselves to creditors, it is the shareholders who bear the costs. Shareholders would prefer bonding over monitoring since that is likely to be cheaper in many circumstances:[72]

> When monitoring costs, such as direct supervision, are high relative to actions by the debtor that reassure the creditor, both parties will agree ex ante to substitute cost-effective bonding alternatives.[73]

On this reasoning, then, a section 214-type duty would be accepted by shareholders in a real-life *ex ante* bargain.[74] There seems little need to have resort to the ACM.

However, it is submitted that this reasoning is faulty. This can be brought out by noting three qualifications to the points just made.[75] First, not all types of creditor are able to anticipate the motivation costs of managers on the eve of their firm's insolvency. So for example, one-off

[71] IA, s 214 (3) reverses the burden of proof, requiring managers to demonstrate they took "every step" they ought to have taken (s 214 (4)) to minimise potential loss to creditors.
[72] Jensen and Meckling, "Theory of the firm", 325-6 and 338.
[73] Scott, "Relational theory", 927-8.
[74] Notice the assumption here that contrary to appearances, it is not generally the managers who suffer most directly because of this coercive duty. It is the shareholders who "pay" for this duty in the broad sense by being deprived of the managers' allegiance at the time that they have the most to lose. The argument just made is of course that they would choose to be thus deprived, in return for the lower interest rates the firm would have to pay on the credit it incurs during its lifetime. This is not to imply that managers are not affected at all by s. 214. Managers might, for example, want to keep the troubled firm trading in order not to lose their job, and the freedom to do so is curtailed by the wrongful trading provisions. The next Section asks whether they too would voluntarily accept a s. 214-type obligation.
[75] These points are missed, e.g. by Mokal, "An agency cost analysis of the wrongful trading provisions" [2000] CLJ 335, 348-9, from which the argument given above is derived.

transactors like employees (who are not in the business of making loans, and therefore, of making loans to companies which become insolvent) and some inexperienced trade creditors, might be in this position. Second and more importantly, regardless of whether all creditors anticipate (or ought reasonably to anticipate) the existence of this type of motivation costs, not all of them would be in a position to pass them on to the debtor's shareholders. Whether they could do so would depend on their bargaining power *vis-à-vis* that of the shareholders, and there is no reason to think this would always be such as to ensure *all* monitoring costs were borne by shareholders. Further, to the extent that some creditors are non-adjusting and do not take monitoring costs into account when deciding what to charge a particular debtor (e.g. the Crown), the same holds for them as well.[76] Finally, the very types of creditor most likely to be on the wrong side of a disparity of bargaining power between them and shareholders (again, e.g., employees and some trade creditors) are also likely to be intrinsically poor monitors, ill-equipped to gather or demand information about the debtor's activities, and unable to respond to any such information in any case (e.g. by bringing pressure to bear on the debtor's management sufficient to make it desist from misbehaving).

Taken together, these observations lead to the conclusion that *some* types of creditor, by threatening to pass on relatively higher monitoring costs to shareholders, would be able to get agreement from them to relatively lower-cost bonds against eve-of-insolvency misbehaviour on the management's part. But contrary to the argument made above, these bonds would not be *general*, seeking to protect the interests of *all* creditors. Instead, they would be specific, aimed at protecting from misbehaviour only those creditors who could otherwise load on to shareholders the costs of monitoring the debtor.[77] So this line of argument provides no reason for thinking the inclusive section 214 duty, which seeks to encourage managers of a firm on the brink of insolvency to take every (reasonable) step to minimise harm to *all* of the firm's creditors, would be acceptable to the debtor's shareholders. It therefore provides no justification for that duty.

It is submitted that the ACM is more successful in explaining why the wrongful trading provisions would be acceptable to the relevant parties. In its choice position and having been placed in Dramatic Ignorance, the parties do not know whether they would turn out to be the

[76] For a definition and other examples of non-adjusting creditors, see Ch. V.5, above.
[77] See the discussion of the relevant effects of taking security, discussed below, which also mentions the possibility that even bonds meant to benefit individual creditors might provide some indirect protection generally to others.

shareholders, the creditors, or the managers of the firm on the brink of insolvency. So they must equally take into account the interests of all these parties. To start with, and even knowing some of them would turn out to be the debtor's shareholders, all the parties would conclude that, once there remained no reasonable prospect of the firm avoiding insolvent liquidation, managers' efforts, on the shareholders' behalf, to strive *unreasonably* to reverse the firm's fortunes would be harmful to them all, taken as a group, in the ways described above. Being rational, they would seek to minimise these motivation costs, and for the same reason, would seek to do so in the cheapest way possible. It has already been noted that it would generally be less expensive to seek bonds against misbehaviour from managers than to monitor them directly.[78] Parties bargaining in the choice position know, however, that in the real world, some of them would not be able to anticipate the need to monitor, and in addition, may not be able to get the shareholders' approval to managers giving those bonds (for the reasons already discussed). This would be unacceptable to the bargaining parties for two reasons. First, to the extent that monitoring is more expensive than bonding, it would be irrational to tolerate the possibility that some creditors -- unable to compel shareholders to agree to the managers giving such bonds -- would have to monitor nevertheless. Parties in the choice position would wish to avoid these dead-weight costs. And second, parties would seek to be protected against managers' misbehaviour even if they turned out to be the sort of creditors not only unable to compel shareholders to allow managers to offer them bonds, but also unable efficaciously to monitor managers themselves.

For both these reasons, it would be acceptable to all the parties treated as equals for an inclusive bond in the creditors' favour to be extracted from the managers. In the choice position, each party would have an equal incentive to provide that, on the eve of insolvent liquidation, the firm's managers should be required to switch allegiances, coming under obligations to act so as to prevent harm to all of the firm's creditors as a group.[79] This, it is submitted, provides justification for the section 214 duty.

[78] The parties would acknowledge the desirability of these bonds even though some of them would turn out in the real world to be the managers thus bonded, as long as the obligations imposed on managers through these bonds were clear in advance and did not require of them guarantees they could not reasonably provide; on this, see the discussion in Section 6, below.
[79] For a qualification, see the discussion of secured credit, below.

5. Predictions and observations

This analysis of section 214 suggests that the duty imposed thereunder would not be equally relevant to all types of firm, nor would all types of creditor stand equally in need of its protection. Section 214 is merely one way in which parties bargaining *ex ante* would seek to overcome creditor/manager agency problems. The argument just made implies that where more effective or more focused ways of overcoming these problems are available, section 214 would be far less important. In this respect, the role of the market for managerial labour, and of secured credit, is especially important.

a. The influence of the market for managerial labour

Consider first the function of the market for managerial labour.[80] In an "openly-held" firm, where the residual risk-bearers (shareholders) are different from the decision-makers (managers), the latter are subject to the discipline of the managerial labour market. The firm itself is always in the market for new talent, and seeks to attract it by promising to reward performance. Existing managers too are concerned with the efficiency with which the firm can differentiate the good from the indifferent decision-maker; the former would be the first to leave if the firm responds sluggishly to the distinction.[81] Further, how well the manager performs in his current position determines not just his present but his future income as well. Remember that managers have invested their human capital heavily in the firm's fortunes. More than many shareholders, who are likely to hold a diverse portfolio of equity in many firms, and many creditors, who are likely to be supplying goods or credit to many firms, the manager's investment is firm-specific. So the value of the manager's human capital is linked very closely to the fortunes of his firm:

> The function of management is to oversee the contracts among factors and to ensure the viability of the firm. For the purposes of the managerial labor market, the previous associations of a manager with success and failure are information about his talents. The manager of a firm, like the coach of any team, may not suffer any immediate gain or loss in current wages from the current performance of his team, but the success or failure of the team impacts his future wages, and this gives the manager a stake in the success of the team.[82]

[80] The ground-breaking work on this point is Eugene F. Fama, "Agency problems and the theory of the firm" (1980) 88 J of Political Economy 288 (hereafter, Fama, "Agency problems").
[81] *Ibid.*, 292.
[82] *Ibid*.

The managerial labour market exercises control over the manager by ensuring that his future wage reflects his current performance. Indolence or mismanagement on his part affect the fortunes of his firm, which in turn signals the managerial labour market to revise downwards the rewards he can expect in the future. If he has contracted to provide a certain quality of oversight of the firm's affairs, the market judges him according to how successfully he delivers it. Any failure on his part is compensated for by the lower wages the market is willing to offer him in the future.[83] The *impact* of this downward revision on the performance of the rational manager does not just lie in the future, though. The present value of his human capital is a function both of the stream of present wages, but also of the stream of future wages. So the manager's current performance affects his current wealth. He has an incentive to deliver the performance he promised.

Crucially, though on the margins, the managerial labour market's assessment of his performance encompasses how the manager is likely to behave towards his firm's creditors (or more accurately, towards some of them) when the firm is distressed.[84] Remember that the *capital* market anticipates the incentives he has at that time to act in the shareholders' (and his own) interest, and thus to the creditors' detriment. The additional costs implied by this are passed on to the firm's residual claimants as a rise in the interest rate.[85] This affects the *labour* market: shareholders (residual claimants) would seek to pass on this extra cost to the managers themselves by ensuring that the firm pays less to managers if employing them makes it more expensive for it to borrow. Similarly, they would have an incentive *ex ante* to send the correct signal to their company's creditors by employing the right sort of management:

> [T]he reputational integrity of managers is a bond that shareholders can post to other stakeholders [especially some creditors] that reduces the costs of monitoring and contracting... [M]anagerial reputational bonds are so valuable in facilitating cost effective

[83] *Ibid.*, 297-8.

[84] The closest Fama comes to acknowledging this point is *ibid.*, 297: "Suppose the manager perceives that, because of the consequent revaluations of future wages, the current value of his human capital changes by at least the amount of an unbiased assessment of the wealth changes experienced by *other factors, primarily the security holders*, because of his current deviations from contract. Then... these revaluations of his human capital are a form of full ex post settling up" (emphasis added). It is suggested here that while the manager's performance is judged *primarily* by reference to the effects of his actions on the firm's shareholders, a *secondary* aspect of the assessment of his performance is the effect it has on the wealth of his firm's creditors, or at least to some of them.

[85] Once again, this indicates that this argument covers only those creditors able to pass on these additional costs as higher interest rates on their loans.

> contracting that 'shareholders... (will) *seek out* or *train* individuals who are capable of commitment to stakeholders, *elevate* them to management, and *entrench* them'.[86]

And as explained above, this creates an incentive for managers not to misbehave *vis-à-vis* some of the firm's creditors when the firm gets into difficulty.[87] The fact that a firm (partially) under a manager's control is at the point where there are no reasonable prospects of avoiding insolvent liquidation is itself likely to convey information about the manager's abilities to the managerial labour market detrimental to his future prospects. The need for him to act competently and scrupulously after this point therefore becomes even more important. He has an incentive to signal to the market that he is capable of effectively doing all any reasonably competent manager would do to abate the damage done to the company's creditors (who, as it happens, are also the company's new residual "owners"):

> [I]n light of their imminent re-entry into the job market, managers may reason that the best strategy to adopt in a distress situation is one of honesty and integrity. Rather than using wrongdoing as a way of gambling the company back to success, the managers may decide to avoid scrupulously any hint of wrongdoing out of a concern for inflicting irrevocable damage to their reputational capital in the managerial job market.[88]

This argument yields the prediction that the section 214 duty would be more important for firms whose managers are *not* concerned about the value of their managerial services in that market. Here, section 214 would be the primary way of countering creditor/manager agency problems. Now the wording of the actual section of the Insolvency Act 1986 makes no distinctions based on how severely a particular manager is subject to the labour market's

[86] R J Daniels, "Must boards go overboard? An economic analysis of the effects of burgeoning statutory liability on the role of directors in corporate governance" (1994-5) 24 Canadian Business Law Journal 229 (hereafter, Daniels, "Boards"), 241 fn 43, quoting A Shleifer and L Summers, "Breach of trust in hostile takeovers", ch. 2 in A Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press, Chicago, 1988), at p 40 (original emphasis).

[87] In the last two paragraphs, some important functions have been attributed to the markets for credit and for managerial labour. The former sends out signals in the form of higher interest rates on a firm's loans, and these are understood and employed by the latter in determining the demand price for the services of particular managers. Some readers might wish to object that this "makes heroic assumptions about the efficiency of [one or both of these] market[s]" (D D Prentice, "Directors, creditors, and shareholders": Ch 4 in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (Oxford University Press, Oxford, 1992), 75 fn 8, in a somewhat different context). In response, it is suggested that the assumptions are not unreasonable, and that an analogy can be drawn with the role of the market in placing a value on the firm itself: "Although we do not understand all the details of the process, available empirical evidence... suggests that the capital market generally makes rational assessments of the value of the firm in the face of imprecise and uncertain information. This does not necessarily mean that information processing in managerial labor markets is equally efficient or rational, but it is a warning against strong presumptions to the contrary" (Fama, "Agency problems", 296-7, citing Fama, *Foundations of Finance* (Basic, New York, 1976), Chs. 5 and 6).

discipline. But this is reasonable. Firms might go through periods where its managers were more or less subject to that discipline. For example, a manager approaching the end of his working life would be increasingly unaffected by the incentives of the labour market. It would be prohibitively expensive to design a bond which applied with the correct force just at the right time. An all-encompassing obligation is more cost-effective, given the variability of the degree of influence of the managerial market and the diverse reasons for those differences. Still, one would expect the practical significance of the section to be greater, the smaller the influence of the market.

Most obviously, managers of closely-held firms, who also own a substantial proportion of the firm's equity, are somewhat more immune to labour market incentives.[89] They are not threatened with the loss of their job if they deliver a performance inferior to the one they promised *ex ante*, since they are in a position *qua* shareholders to ratify this breach. Put differently, the firm derives idiosyncratic (i.e. non-market) value from employing them. Further, most closely-held firms restrict the alienability of their shares.[90] This means that the take-over mechanism, which limits managers' ability to engage in behaviour detrimental to the value of the firm, is "unimportant in creating incentives to operate efficiently".[91] A consistently poor performance of course decreases the shareholder-manager's wealth, but there is nothing to overcome manager/creditor agency problems. The manager is not going to be fired by his firm, and is therefore not as concerned with keeping a clean record to smooth his future passage in the managerial market. Entrenched as he is in his current position, he does not see himself in the market for managerial talent.

When the firm is on the verge of insolvent liquidation, it might be thought that a more detached actor in the shareholder-manager's shoes would realise that, his firm no longer being viable, his behaviour *vis-à-vis* creditors might affect his future prospects. But this is not necessarily the case:

> At least for some [closely-held] firms, the owner-manager will anticipate making substantial nonpecuniary or sentimental investments during the life of the enterprise. These investments are reflected in common metaphors such as "It's my life's work," and "My

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[88] Daniels, "Boards", 241.

[89] Generally on closely-held companies, see F H Easterbrook and D R Fischel, "Close corporations and agency costs" (1986) 38 Stanford LR 271 (hereafter, Easterbrook and Fischel, "Close corporations").

[90] *Ibid.*, 273; J H Farrar, B Hannigan, N E Furey and P Wylie, *Farrar's Company Law* (Butterworths, London, 1998) (hereafter, *Farrar*), 519.

[91] Easterbrook and Fischel, "Close corporations", 276.

> name is over the door." Furthermore, an owner-manager's firm-specific investment is essentially nondiversifiable.[92]

Since the shareholder-manager is likely to have invested a significant proportion of his wealth, material and non-pecuniary, in the firm, and since this investment is likely to be undiversified, he can be expected to fight even more single-mindedly to keep the firm afloat. So the shareholder-manager's identification with his firm remains strong. Correspondingly, the influence of the managerial labour market remains small. This analysis of section 214 suggests the legal duty to have regard to the interests of creditors when insolvency becomes inevitable would be more relevant to directors of closely-held firms.

A similar argument applies to shadow directors. Consider a simple example. Director D calculates that the value of his human capital varies in line with the fortunes of Firm X, for which he has contracted to provide oversight and decision-making. Yet the board of Firm Y, which is wholly owned by Firm X, are accustomed to act according to the directions of either D himself, or of the whole of Firm X's board of directors. In fact, then, D or X itself might be shadow directors of Y.[93] But neither is subject to the discipline of the managerial labour market. This is obviously true in case of X; the rise and fall of the value of Y might have an effect on X's own well-being, but X simply is not an actor on the supply side of the managerial labour market, and there is no counter-weight provided by that market to X's incentive to further its own self-interest to the detriment of Y's creditors. But X's director D too considers that the market has no reason to judge him by looking at the fortunes of Y. D has no explicit contractual obligations towards Y, and *prima facie*, in calculating D's future wages, the labour market disregards the actions he induces Y's board to take, even though those actions hurt Y's creditors on the eve of Y's insolvent liquidation. This is because the interests of Y's creditors would not necessarily be coterminous with those of X's creditors. There might even be a conflict between them. Director D's future prospects in the labour market depend of course on how his actions affect the fortunes of his own firm's stakeholders. Here again, it can be predicted that section 214 would provide the more important bulwark against anti-creditor actions. One normative recommendation would then be that courts, contrary to their present bias,[94] be somewhat more willing to hold shadows liable for wrongful trading.

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[92] Jackson and Scott, "Bankruptcy", 174.
[93] IA, s 251.
[94] See G Bhattacharyya, "Shadow directors and wrongful trading revisited" (1995) Company Lawyer, 16(10), 313.

Is there any empirical confirmation for these predictions? An interesting exercise would be to examine decided cases where wrongful trading (as defined by section 214) was an issue. It must be emphasised that such an exercise would not produce statistically significant results, since the sample size would be too small in relation to the total number of financially distressed firms, and since there is a preponderance of closely-held firms as a proportion of all the firms in the economy.[95] Further, decisions which find their way into print, or whose transcripts are readily available, are not necessarily a good guide to the factual circumstances where a legally-imposed section 214-type duty is most relevant, especially in cases where the section 214 claim in never litigated. Having said that, a particular trend in these decisions might provide some ('impressionistic') insight into the role of section 214 as a secondary device for controlling agency problems.

A rough and ready survey of the English and Welsh cases provides interesting results. Information is available about six decisions where a section 214 claim was successful, and in all these cases, at least one of the wrongfully trading directors had a substantial shareholding.[96] In another nine decisions, the facts revealed the directors might have been trading wrongfully. These decisions concern claims (or potential claims) under section 214 by the liquidator where a preliminary point was litigated, or where an allegation amounting to wrongful trading was made as part of an application to disqualify a director. Again, all of these cases concern closely-held firms.[97] Further, there are six decisions where applications for a section 214 contribution were

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[95] *Farrar*, 518-9; B V Carsberg *et al*, *Small Company Financial Reporting* (Prentice-Hall, Englewood Cliffs, 1985) at 79.

[96] The brackets following the case citation indicate the proportion of the issued shares of the company held by the relevant director, where this information is available or can be surmised from the facts: *Official Receiver and Hickling v Dhiren Doshi* (1.3.2001, Transcript available on Westlaw, 2001 WL 172017), (close to 100%); *Re Brian D Pierson (Contractors) Ltd* [1999] BCC 26 (H and W between them held 100%); *Re Fairmont Tours (Yorkshire) Ltd* (unreported) noted in Insolvency Litigation and Practice, July 1996, 12 (100%); *Re Purpoint Ltd* [1991] BCLC 491 (100%); *Re DKG Contractors Ltd; Lewis v DKG Contractors Ltd* [1990] BCC 903 (98%); *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520 (50%).

[97] *Official Receiver v Zwirin* (26.7.01, 2001 WL 825078) (nearly 100%); *Lewis v Commissioner of Inland Revenue and Others; Re Floor Fourteen Ltd.* [2001] 3 All ER 499 (CA), [2000] BCC 416 (ChD) (seems closely-held); *Re TLL, Secretary of State for Trade and Industry v Collins and others* (Ch D, 27 Nov 1998) (Transcript) (5%, plus an option for another 5%); *Re Leading Guides International Ltd (in liq)* [1998] 1 BCLC 620 (100%); *Re Sykes (Butchers) Ltd (in liq); Secretary of State for Trade and Industry v Richardson and another* [1998] 1 BCLC 110 (at least 20% of one relevant company by director against whom the application to disqualify succeeded); *Secretary of State for Trade and Industry v Laing and others* [1996] 2 BCLC 324 (the disqualified *de jure* director held at least 51% shares at all material times); *Re Living Images Ltd* [1996] 1 BCLC 348 (99%); *Re Keypack Homecare Ltd* [1987] BCLC 409 (unclear,

abandoned or lost at trial or struck out for want of prosecution, or where an application to disqualify a director on charges amounting to wrongful trading failed, and all of these firms seem closely held as well.[98] Even these 'failures' are instructive for the purposes of this Chapter: whether the allegations of wrongful trading 'stick' or not, it is only where the influence of the managerial labour market is weak that issues concerning the *legal* solution to creditor/manager agency problems are likely to arise. Nine cases concerned with possible wrongful trading issues were litigated where the target of the (potential) action was alleged to be a shadow director.[99] For the sake of completeness, no relevant information was available in two cases,[100] and the one reported case where an administration order was sought (in extreme haste), *inter alia*, explicitly to avoid any wrongful trading by the directors seems to involve an openly-held company.[101]

So of the 29 decisions where relevant information was available, 27 concern either closely-held firms, or shadow directors, or both.[102] Bearing in mind the statistical insignificance of these

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but seems to be closely-held); *International Westminster Bank plc v Okeanos Maritime Corporation* [1987] 3 All ER 137 (again unclear, but again, seems to be closely-held).

[98] *Secretary of State for Trade and Industry v Blake and others* [1997] 1 BCLC 728 (seems closely-held); *Re Grayan Building Services Ltd (in liq)* [1995] Ch 241 CA, [1995] BCC 554 HC (100%); *Re Farmizer (Products) Ltd; Moore and another v Gadd and another* [1997] 1 BCLC 589 (CA), [1995] 2 BCLC 462 (HC) (100%); *Re MC Bacon Ltd* [1991] Ch 127 (again, seems closely-held); *Re Sykes (Butchers) Ltd (in liq); Secretary of State for Trade and Industry v Richardson and another* [1998] 1 BCLC 110 (80% by director against whom the application to disqualify failed); *Ward (liquidator of Span Technology Ltd) v Sellors and others* (CA, 27 Oct 1997) (Transcript) (100%); *Re Sherborne Associates Ltd* [1995] BCC 40 (36%, 36%, and 3% of the initial shares issued).

[99] *Official Receiver v Zwirin* (26.7.01, 2001 WL 825078) (evidence that the shareholder-director acted as a shadow after resigning as the *de facto* director); *Burgoine and another v Waltham Forest London Council and another* (Transcript), 95 LGR 520, *The Times*, 7 Nov. 1996 (The Council here was clearly a shadow director, as well as owning 50% shares in the company); *Re Oasis Merchandising; Ward v Aitken and Others* [1998] Ch 170 (very inadequate information on the subject, but some directors were shadows); *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 (on the facts, claim against the parent company as shadow failed); *Re Latreefers Inc., Stocznia Gdanska SA v Latreefers Inc.* [1999] 1 BCLC 271; decision affirmed by the Court of Appeal at [2001] BCC 174 (Court of first instance thought a s 214 claim might exist); *Re a Company (No 005009 of 1987), ex p Cropp and another* [1989] BCLC 13; *International Westminster Bank plc v Okeanos Maritime Corporation* [1987] 3 All ER 137 (seems shadows were involved); *Secretary of State for Trade and Industry v Laing and others* [1996] 2 BCLC 324 (Held that directors of the company which had abortively tried to purchase the now-insolvent firm were not shadows); *Re PFTZM Lid* [1995] 2 BCLC 354 (Bank was major creditor of closely-held company; its officers were held not to be the insolvent company's shadows).

[100] *Hughes and another v Beckett and others* (CA, 6 April 1998) (Transcript) (public company, but no information as to whether any director had substantial shareholdings, or whether a shadow was involved); *R v Millard* (CA Criminal Division) (unreported) noted in [1994] Crim LR 146 (conviction for fraudulent trading; issue was length of disqualification).

[101] *Re Chancery plc* [1991] BCLC 712.

[102] Both the exceptions are interesting, and it is submitted neither can be regarded as an easy counter-example to the arguments made here. Consider first *Re Howard Holdings Inc.; Norton Coles and Others v Thompson* [1998] BCC 549. An important feature of this case is the fact that, while the three directors

results, all that can be said is that they at least do nothing to disconfirm the hypothesis that the section 214 duty is relevant primarily to managers who are not subject to the full discipline of the managerial labour market. As noted above, this conclusion is reinforced by the consideration that shareholder-managers of such firms are likely to continue strongly to identify with their firm even when the latter becomes financially unviable.[103] It can be expected that most wrongful trading claims would be brought against such managers.[104]

b. The role of secured credit

Consider now the effect of the existence of secured credit. The role of security in overcoming agency problems has long been recognised, even though there is little consensus on how it works, on what sort of incentives it creates, and on whether it is cost-effective collectively for the firm and its creditors![105] But the debate rages mainly on whether there are *net* benefits of secured

subject to the present claim were not shareholders of the company or shadows, neither did they exercise any real control over the company's affairs. The company's management was actually undertaken by E, who was either a *de facto* or a shadow director (550F; Millet J's *dictum* in *Re Hydorodam* [1994] 2 BCLC 180 emphasising the mutual exclusivity of the two relationships is duly noted here, but information to ascertain which label better describes E's position is simply not available). Proceedings against the three nominal directors seem to have been initiated because E had been adjudged bankrupt, and his whereabouts were uncertain (551E).

The second case, *Re Continental Assurance Company of London plc* (2001, Transcript available on Westlaw, 2001 WL 720239), is difficult to classify. This was an unsuccessful claim under s. 214. There had been no public issue of Continental's shares (para. 19). It is clear that the managing director of Continental (Burrows) owned shares in Continental's parent and sole shareholder, Yorkdale (paras. 10 and 17). The claim against the other executive director (Davis) was settled out of court (para. 20(2)). Of the five remaining directors, three were nominees of the institutional investors in Yorkdale (Bostock, Burt, and Jennings; paras. 20(4)-(6)). Without wishing to cast any doubt on the correctness of the court's decision here, the significance of the board's composition should be noted. Even when Continental had dubious prospects of avoiding insolvent liquidation, most of its directors would have had *some* incentive to act in the interests, not of Continental's creditors, but of Yorkdale's shareholders. This is because they would anticipate being judged, by the relevant sector of the managerial labour market, not on the basis of their performance as directors of Continental *per se*, but *as custodians of the interests of their appointors, the 'owners' of its parent*. In this respect, their position would be analogous to that of shadow directors, as described in the text above, and the comments made there about shadows would arguably apply to them as well.

[103] For a somewhat similar point, see Pettet, "Liability", pp. 148-9.

[104] Discussion here has been restricted to directors of closely-held firms and shadows. But the prediction generated by the agency analysis of the wrongful trading provisions applies wherever the labour market's influence is weak. This is truer for older directors than younger ones, and for non-executive directors who are not professional managers than career managers, etc. For interesting examples of managers falling into the various categories mentioned, see *Re Continental Assurance Company of London plc* (2001, Transcript available on Westlaw, 2001 WL 720239).

[105] For this author's views, see the detailed discussion in Ch. V, above.

credit.[106] Hardly anyone doubts that security helps control agency *for the secured creditor himself*, and it is this uncontroversial proposition which forms the basis for the argument in the rest of this Section.

It is important to realise that secured credit itself represents a form of bonding by management to secured creditors.[107] Let us recall the various forms of creditor/manager agency costs discussed in the previous Section as they exist on the eve of the firm's insolvent liquidation. The secured creditor has the first claim against the assets the debtor has offered as collateral, and this priority is good against any subsequent purchaser or lender. The initial creditor is immune from having his claim diluted by the debtor taking on (unauthorised) higher priority debt after contracting with him. He is also protected from the incentive the debtor's managers have to increase the risk he must bear:

> If... after a fully secured loan, management has the firm borrow additional funds from a subsequent creditor and then squander those additional funds on a risky project, the initial creditor receives payment in full before the subsequent lender receives any property from the firm... [When the firm approaches insolvent liquidation,] [s]ecured credit's restriction on asset substitution can be valuable, [even] if it does nothing more than prevent a firm from cannibalizing itself, perhaps one Xerox machine at a time [to buy time outside the collective insolvency forum].[108]

Security also has a role as "hostage",[109] because the creditor can seize the collateral if the debtor attempts to misbehave; alternatively, the creditor can assume control of the relevant portion of the business by appointing a receiver. In addition, when the firm is financially distressed, other creditors are reluctant to lend and be subordinated to the secured creditor, and approaching the latter might be the only way the firm can obtain ready credit. The debtor firm's managers therefore have an incentive to keep the secured creditor abreast of the state and prospects of the firm's business, and he is unlikely to be surprised by the firm's distress.

With this in mind, adopt once again the perspective of the bargaining parties in the choice position of the ACM. It would be obvious to them that creditors who intend to extract security have no need for a section 214-type bond. All the advantages associated with the section 214-

[106] See e.g. J. Drukarczyk, "Secured debt", at 208: "The crucial question is whether the reduction of *individual* monitoring costs for secured creditors will generate a reduction of the sum of the monitoring costs of *all* creditors" (emphasis in the original).
[107] See e.g. Adler, "An equity-agency solution", at 77.
[108] *Ibid.*, pp 78 and 82. Of course the debtor can still do so, but only *with* the secured creditor's consent.
[109] Scott, "Relational theory", 927-8.

type duty have already been obtained by secured creditors for their own benefit in the process of acquiring security. It is only the unsecured creditors who have no contractual protection against manager misbehaviour, and only they would benefit from the section 214 duty.

This analysis provides a justification for the Court of Appeal's decision in *Re Oasis Merchandising Services Ltd*[110] that recoveries from errant directors under section 214 are held by the liquidator on a statutory trust for the insolvent firm's unsecured creditors.[111] This serves to highlight the fact that wrongfully trading directors have breached their bond obligations to unsecured creditors, who have also suffered the costs resulting from this breach. Secured creditors do not benefit from the recoveries under this section because, simply, they do not need its protection.

This analysis also suggests how secured credit might have evolved as an alternative to a more general section 214-type bond. If shareholders and managers derive benefit from the section 214 duty, why did something very similar not appear voluntarily in corporate debt contracts before section 214 was enacted?[112] The most obvious response has already been mentioned above: some creditors simply would lack either the foreknowledge or the bargaining power to extract a section 214-type bond. But even apart from that, creditors themselves could not extract a bond too similar to the section 214 duty. In the real world, all the creditors who would lend to the firm during its existence can not come together to negotiate collectively with the firm's shareholders and managers before any lending takes place. Each creditor must transact separately on his own behalf. The problem is that to extract a promise from the firm that on the eve of the debtor's insolvent liquidation, managers would act to minimise loss to *all* creditors, would be to create an externality: the one creditor pays for benefit to be conferred on all. Conversely, a promise to minimise loss only to the *one* creditor would be to confer a preference on him, and this offends the policy of insolvency law.[113] Another way would be for the duty to appear in the articles of association of firms, inserted by the firm's founders to signal to all creditors that they were protected against eve-of-insolvency manager misbehaviour. But the articles of association constitute a contract, though a distinctive one with its own special

[110] [1997] 2 WLR 764.
[111] *Ibid.*, at 773-A - 777-F.
[112] This question is posed by Cheffins, *Company Law*, 547, as a possible objection to viewing s 214 as mirroring the agreement interested parties themselves would strike.
[113] *Re MC Bacon* [1990] BCLC 325. The debtor's desire to prefer would be obvious from the actions of its managers in having contracted *ex ante* to do so.

features,[114] between the firm's shareholders, or between them and the firm's directors as representing the company.[115] Legal doctrine regards the firm's creditors as "outsiders", not privy to that contract, and therefore unable to enforce anything contained in the articles of association.[116] So a duty imposed there for the benefit of the firm's creditors, not being enforceable by the latter, would provide, at best, a very weak signal. That component of the interest rate charged to compensate creditors for the risk of eve-of-insolvency misbehaviour by the firm's managers would therefore be unlikely to be reduced.

The solution to this would-be problem surely lies in the existence of third party security. As already noted in the previous Chapter, commercially powerful lenders (i.e. banks) often seek personal guarantees from shareholder-managers of closely-held firms, or even charges over their personal property, including family homes.[117] This creates a powerful bond, providing banks with effective ways of preventing misbehaviour at the time that the business is in trouble.[118] The predominance of this form of bonding might have compensated for the lack of -- and even impeded -- the evolution of a more inclusive section 214-type alternative. This also suggests the continuing existence of third party security might be creating a tension between directors' duties under section 214 to general creditors, and their incentive to uphold the interests of the bank which has the right to sell their homes if the firm defaults on the secured loan. To the extent that this analysis holds, we should note two implications. First, section 214, properly understood and enforced, might correct the previous imbalance, creating a counter-weight to security-induced incentives to act exclusively in favour of the banks. Second, it might be that in any competition between allowing banks to enforce a charge over the director's personal property, and allowing the liquidator to claim access to that property through a section 214 claim, the balance to be

[114] Companies Act 1985, s 14; *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693, CA.
[115] *Eley v Positive Government Security Life Association* (1876) 1 ExD 88.
[116] *Hickman v Kent or Romney Marsh Sheep-Breeders' Association* [1915] 1 Ch 881; *Beattie v Beattie* [1938] Ch 708; see generally *Farrar*, 118-124.
[117] See also LoPucki, "The unsecured creditor's bargain" (1994) 80 Virginia LR 1887, 1915: "Secured creditors already commonly require individual guarantees from the owners of their corporate borrowers. In effect, they contract for a selective unlimited corporate liability in which they are the only beneficiaries."
[118] Cheffins, *Company Law*, 547, also points out that lenders do not usually seek such protection when dealing with public companies. Adopting the analysis in this Section, this is easy to understand: contractual protection against eve-of-insolvency misbehaviour by managers of publicly-held companies is generally superfluous because of the stronger influence of the market for managerial labour.

struck is rather more delicate than is afforded by the simple incantation that mortgagees seek no more than access to their own property.[119]

6. Perverse incentives

The previous sections of this Chapter have suggested that despite being redistributive, the section 214 duty would be accepted as being in their interest by the relevant parties negotiating as equals in the ACM's choice position. This Section examines the effect of the duty on directors both while their company is healthy, and when it is in terminal decline. Three different types of incentive have been identified,[120] and these are analysed in turn. Each of these incentives -- again varieties of motivation costs -- exists because of the agency relationship between both managers and creditors, and managers and shareholders, and because when the firm is financially distressed, there is a sharp divergence of interests between shareholders and managers on the one hand, and creditors on the other. Motivation costs exist because managers try to maximise their own utility. Such behaviour is not utility-maximising from the creditors' perspective (the punishment, delay and haste effects). It might even be disadvantageous to shareholders (the punishment and haste effects).

a. The punishment effect

The punishment effect exists for all firms, whether they are healthy or troubled. Consider the suggestion that the expected value of the firm is a function of (*inter alia*) the efforts and abilities of its managers. To create incentives for managers to give their best, the firm's shareholders, who benefit from a rise in its value, would design a pay structure which rewarded the managers when the firm did well, and punished them when it performed poorly. The existence of debt in the corporate structure opens up the possibility that the firm would be forced into insolvent liquidation if management fails to provide adequate decision-making and supervision. In this way, debt itself bonds management to shareholders, encouraging them to work to avoid this eventuality and thus in the shareholders' interest. But "for the bonding role of debt to be

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[119] See e.g. James LJ's judgment in *Re David Llyod & Co.*, excerpted at the beginning of Chapter V, above. The balance would obviously have to take into account the argument in the previous Chapter that the security-holders' priority is beneficial for *all* the creditors as a group.

[120] Adopted with some modification from M. J. White's insightful modelling of bankruptcy costs in "The costs of corporate bankruptcy: a US-European comparison": Ch 30 of J. S. Bhandari and L. A. Weiss (eds.),

effective, management must suffer a significant penalty for nonpayment of debts, that is, for going bankrupt."[121] This line of reasoning suggests a provision of insolvency law which penalises managers when the firm becomes insolvent creates the correct incentives for diligence and hard work.

But if the managers are risk averse, the punishment effect may create perverse incentives. Recall that if Claim A carries a certain £100 return, and Claim B carries a return which might be either £200 or £0 with equal probability, the risk averse actor chooses Claim A.[122] Put differently, he prefers a lower but more stable stream of income over a higher but more variable one. There is in fact some evidence that managers in real life are risk averse,[123] which means they:

> may work harder if the variability of their incomes is reduced (i.e., lower income when the firm is successful in return for more lenient treatment when the firm is in financial distress)... This suggests that real world managers may work harder if they are treated leniently, rather than harshly, when the firm is [seriously troubled].[124]

A policy punishing risk averse managers in their firm's insolvency might not then create the correct incentives. It is important, though, to examine *why* managers might be risk averse:

> One reason for managers' risk aversion may be that the value of the firm depends both on managers' effort and on industry-wide or economy-wide factors that are beyond the manager[s'] control. If a firm is unsuccessful, it could either be because managers' effort level was low or because factors beyond managers' control were unfavorable and shareholders may not be able to distinguish between these two.[125]

In other words, managers might be willing to accept responsibility for the variation in their firm's value attributable to their efforts, but they do not wish to act as insurers for shareholders against a downturn in the firm's fortunes totally unrelated to any action or omission on their part. This would imply that an insolvency law rule which focused only on the efforts of managers in penalising them would create an incentive for them to provide the right level and quality of decision-making. The same must hold *mutatis mutandis* as to the managers' incentives to work in

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Corporate Bankruptcy: Economic and Legal Perspectives (Cambridge University Press, New York, 1996), 467 (hereafter, White, "Costs").

[121] P. Aghion, O. Hart and J. Moore, "The economics of bankruptcy reform" (1992) 8 J of Law, Economics, & Organization 523, 531 (footnote omitted).

[122] See generally R. S. Pindyck and D. L. Rubinfeld, *Microeconomics* (Prentice-Hall, New Jersey, 1998) (4 ed), Ch 5.

[123] White, "Costs", at 481, citing M. C. Jensen and K. Murphy, "Performance pay and top-management incentives" (1990) 2 J of Political Economy 225.

[124] White, "Costs", at 481.

[125] *Ibid.*, fn 36.

the creditors' interest, especially on the eve of the firm's insolvent liquidation, when creditors replace shareholders as the firm's residual "owners".

Now section 214 does penalise managers,[126] making them personally liable for harm done to the company's creditors. The concern is not with management's culpability in bringing the firm to the brink of insolvent liquidation, but on what happens past this point. Interestingly, the provision concerns itself exclusively with the managers' actions, requiring them to demonstrate they took "every step [they] ought to have taken" to minimise potential loss to creditors.[127] Note also that the steps required of them are those "which would be... taken[] by a reasonably diligent person" having both the skill and expertise "that may reasonably be expected" of someone occupying that position, and the knowledge and experience possessed by the actual managers respectively.[128] It is clear, then, that section 214 does not require of managers anything they ought not to be expected to bring to their job, and it does not require them to bear the risk of extraneous factors affecting the firm's health. If the analysis above is correct (and depending on what other reasons, apart from the one mentioned, make managers risk averse), section 214 does in fact create the proper incentive for managers to provide the service they were contracted to provide.

A final word on the punishment effect. It is vital to realise that:

> if the goal is to design an economically efficient bankruptcy law, then the effects of the law on firms that are in financial distress or bankruptcy are less important than the incentives that the law sets up for managers of healthy firms.[129]

The reason is that only a small proportion of the firms in the economy at any time are in the formal insolvency forum, and only a somewhat greater number are in financial distress. The punishment effect is by far the most important of the incentives discussed in this Section because it applies to managers of *all* the firms in the economy.[130] It follows that it would be misguided to judge the efficacy or otherwise of the punishment effect created by section 214 only by looking at the number of proceedings brought by liquidators or the number of successful recoveries made

[126] The use of the word "penal" in relation to s 214 in this Chapter should be taken to mean no more than that it compensates the insolvent company's creditors for a particular category of loss *at the expense of* its managers. But see the text later in this sub-section as to the primary role of the provision.
[127] S 214(3).
[128] S 214(4).
[129] White, "Costs", p 467; see also p 496.
[130] *Ibid.*, p 491.

under it.[131] In fact, the effect of the section is somewhat more abstract, bringing very close to home for all directors the reality of the interests of unsecured creditors throughout the firm's life. Empirically, a more accurate approach would be to compare the dividends paid out in all insolvent liquidations as a percentage of the value of all unsecured claims, before and after the coming into force of the provision.[132] This would indicate whether the section is successful in its aim of encouraging directors to minimise loss to creditors on the eve of their company's insolvency.

The analysis above also suggests a partial answer to critics of penal provisions like section 214 who argue that it is pointless to pursue directors of failed companies who might have offered personal security to banks etc., or have invested heavily in their firm while it was on its deathbed. The liquidator, wielding his section 214 claim, would be unable to recover much from them for the company's creditors.[133] This criticism focuses too narrowly on the position when the firm is already distressed, and overlooks the fact that the punishment effect associated with the wrongful trading provisions exists through out the time that the firm is in operation. The *dominant* role of section 214 is not to make good a particular category of loss to the company's creditors, but to encourage managers to do all they reasonably ought to, to minimise that loss in the first place.[134]

b. The delay effect

This incentive arises where managers anticipate a harsh treatment in insolvency proceedings, and take steps to avoid putting their financially troubled company into the insolvency forum. Recall also the argument that creating new rights only within the insolvency forum causes those who lose out as a result (the insolvent firm's directors, in the case of section 214) to try to avoid that forum altogether.[135] If the company is inefficient, so that its assets would be better used elsewhere or under new management, the incentive to delay the onset of formal proceedings is

[131] Criticism on this basis has come for example from Cheffins, *Company Law*, 545, and the sources cited therein (fn 269).
[132] The ratio of recoveries to claims should rise as knowledge of the section and the duties it imposes becomes more widespread.
[133] See e.g. D. G. Baird, "The initiation problem in bankruptcy" (1991) 11 International Review of Law and Economics 223, and C. Williams and A. McGee, "Curbing unfit directors -- Is personal liability an empty threat?", Insolvency Lawyer, Feb 1993, p 5.
[134] For the view that lack of litigation under the section might be undermining its ability to influence manager behaviour, see Cheffins, *Company Law*, 545.
[135] See Section 2, above.

perverse.[136] The paradox is that the harsher the treatment of the managers of insolvent firms, the greater is the incentive for managers to work hard,[137] and the smaller the number of firms which are financially distressed because of manager inefficiency in the first place.[138]

Look at the costs resulting from maintaining the firm's assets in an inefficient use U1; let the value of the firm engaged in U1 be V(U1). Suppose these assets can be put to another more profitable use, U2, which would increase the value of the firm to V(U2). Creditors would benefit from the firm being committed to the new enterprise. Alternatively, all the creditors of the company might be better off as a group if the firm were to be liquidated at the earliest, so that its assets could move to the higher value use.[139] But managers might not choose either alternative. They would not adopt the more efficient use of the firm's assets because "[their] human capital [was] specialized to the old use of [the firm's] capital",[140] and they would not cause the firm to enter the insolvency forum because they would lose their jobs. The delay effect includes the opportunity cost of the forgone use U2, which is V(U2) - V(U1).[141] In addition, managers would contrive to keep the firm out of the insolvency regime's reach either by choosing excessively risky projects (over-investment), or by conserving cash (under-investment), or by inducing creditors to lend to them in return for a charge on the firm's assets (claim dilution).[142] When the firm is finally liquidated, there would not be much left for its unsecured creditors.

Consider now the effect of section 214, which is redistributive and "harsh".[143] Does it create perverse incentives for directors to postpone the moment at which the insolvency regime applies? It is suggested here that the reverse is in fact true. Recall that once there remains no reasonable prospect of their firm avoiding insolvent liquidation, directors are required to take every step they ought to take to minimise harm to creditors. To continue with the notation employed above, section 214 compels directors to choose at the earliest to commit the firm's assets to their most valuable use, U2, since that is one of the steps reasonable directors faced

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[136] White, "Costs", p 485.
[137] Subject to the remarks about risk aversion, *supra*.
[138] White, "Costs", p 485. As has already been noted, firms might be distressed for industry- and economy-wide reasons and not because of any management shortcoming.
[139] *Ibid.*, p 486.
[140] *Ibid*.
[141] That is, the excess in the firm's value, had its resources been applied to U2, over the value of the firm with its resources sunk in U1.
[142] *Ibid.*, p 487.
[143] Because it punishes directors for their acts or omissions by making them personally liable for the resulting harm to creditors.

with that situation would take. If this is not done, the opportunity cost [V(U2) - V(U1)] is in fact the harm done to the firm's creditors by the directors' omission, and this amount is a constituent of the total amount of their liability. In the alternative and more generously for them, they might be ordered to contribute "the amount by which the company's assets can be discerned to have been depleted"[144] by the continuation of the company's business beyond the point at which the directors ought to have concluded liquidation was more efficient a choice than continuation in use U1.

Finally, note that if a creditor enables the business to be continued in return for a charge over the company's assets and the directors continue to ward off liquidation, the amount they are eventually ordered to contribute would be immune from any claim the secured creditor might later make.[145] The result is to focus the loss on those making the inefficient decision to continue, and to direct the recoveries towards those who would otherwise lose out because of that decision. As has been mentioned above,[146] the secured creditor might be able more effectively to monitor assets subject to its security interest, and is unlikely to be taken by surprise when the firm becomes seriously distressed. Directors are unlikely to be able to substitute assets which form part of the collateral without the secured creditor's consent, and in many cases, they would be unable to continue the troubled business without his collusion. The effect of the *Re Oasis* decision is to ensure the secured debt is not insured, beyond the value of the collateral, by the personal assets of directors. To hold otherwise would have been to reward secured creditors either for inefficient monitoring or for collusion with errant directors.[147]

c. The haste effect

Does section 214 encourage liquidation of efficient but troubled firms? The costs result from the loss of going concern value,[148] because the firm's assets are more valuable together than if they were split up and sold piecemeal. As a preliminary point, it must be emphasised that the

[144] *Re Produce Marketing Consortium Ltd (No. 2)* [1989] 5 BCC 569, 597, per Knox J.
[145] *Re Oasis Merchandising Services Ltd* [1997] 2 WLR 764, 773-G.
[146] Section 5, above.
[147] Generally on the delay effect, White, "Costs", at 486, notes that the delay effect would be smaller in jurisdictions (like England) where creditors can appoint receivers and frequently initiate involuntary winding-up proceedings. What she does not consider here is the fact that the right to appoint a receiver is available only to secured creditors, and that there is significant informational asymmetry between managers and unsecured creditors as to the firm's financial state, which might impede the latter in making a timely decision to initiate winding up.

obligation to take "every step" the directors ought to take to minimise loss to creditors should enable directors subsequently challenged under section 214 to show that continuation of the business was in fact in the creditors' interests at the time that they concluded there was no reasonable prospect of avoiding insolvent liquidation. This view can only gain support from the fact that, when enacting the section, Parliament rejected an attempt to define the obligation with reference to the incurring of further debts or other liabilities, and the word "trading" was omitted from its formulation.[149] In fact, then, the immediate shutting down of the business, while presumably avoiding any further (variable) costs, would not prevent the directors being held liable under the section. By the same token, it should in appropriate circumstances be a good defence that the firm was kept trading, even though this adds to its liabilities:

> If directors reasonably believe that creditors may fare worse in a premature forced sale of assets, and that this combined with the cost of liquidation proceedings may well be disastrous from unsecured creditors' point of view, the directors' duty under section 214 may well include a duty to attempt a company rescue or to stay at the helm.[150]

But the concern about over-hasty liquidation becomes important against the background that -- at least in the early days of the wrongful trading provisions -- directors were repeatedly urged to seek a winding up or administration order, or to invite the appointment of a receiver, in order to avoid a section 214 order against them.[151] Against that background, fears were expressed that:

> There is a clear risk that this may now seem the safest course for directors, faced as they are with the threat of personal liability and possible disqualification, even when in their own business judgment there is a good case for carrying on.[152]

Note that if the costs of acquiring and transmitting information about the firm's business prospects, and of transferring its assets from an inefficient management (or use) to a more efficient one, are low, the going concern value would not be lost. The liquidator or administrative receiver[153] would be able to dispose of the business as a unit, and the new management would

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[148] White labels these as Type-II costs; *ibid.*, at 489.

[149] L. S. Sealy and D. Milman, *Annotated Guide to the 1986 Insolvency Legislation* (CCH Editions Ltd, Bicester, 1987), 223.

[150] V. Finch, "Directors' duties: insolvency and the unsecured creditor", in A. Clarke (ed), *Current Issues in Insolvency Law* (Stevens, London, 1991), at 96.

[151] See again e.g. *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984), *supra*, para 12; R. Goode, *Insolvency*, pp 472-3.

[152] Sealy and Milman, *supra*, 224. For a balanced view, see Keay, *Liquidation*, pp. 628-9.

[153] The latter relying in part on IA, s. 43, which empowers the court to authorise disposal of property subject to a prior charge.

decide to keep it running as such.[154] In such a situation, section 214 does not create unnecessary costs even if directors interpret their obligations under it so as to give undue emphasis to the appointment of outside managers.

But suppose information and other transaction costs are high. In this case, the liquidator might find it difficult to dispose of the business as a going concern because potential buyers are not informed enough to arrive at the correct conclusion that it would pay to keep the business together. Or the reason might be the difficulties inherent in "assembling a suitable group of investors to be risk bearers" of an extensive and costly undertaking.[155]

Be that as it may, it is to be noted that these costs arise because of the misguided elevation of the appointment of outside management as a panacea to all section 214-related problems. Even in this limited situation where section 214 might create perverse incentives, though, it is difficult to see how it is its redistributive nature that is to blame. Recall that the perverse incentive to hasten the company into the insolvency forum is supposed to arise because the claimants in whose favour the redistribution is carried out would want to capture the advantages available only in that forum.[156] Under section 214, the firm's unsecured creditors benefit from the redistributive nature of these provisions. But the quantum of the benefit they receive under the insolvency regime is determined by reference to the loss that is attributable to the actions or omissions of the management once insolvent liquidation becomes inevitable. So if the firm's managers *delay* the inevitable, or otherwise fail to respond appropriately, any additional loss to unsecured creditors would be recovered from them. But if one or more of the unsecured creditors unduly *hasten* the firm's demise, then it would be easy for directors to show they took every step they ought to have taken -- including taking steps to oppose the winding up petition -- to minimise loss to creditors.

[154] White, "Costs", 490.
[155] P. Aghion, O. Hart and J. Moore, "The economics of bankruptcy reform" (1992) 8 J of Law, Economics, & Organization 523, 528-9.
[156] See *supra*, *What is wrong with redistribution?*

7. Conclusion

The wrongful trading provisions of the Insolvency Act are meant to ensure that hopelessly troubled companies enter the insolvency forum at the optimal time.[157] This forum enables -- and forces -- those interested in the company's undertaking to forego aggressive and value-destroying individual action. In other words, one of the functions of the collective insolvency regime is to minimise the co-ordination costs of the creditors of a firm threatened with insolvency. Section 214 is a tool enabling the regime to take over when these costs would be most acute. The existence of the collective regime might itself create motivation costs by producing incentives for parties who would lose out under it to try to prevent the company becoming subject to it. Directors would act for themselves and on behalf of shareholders to keep the firm out of the insolvency forum. The central insight offered into section 214 in this Chapter is that the section assists in overcoming the co-ordination costs of creditors by controlling creditor/manager agency costs on the eve of insolvent liquidation.

The analysis in this Chapter has operated on two levels. First, this Chapter has shown that the wrongful trading provisions would be voluntarily accepted by all the relevant parties bargaining in the choice position of the ACM. Here, all the parties anticipate the incentives of managers to misbehave towards creditors when their firm is on the brink of insolvent liquidation. A provision like section 214 bonds managers to creditors when the firm is terminally distressed, and thus signals the credit and labour markets not to penalise shareholders and managers. Of course where a market solution is available -- as it is in the shape of the discipline imposed by the market for managerial labour, and the existence of security -- the section 214 bond takes the back seat. This Chapter has suggested that wrongful trading claims would generally be brought against shareholder-managers of closely-held companies, and shadow directors, and has examined 'impressionistic' evidence which is not inconsistent with this hypothesis. It has also been shown that on this analysis, the Court of Appeal's decision in *Re Oasis*, directing section 214 recoveries away from secured creditors, is perfectly reasonable.

On another level, the Chapter challenges the well-established Law and Economics proposition that to redistribute in insolvency leads to perverse incentives. It has been argued that the wrongful trading provisions are redistributive. They strip away the benefit of limited liability

[157] Either through the invocation of a formal insolvency proceeding by the directors, or more generally, by realigning their own duties towards protecting the interests of the company's creditors as a group.

from the insolvent company's directors, making their assets vulnerable to a claim by the liquidator on behalf of the company's unsecured creditors. This takes place only within the specialised insolvency forum, and only because the distinct insolvency regime creates new rights and liabilities which are incapable of existing while the company is still solvent. Three types of perverse incentive which might potentially lead to unnecessary motivation costs are described. The analysis has suggested that, far from creating perverse incentives, section 214 in fact encourages directors of troubled and healthy companies alike to operate with some much-needed regard for the company's unsecured creditors.

One way to respond to this analysis would be to argue that the wrongful trading provisions are exceptional in not being inefficient despite being redistributive. It might be suggested that "the question of relative mismatch [between the value of pre- and post-insolvency rights] may not be decisive."[158] One must focus also "on the incentives to misuse bankruptcy created by one rule or the other."[159] It is only if a change in the value of rights creates incentives to use the insolvency regime strategically that the change should be condemned. But this response gives the game away. The position then taken amounts to saying that insolvency redistribution creates perverse incentives, but *only* where it creates perverse incentives! It is tentatively suggested here that, using Occam's Razor, the objection to the redistribution of rights *per se* can be cut out altogether. A provision, like section 214 of the Insolvency Act, may or may not encourage strategic misuse of the insolvency regime, but its redistributive nature is only one relevant factor to be taken into account, and by no means is it decisive. The dogmatic opposition to any alteration of the relative values of parties' rights can be dropped. If this cautious suggestion is accepted, then the Law and Economics approach can free itself of a self-imposed shackle in dealing with insolvency issues.

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 maximisation goals. The redistribution is principled, focusing on minimising 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 section quite clearly preserves and maximises the pool of assets with which the firm enters that forum. It therefore serves a primary goal of insolvency law. It also encourages a smooth transition from the

158 Jackson, *Bankruptcy*, 74.

individual pre-insolvency to the collective post-insolvency regime by creating a counter-weight to the value-destroying incentives which otherwise come into existence (unjustified delay in initiating insolvency proceedings is penalised, for example). The wrongful trading provisions also therefore serve the collectivisation goal.

[159] *Ibid.*, commenting on J McCoid, "Bankruptcy, the avoiding powers, and unperfected security interests" (1985) 59 Am Bankr LJ 175.

Chapter VII: Conclusion

The aim of this thesis was to show that English corporate insolvency law is consistent in principle. This was taken to mean that this law could be shown to be supported by principles which are internally coherent, which treat all those affected by this law as equals, and which are transaction-cost efficient. The thesis began by sketching out and defending the way in which this claim was to be understood. It was argued that the principles taken to be embedded in insolvency law are not to be discovered by reference to the states of mind of the numerous legislators who have defined this body of law over the centuries. Nor are they simply to be excavated from its history. Rather, the principles of this law must be 'constructed' in a way which, both, explains the existing law in an illuminating way, and which justifies it with reference to its abstract 'point'. That 'point' was argued to lie in conceiving of insolvency law as a scheme of fair co-operation in the circumstances peculiar to insolvency. Seen in this light, it was claimed that insolvency law displays consistency of principle.

Since an important aspect of the project of the thesis was to build a new model for the analysis and justification of insolvency law, it needed to be demonstrated why prior attempts at doing so might be considered inadequate. So attention was first paid, in Chapter II, to the Creditors' Bargain, the best-known of these attempts. It was argued that the Bargain model has neither descriptive nor moral force. The model relies on a confused and ultimately meaningless notion of consent. It seeks to appeal to the antecedent self-interest of creditors to suggest they would choose certain principles to decide how their debtor's assets should be dealt with in the latter's insolvency. But it suggests no privileged point from which the choice is to be made. Since the self-interest of creditors depends on how effective they would be (*vis-à-vis* other creditors) in each transaction in collecting what is owed to them in any insolvency regime not marked by the automatic stay, certain types of creditor would benefit but others would be worse off in any given transaction because of the automatic stay. Further, the interest of each creditor would be different depending on when it is calculated. The Bargain model therefore fails to explain why *all* creditors equally would accept the automatic stay.

What is more, the Bargain is built on the simple preferences creditors would express, based on their individual self-interest. But it provides no reason why preferences expressed at one instant in time ought permanently to be imposed on creditors by being enshrined in the law, when contrary preferences would be expressed by the same parties, based again on self-interest, at other times. The model thus provides no justification for the coercion inherent in insolvency law. And finally, the model allows the parties to be as different from each other during the bargaining process as they are in real life. This means stronger parties would be able to oppress weaker ones. Thus, the rules selected by the model are likely to be exploitative rather than just.

The thesis then constructed, in Chapter III, an alternative contractarian model to analyse and justify the principles of corporate insolvency law. This model built on the assumption that all those affected by insolvency law are to be regarded as equals, with the consequence that their interests must be accorded equal care and concern in the choice of insolvency law principles. The notion of Dramatic Ignorance was introduced to accomplish this result. It was argued that, given the features of the Model, principles approved by the ACM could be regarded as being those that the relevant parties themselves would choose in exercise of their political autonomy, if given the chance to bargain with each other under the appropriate conditions. The automatic stay on the individualistic collection efforts of unsecured creditors, which defines the collective liquidation regime, was argued as passing the tests set by the ACM.

An important part of the argument in this Chapter was addressed to defining the proper ambit of insolvency law. This point was made through a contrast of the approach of the ACM, with that of others, most notably of Donald Korobkin. Korobkin's Rawlsian model for the analysis and justification of (US) bankruptcy law seeks to address problems which, it was argued, are not unique to the context defined by corporate insolvency. This means his model would sometimes generate principles for inclusion in bankruptcy law which are inconsistent with the principles enshrined in other branches of the law, even though both sets of principles (bankruptcy and non-bankruptcy) dealt with situations identical in all material respects. The examples considered to illustrate this point included those of workers losing their jobs, and of communities being harmed because of the closure of businesses; both these situations can and do arise with or without the relevant legal entity becoming insolvent. So some people might be treated differently from each other, depending not on any *relevant* difference in their situations, but simply because some of them did and others did not become subject to insolvency law. This violates the basic assumption of all reasonable legal systems, that people should be treated alike except when there is a good reason for treating them differently. It was suggested that the proposals of some other scholars in this area, including Elizabeth Warren, Karen Gross, and

Venessa Finch, are also open to the same objection. To avoid this problem, the ACM requires a demonstration that a principle proposed as being suitable for inclusion in insolvency law deals only with some situation peculiar to (corporate) insolvency.

The claim that the law of corporate insolvency can and should be seen as consistent in principle was put to the test in Chapters IV to VI. The analysis in Chapter IV was concerned with the long-established *pari passu* principle of insolvency law. The law adopts a number of different priorities for dealing with different types of claim in corporate insolvency, and these were considered in the light of empirical evidence as to the constitution of corporate debt in this jurisdiction. This confirmed what has long been known as an anecdotal matter, that the *pari passu* principle is very much an exception as a method of *actual* distribution of insolvent estates. The analysis then employed the distinction between immunity and priority (introduced in Chapter III) to suggest that the 'equality' principle plays little role in ensuring an orderly winding up of insolvent companies. Nor does it underlie or justify the collectivity of the liquidation regime, or the insolvency rules for the adjustment of certain pre-liquidation transactions. The ACM was invoked to show that the 'equality' principle also has little to do with fairness in liquidation. Some of the case law said to demonstrate the operation of the principle was examined in support of these arguments. The view put forward in the Chapter was that the *pari passu* principle is actually a fall-back provision, ideally suited to governing those claims which will not be met to any significant degree in most insolvent liquidations.

Chapter V examined the case against the priority of secured claims in corporate insolvency. Arguments that it allows for the exploitation of "involuntary" or "uninformed" or "unsophisticated" creditors are of course of special concern to the project of this thesis: if the law allows the exploitation of some parties by others, then it does not treat all of its subjects as equals. Empirical and economic reasons were given in favour of the proposition that the priority of secured credit is unlikely to create opportunities for exploitation. The claim that this priority creates motivation costs for the parties as a group by encouraging the debtor and favoured creditors to switch from the extraction and enforcement of monitoring covenants, to simple reliance on the protection offered by security, was also examined in some detail. This argument was shown to be based (as is the one before) on the assumption that secured debt is cheaper than unsecured debt. As it happens, however, this assumption is strongly belied by whatever evidence is available from this jurisdiction.

In addition, there is reason to suppose monitoring covenants on the one hand, and the protection offered by security on the other, are not substitutes for each other. The former have a bi-directional informational role which means they would be indispensable even in secured debt transactions. For these reasons, it was suggested that these anti-priority arguments are also unsuccessful. The Chapter closed with the demonstration that the priority of secured credit, by enhancing the liquidity of the debtor, raises the expected value of *all* the claims against it. Being thus of mutual benefit to all the relevant parties, it passes the tests set by the ACM, and would be part of any rational scheme of fair co-operation devised to deal with insolvency matters.

The wrongful trading provisions of the Insolvency Act 1986 were the subject of Chapter VI. They were used to challenge the Law and Economics proposition that any re-distribution of rights carried out by insolvency law would be illegitimate and inefficient. The ACM was deployed to argue that, despite being re-distributive, the wrongful trading provisions could be regarded as acceptable to all the relevant parties treated as equals, and are thus justified. It was also shown that, given the role of the managerial labour market, these provisions could be expected to be invoked mostly against the directors of closely-held companies. Finally, the incentives created by these provisions were considered. Contrary once again to the arguments of many of those writing in the Law and Economics tradition, these were demonstrated to be useful in reducing the motivation costs of directors' activities on the eve of their company's insolvent liquidation.

It is submitted that these arguments show that, not only is it *possible* to see insolvency law as consistent in principle, but in fact, that it is both analytically and normatively *valuable* to do so. Adopting the perspective that this body of law stems from principles which could be regarded as acceptable to all those subject to it, conceived of as equals, allows an insight into the deep structure of those features of insolvency system considered in Chapters III to VI. This perspective also reassures us that (much of) this part of our law is justifiable and legitimate. And since it has been argued that a *rational* scheme of fair co-operation under the circumstances peculiar to corporate insolvency would seek to minimise waste, concluding that these features would be part of just such a scheme then allows us to be confident that this part of the law is also (transaction-cost) efficient. To the extent that these arguments are accepted, we can see finally that the Authentic Consent Model, which has yielded insight into some of the features of insolvency law, is available for the analysis of the rest of it. This thesis, though conceived of and executed as a self-standing project, can then be regarded as the first part of a work in progress.

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