CORPORATE RESCUE LAW IN SINGAPORE AND THE APPROPRIATENESS OF CHAPTER 11 OF THE US BANKRUPTCY CODE AS A MODEL

This article looks at some of the main features of Chapter 11 of the US Bankruptcy Code and considers their appropriateness for adoption in the Singaporean context. Chapter 11 deals with the reorganisation of ailing businesses though there is no formal insolvency requirement before a company can file for Chapter 11 protection. The nearest statutory equivalent to Chapter 11 in Singapore is perhaps judicial management under s 227 of the Companies Act or perhaps judicial management coupled with a s 210 scheme of arrangement. The article begins by endeavouring to explore the underlying objectives of corporate rescue law. This is followed by a look at the main features of Chapter 11. Some specific features of Chapter 11 are then considered with a view to their possible adoption in the Singaporean context.

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I. The objectives of Chapter 11 and corporate rescue law in general

1 Many countries now have corporate rescue or restructuring laws which seek to preserve the going concern value of an ailing enterprise. The underlying principle behind restructuring or reorganisation proceedings is that a business may be worth a lot more if preserved, or even sold, as a going concern than if the parts are sold off piecemeal.[1] In

1 For a somewhat sceptical perspective see Douglas G Baird & Robert K Rasmussen, "The End of Bankruptcy" (2002) 55 Stan L Rev 751 at 758: "We have a going-concern surplus (the thing the law of corporate reorganizations exists to preserve) only to the extent that there are assets that are worth more if located within an existing firm. If all the assets can be used as well elsewhere, the firm has no value as a going concern." Richard V Butler & Scott M Gilpatric see "going-concern surplus" more broadly in "A Re-Examination of the Purposes and Goals of Bankruptcy" (1994) 2 American Bankruptcy Institute Law Review 269 at 282: "part of the going concern surplus represents the value to the firm of the relationships which it has established with factor owners. The rest reflects the value to it of its relationships with customers, regulators, and other interested parties."

other words, there is a surplus of going concern value over liquidation value.[2]

2 In the US, as one court put it "the purpose of [Chapter 11] is to provide a debtor with the legal protection necessary to give it the opportunity to reorganize, and thereby to provide creditors with going-concern value rather than the possibility of a more meagre satisfaction of outstanding debts through liquidation".[3] Influential US commentators have reduced the liquidation versus reorganisation question to a quasi-mathematical formula. It has been suggested that whether a firm should be kept together as a going-concern is answered by estimating the income stream that the assets would generate if they were kept together, taking into account the risk of reorganisation failure, discounting that stream to present value, and comparing it to the amount that the assets would realise if they were sold off in separate pieces.[4] Since going concern value may be a lot more that break-up value, reorganisation proceedings are designed to keep a business alive so that this additional value can be captured.[5]

3 This objective is itself controversial for there is a widely held view that if a company encounters economic difficulties the simplest and most effective solution is to put it out of its misery, so to speak, by terminating its existence. If a business is no longer viable, then the most sensible solution may be to shut it down. If a company is producing goods and services for which there is no ready market, then why not liquidate it? For example, take the case of a dog food company that is producing food that dogs do not like. There seems little gain in keeping such a company alive.[6] Moreover, preserving dying companies or putting them on a life support and resuscitation machine may do little to benefit the industry in which they operate. Instead, it may hurt

2 Omer Tene, "Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganisations" (2003) 19 Bankruptcy Developments Journal 287.

3 *Canadian Pacific Forest Products Ltd v JD Irving Ltd* (1995) 66 F 3d 1436 at 1442.

4 See D G Baird & T H Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment of adequate protection of secured creditors in bankruptcy" (1984) 51 U Chi Law Review 97 at 109. See also Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, 1986) at p 184.

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

6 See, generally, Michelle J White, "Does Chapter 11 Save Economically Inefficient Firms" (1994) 72 Wash U LQ 1319; "The Corporate Bankruptcy Decision" (1989) 3 J Econ Persp 129; James J White "Death and Resurrection of Secured Credit" (2004) 12 American Bankruptcy Institute Law Review 139.

competitors by forcing them to compete with debt-reduced and restructured companies, but ultimately inefficient companies, in a crowded market place. The US airline industry may be an example of this."[7]

4 One of the principal characteristics of a market economy is that some companies fall by the wayside. Forcing investors to keep their assets locked up in what is at best a marginal enterprise may prevent the same investors from making more productive use of the assets in a more efficient enterprise. It also may reduce their incentive to invest these assets in the first place.[8]

II. Going concern value and the modern service sector oriented economy

5 Certain commentators have put forward the thesis that because of changes in the economy and, in particular, technological advances, globalisation and the rise of the service sector, we are witnessing the end of corporate reorganisations as traditionally understood.[9] They point to the decline of heavy industry and make the point that successful companies today are not very much like the US railways of the 19th century which were the historical prototype for Chapter 11. In the case of a railroad company, the assets had very little value when sold off individually – nothing but "a streak of rust iron in the prairie" to use a memorable phrase. In the case of a modern company, the most valuable resource may be human capital who can walk out the door at five o'clock in the evening. The accoutrements of the modern office may have just as much value if sold off to another company than if kept by the debtor.

6 In the real world, however, transaction costs cannot be ignored.[10] Transaction costs are all around us. They exist in almost every

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7 See Robert K Rasmussen, "The Efficiency of Chapter 11" (1991) 8 Bankruptcy Developments Journal 319 at 320–321.

8 See Baird & Jackson (1984) 51 U Chi L Rev 97 at 102.

9 One study suggests that in 2002, in more than 80% of all large Chapter 11s, the companies concerned used the process to sell off their assets rather than to reconstruct their debts in the traditional way – see D G Baird & R K Rasmussen, "Chapter 11 at Twilight" (2003) 56 Stanford Law Review 101 at 102.

10 Even Professor Baird himself seems to acknowledge this implicitly – see the discussion in *Elements of Bankruptcy* (New York: Foundation Press, 4th Ed, 2006) at pp 229–235 and see the comment at p 235: "The players in a large corporate reorganization, even those that most resemble the nineteenth-century railroad, no longer see a Hobson's choice between a sale in an illiquid market or a costly reorganization. Instead, they see the choice as one between selling the business to other investors in a developed, but not perfect, market or keeping it themselves in a proceeding that has become cheaper and easier to control over time."

move of daily life. Going concern value resides principally in various relationships "among people, among assets, and between peoples and assets".[11] It is tough to start a business from scratch. Networks of relationships are at the heart of a modern business. Costs incurred in creating most of these necessary relationships will inevitably be lost if the business is scattered to the winds through a piecemeal sale of assets. Substantial additional costs will be incurred in the establishment of new relationships and the starting up of a business afresh. Moreover, centralised management and other benefits from economies of scale can be the source of going concern value.[12]

7 These points have been well made by the Legal Department of the International Monetary Fund ("IMF") who go so far as suggesting that changes in the nature of the economy has meant that reorganisation and restructuring of ailing firms has become more important than ever before:[13]

> [I]n the modern economy, the degree to which an enterprise's value can be maximized through liquidation of its assets has been significantly reduced. In circumstances where the value of a company is increasingly based on technical know-how and goodwill rather than on its physical assets, preservation of the enterprise's human resources and business relations may be critical for creditors wishing to maximize the value of their claims.

8 Simply stated, some companies are worth more as going concerns run by existing managers and with existing shareholders than if sold to third parties and managed by new teams.[14] The going concern surplus may result from the informational advantages of existing management or from the sunk costs of arranging assets in strategic blocks. The surplus has to be substantial, however, to justify the very substantial administrative, negotiating and legal costs of the reorganisation proceedings themselves.

III. Economic distress versus financial distress

9 In commenting on the value of corporate rescue laws, it is common to draw a distinction between economic distress and financial

11 L M LoPucki, "The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy" (2003) 56 Stan L Rev 645.

12 See H Miller & S Waisman, "Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for The Twenty-First Century?" (2004) 78 Am Bankr LJ 153 at 192–93.

13 *Orderly & Effective Insolvency Procedures* (Legal Department, International Monetary Fund, 1999) at p 14.

14 See D Baird & R Picker, "A Simple Noncooperative Bargaining Model of Corporate Reorganizations" (1991) 20 J Legal Studies 311 at 315.

distress. Economic distress implies that the business plan is not working. The economic model on which the company is based suffers from some flaws. Companies in economic distress are not good candidates for reorganisation unlike companies in financial distress. Financial distress implies liquidity problems of some sort and where a company cannot meet its current liabilities. This may have been caused by some short-term dislocations in market conditions. The bankruptcy of a customer may have affected the company's capacity to honour its commitments to its own suppliers. The company may have been trading across national frontiers and been badly caught out by currency fluctuations. Alternatively, debt-servicing costs may have risen sharply beyond the company's capacity to service them.[15] In the latter scenario, an obvious solution (if difficult to achieve in practice) would be to convert some or all of the company's debt into equity. The necessary consent from creditors may not be forthcoming, however, and so recourse to formal procedures is necessary to concentrate minds sufficiently.

IV. Wider purposes served by corporate rescue laws

10 In many jurisdictions, including the US, discussion of the purposes served by corporate rescue laws has ranged beyond a narrow focus on the going concern surplus. For instance, in the US Congress, it has been stated that:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors and provide a return for its stockholders.[16]

11 Outside the congressional context, Chapter 11 has even been spoken of as bound up with the preservation of the American way of life in that it provides the opportunity for the small business debtor to survive economic upheaval. If jobs in small business enterprises

15 See Richard Posner, *Economics Analysis of Law* (Aspen, New York, 6th Ed, 2003) at p 421: "… the firm may find that its revenues do not cover its total costs, including fixed costs of debt. But they may exceed its variable costs, in which event it ought not be liquidated yet. And maybe in the long run the firm could continue in business indefinitely with a smaller plant. In that event it might not have to replace all of its debt when that debt was retired, its total costs would be lower, and its (lower) demand and (lower) supply curves might once again intersect. In short, the company may have a viable future, short or long, which it can get to if it can just wipe out its current debt. One way of doing this is to convert that debt into equity capital, at which point the debt will cease being a fixed cost and thus cease preventing the company from meeting its other expenses."

16 HR Rep No 595, 95th Congress, 1st Sess 220 (1977).

disappear, then competition and convenience may disappear with them.[17]

12 Similar themes have also been taken up by the IMF in its paper "Orderly & Effective Insolvency Procedures: Key Issues".[18] The IMF has spoken of corporate rehabilitation procedures as serving a broader societal interest in that business debtors are given a second chance and this encourages the growth of the private sector and an entrepreneurial class. More generally, the IMF has acknowledged that:[19]

> [E]conomic efficiency is not the only consideration when designing insolvency laws. There are social and political factors that are served by the existence of formal rehabilitation provisions and, in particular, the protection of employees of a troubled enterprise. These considerations explain why the design of rehabilitation provisions varies from country to country. When countries evaluate and reform their insolvency laws, the key question will often be how to find the appropriate balance between a variety of social, political, and economic interests that will induce all actors in the economy to participate in the system.

13 To sum up, apart from maximising returns to creditors, corporate rescue law is seen as also helping to secure other objectives. These include preserving employment, encouraging the creation and development of an entrepreneurial class of business people and facilitating national strategic objectives such as maintaining choice for the consumer and keeping alive national champions that might otherwise fall victim to foreign competition.

14 There is a degree of ambiguity, however, about whether the preservation of employment and the other identified objectives should be seen as independent goals of corporate rescue law or merely incidental benefits that come from rescue proceedings and the preservation of the going concern surplus.

15 Some "community-minded" commentators suggest that the law should be designed to save jobs and companies for the benefit of numerous impacted constituencies, and not just for the exclusive benefit of creditors:[20]

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17 James B Haines & Philip J Hendel, "No Easy Answers: Small Business Bankruptcies after BAPCPA" (2005) 47 Boston College Law Review 71 at 92. "We know this form common experience in the retail industry. When the small, local business disappears, consumers are left largely with the regional megastores. Less competition usually results in higher prices and poorer service."

18 Legal Department, International Monetary Fund (1999).

19 *Orderly & Effective Insolvency Procedures* (1999) at p 14.

20 E Warren, "Bankruptcy Policymaking in an Imperfect World" (1993) 92 Michigan Law Rev 336 at 354–355.

> Bankruptcy policy also takes into account the distributional impact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business. Business closings affect employees who will lose jobs, taxing authorities that will lose rateable property, suppliers that will lose customers, nearby property owners who will lose beneficial neighbours, and current customers who must go elsewhere. Congress was acutely aware of the wider effects of a business failure on the surrounding community and it adopted the 1978 Bankruptcy Code specifically to ameliorate those harmful effects …

16 Contractarian theorists would respond broadly by saying that only legally enforceable interests of particular members of these constituencies under the general law applying outside the insolvency context should be taken into account.[21] These theorists have advanced a "creditors bargain" view which suggests that that insolvency law should generally reflect the hypothetical agreement that creditors would reach if they were to bargain amongst themselves before extending credit to the company.[22] The terms of the hypothetical bargain are regarded as efficient because those terms represent the product of unfettered bargaining among property owners and, once derived in this way, they stand as a critique of the corresponding provisions of insolvency law. The analysis assumes that the parties bargained solely on the basis of entitlements that are created by the general law applying outside the insolvency framework and did not bargain from any entitlements created under insolvency law.[23] Moreover,[24] "[t]he cornerstone of the creditors' bargain is the normative claim that pre-bankruptcy entitlements should be impaired in bankruptcy only when necessary to

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21 For a more inclusive perspective see R J Mokal, "The Authentic Consent Model: Contractarianism, Creditors' Bargain and Corporate Liquidation" (2001) 21 Legal Studies 400 at 440–443 and see also D R Korobkin, "Rehabilitating Values: A Jurisprudence of Bankruptcy" (1991) 91 Columbia Law Review 717.

22 Jackson in *Logic and Limits of Bankruptcy Law* (1986) at p 17 footnote 22 suggests that this is an application of the famous Rawlsian notion of bargaining in the "original position behind a veil of ignorance" – see John Rawls, *A Theory of Justice* (1971) at pp 136–142. But for claims that Jackson got Rawls wrong see Donald R Korobkin, "Contractarianism and the normative foundations of bankruptcy law" (1993) 71 Texas Law Review 541; R J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press) at pp 61–62.

23 See the comments of the US Supreme Court in *Butner v US* (1979) 440 US 48 at 54–55: "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analysed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy."

24 Thomas H Jackson & Robert E Scott, "On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain" (1989) 75 Virginia Law Review 155 at 155–156.

maximise net asset distributions to the creditors as a group and never to accomplish purely distributional goals".

17 It is easy to be critical of the creditors' bargain theory. The theory is ultimately based on some conception of what parties will do in practice in the real world but the parties are some figments of a theoretician's imagination with all the imaginary attributes ascribed to them by their creator. The creator is conceiving certain characteristics and then investing the characters with these qualities. Such fictional features may not have any necessary relationship with the qualities of actual creditors.[25] Nevertheless, the theory is in tune with a lot of contemporary thinking in the US which puts increased emphasis on the rights of creditors. If the choice between liquidation and reorganisation is not to be skewed, there is a lot to be said for making those who benefit from a possible upswing of company fortunes bear the cost if the rescue attempt turns out to be unsuccessful.[26] The creditors' bargain theory would suggest that secured creditors should be compensated for any delay in enforcing their collateral. It is argued that such a rule does not prevent desirable reorganisations but instead encourages junior creditors and shareholders to pay for the rescue opportunities sought by them.

18 The creditors' bargain theory, while it does not provide the whole picture, is useful because it tells us that somebody has to pay for the costs of corporate rescue. If secured creditors have to bear these costs without gaining any corresponding benefits then this may impact on their initial lending decisions. But the theory seems too narrow and artificial insofar as it suggests that the focus of corporate rescue law should be entirely upon the rights of creditors and that the law should reflect the contents of some fictitious bargain among creditors. Others have suggested that insolvency law should be evaluated from the point of view of multiple values or frameworks. For example, Prof Elisabeth Warren has identified four principal goals of the insolvency system as being to enhance the value of an ailing company, to distribute that value according to multiple normative principles, to internalise costs of business failure among parties dealing with the company and, finally, to promote reliance on private monitoring arrangements.[27] In her view, however, the insolvency regime protects only in an indirect fashion the interests of parties without formal legal rights largely through provisions that permit businesses to reorganise instead of being shut

25 See Roy Goode, *Principles of Corporate Insolvency Law* (Thomson, 3rd Ed, 2005) at p 46.

26 D G Baird & T H Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment of adequate protection of secured creditors in bankruptcy" (1984) 51 U Chi Law Review 97 at 108–109.

27 "Bankruptcy policymaking in an imperfect world" (1993) 92 Michigan Law Review 336 at 344.

down by a few anxious creditors.[28] Moreover, the system encourages entrepreneurial endeavour and risk-taking in that if the opportunity for corporate reorganisation exists, companies that pursue high risk but potentially rewarding strategies can survive some short-term dislocations and have a greater chance of seeing their risk-taking strategies pay off.[29] The existence of a rescue regime also insulates the Government to a degree from pressure to fund bailouts for individual business failures.[30]

19 One might criticise, in turn, this multiple values approach for some degree of vagueness and indeterminacy. There is little assistance given to decision-makers on the management of tensions and contradictions between different values or on the way that trade-offs between various ends should be carried through. If a multiple values approach is to avoid imprecision and indeterminacy, it may be important to establish a loose hierarchy or weighting of values so that trade-offs can be determined.[31] Nevertheless, if one examines the legislative history in the US (and in the UK for that matter) it becomes apparent that there is some degree of ambiguity about the respective merits of reorganisation versus liquidation of ailing enterprises and about the interests that corporate restructuring law should protect. It is difficult to escape the conclusion that, at times at least, this ambiguity is deliberate and serves to obscure or gloss over difficult choices between potentially competing goals.

20 In the influential Cork Committee report which led to the UK Insolvency Act 1986 (and arguably indirectly to judicial management in Singapore) there is at least a bow in the direction of goals other than creditor wealth maximisation. The committee suggested that the aims of a good modern insolvency law included recognising that "the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public interests are recognized and safeguarded".[32] The committee also talked about providing "means for the preservation of

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28 *Id*, at 356.

29 *Id*, at 358: "If investors perceived that businesses in some financial trouble faced immediate liquidation, they would likely have two responses: they would not invest their money to start businesses, or they would direct their business investments toward less risky enterprises … At the margins, any law permitting reorganisation of a business increases the likelihood of survival of companies through troubled times, which makes risk-taking more attractive."

30 *Id*, at 361.

31 See Vanessa Finch, "The Measures of Insolvency Law" (1997) 17 OJLS 227 at 241.

32 Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982) at para 198(i).

viable commercial enterprises capable of making a useful contribution to the economic life of the country".[33]

21 On the other hand, the Enterprise Act 2002, which revamped the administration procedure (on which judicial management in Singapore is based), seems to have creditor wealth maximisation at its core. This core is, however, well disguised since corporate rescue is ostensibly placed at the top of the tree. The legislation states that an administrator must perform his functions with the objective of (a) rescuing the company as a going concern, or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors.[34] The statute sets out this hierarchy of objectives and an administrator can only descend the list of objectives if he thinks that it is not reasonably practicable to achieve any of the preceding objectives though an administrator has to move from (a) to (b) if he thinks that (b) would achieve a better result for the company's creditors as a whole. There is an overarching general requirement that an administrator should not unnecessarily harm the interests of the creditors of the company as a whole.[35] While the administrator cannot act solely in the interests of an appointing creditor, producing better returns for company creditors appears, at the end of the day, to be essentially what administration is about.[36]

22 The first objective stated in the legislation (though not necessarily the primary objective) is rescuing the company as a going concern. The parliamentary debates make it clear that this objective is about preservation of the business of the company rather than preservation of the company as an empty corporate shell. Rescuing the company on its own was said to be a pointless objective in that a company that "has nothing, does nothing and has no purpose that is of

33 *Id*, at para 198(j). On the other hand, the subsequent White Paper, *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984) focused on the interests of creditors.
34 Insolvency Act 1986 Sched B1, para 3(1). An administrator must also perform his/her functions in the interests of the company's creditors as a whole.
35 Sched B1, para 3(4).
36 See S Frisby, "In Search of a Rescue Regime: The Enterprise Act 2002" (2004) 67 MLR 247 at 262 and, more tentatively, Vanessa Finch, "Control and co-ordination in corporate rescue" [2005] Legal Studies 374 at 395–396: "The terms of EA 2002 mean that it is arguable that an administrator is obliged to pursue a going concern sale where he thinks this will serve creditors better than efforts made to rescue the company – even where it might be possible to rescue the company. Primacy is accordingly given to maximising overall returns to creditors, rather than to rescue per se." See also D Prentice, "Bargaining in the Shadow of the Enterprise Act 2002" (2004) 5 European Business Organization Law Review 153 at 158.

no use".[37] On the other hand, the objective of preserving all or part of the company's business would be beneficial to employees, to creditors who may be paid out of the proceeds of the sale of the business or from future profits and also would be beneficial to the overall economy. What was important was preserving a business activity in the company and not just rescuing empty corporate shells. Nevertheless, the Government stressed: "We would not want the administrator to rescue the company if it is to the detriment of creditor value."[38]

23 If there are any reforms of the Singaporean legislation then perhaps this hierarchical approach might be followed.

V. Main features of Chapter 11

24 Chapter 11 is generally considered to be pro-debtor rather than pro-creditor though there is much to be said for the view that the label is nothing more than a potentially misleading over-simplification. The pro-debtor label is used for a number of reasons. These include the fact that the Chapter 11 process is normally begun by the company itself seeking protection from its creditors, the existing management is not displaced in favour of some court-appointed outsider, the management itself can prepare a reorganisation plan and put it to creditors and shareholders, there is a specific mechanism for the financing of the company during the Chapter 11 period which may include the "priming" or "trumping" of existing security interests and, finally, in certain circumstances, secured creditors can be crammed down, *ie*, forced to accept a reorganisation plan against their wishes.

VI. Commencing a Chapter 11 case and the automatic stay

25 A typical Chapter 11 case begins when the company voluntarily files a petition with a bankruptcy court, with the petition being accompanied by, firstly, a list of creditors and, secondly, a summary of company assets and liabilities. Technically, there is no requirement that the company should be "insolvent" and so-called strategic bankruptcies are a conspicuous part of the US scene. In other words, companies may have a number of reasons, other than insolvency strictly so-called, to invoke the protective cloak of Chapter 11.

26 Applications for Chapter 11 relief must, however, be made in "good faith" and with the intention of achieving a corporate

37 See the comments by Lord Hunt of Wirral in the House of Lords – HL debates col 765, 29 July 2002.

38 See the comments by the relevant Minister, Lord McIntosh of Haringey, in HL Debates col 766, 29 July 2002.

restructuring or to bring about a liquidation or sale of the company. If this is not the case, then creditors may make application to have the Chapter 11 petitions dismissed. An example occurred in *SGL Carbon Corporation*[39] where the company's Chapter 11 petition was dismissed on the basis that it evinced bad faith as demonstrated by a lack of "reorganizational purpose".

27 A large company may find itself pushed into Chapter 11 against its wishes if three creditors holding unsecured non-contingent, undisputed claims aggregating more than $10,000, file an involuntary petition against the company and if the company is "generally not paying debts as such debts become due unless such debts are the subject of a bona fide dispute". The company may decide to contest the petition and, if the above standard is not met, may recover costs from the petitioning creditors plus legal expenses. Moreover, if the involuntary petition had been filed in bad faith, punitive damages are potentially available to the company.

28 Far more likely, however, is where a company enters Chapter 11, ostensibly of its own volition, but in reality under pressure from creditors, whether secured or unsecured. Secured creditors may in a sense compel a company to seek Chapter 11 protection by threatening to enforce security interests. More generally, as Professor Lopucki remarks:[40]

> Congress has asserted that "the purpose of a reorganization … case is to formulate and have confirmed a plan of reorganization …". It is likely that only a few of the debtors studied came to Chapter 11 for this purpose. A large majority of them entered Chapter 11 with one or more of their creditors in hot pursuit, and filing was probably the only way they could remain in business or avoid liquidation. Their focus, quite naturally, was on short term survival, and only later, if at all, would a substantial number of them turn their attention to the long range prospects for their businesses.

29 The automatic stay, so-called, is an intrinsic feature of Chapter 11. Put simply, the commencement of a Chapter 11 case imposes a freeze on proceedings or executions against the company and its assets. This stay or moratorium provides a breathing space during which the company has an opportunity to make arrangements with its creditors and shareholders for the rescheduling of its debts, and the

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39 200 F3d 154.

40 Se Lynn M Lopucki, "The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code?" (1983) 57 American Bankruptcy Law Journal 99 at 114.

reorganisation and restructuring of its affairs. The existence of the moratorium or stay has been rationalised as follows:[41]

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganisation plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

30 A secured creditor, along with anybody else affected by the statutory stay, can apply to have it lifted and there is a specific requirement of "adequate protection" for the holders of property rights who are adversely affected by the stay.[42] Examples of "adequate protection" are provided by § 361 although the concept itself is not defined.[43] It should, however, be noted that it is only the value of the collateral that is entitled to adequate protection. An under-secured creditor may find itself footing the bill for an unsuccessful reorganisation attempt. It is prevented from enforcing the collateral by the automatic stay yet it is not entitled to interest during what may be a long drawn out Chapter 11 process. An over-secured creditor is, however, entitled to be paid interest out of the security "cushion" at the plan confirmation stage as a condition of the court approving the plan.

VII. Debtor in possession

31 Chapter 11 is based on "debtor in possession". The old management structures should generally remain in place although legally transformed into a quasi-trustee in bankruptcy. In its new guise, it is referred to as a "debtor in possession" or "DIP".[44] The debtor in possession can run the business in the ordinary way but will need court approval for substantial asset sales. Under § 1107 of the Bankruptcy

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41 HR Rep No 595, 95th Cong, 1st Session 340 (1977). The statement continued: "The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that."

42 US Bankruptcy Code § 361.

43 The examples given are cash payments, additional or replacement security interests on other property and, unusually expressed, something that will give the creditor the "indubitable equivalent" of its security interest.

44 US Bankruptcy Code § 1107. The debtor-in-possession may operate its business without prior court approval. In *Commodity Futures Trading Commission v Weintraub* (1985) 471 US 343 at 355, the Supreme Court said: "… the willingness of courts to leave debtors in possession is 'premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'"

Code, the debtor in possession has all the powers of a bankruptcy trustee. In *Commodity Futures Trading Commission v Weintraub*,[45] the Supreme Court said "… the willingness of courts to leave debtors in possession is 'premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee …'". An outside trustee can only be appointed to take over the management of the business of the company for cause – § 1104(a)(1), and their appointment in Chapter 11 is exceptional.[46]

VIII. New financing

32 Almost by definition, companies in financial difficulties need new finance to be able to survive. In the US, new financing is dealt with in § 364 of the Bankruptcy Code. Under this provision, any credit extended to the corporate debtor during the reorganisation process has priority over pre-petition unsecured claims. If the extension of credit is in the ordinary course of business, then priority is automatic, whereas if the extension of credit is outside the ordinary course, then the priority must be authorised by the court prior to the granting of credit. In the absence of any agreement by the lender to the contrary, a corporate debtor can obtain confirmation of a reorganisation plan only by ensuring payment of the new lender in full at the confirmation stage. Moreover, even if the reorganisation plan fails, "new" debts will have priority over unsecured pre-filing debts in the ensuing liquidation.

33 There may be a significant number of cases where the company's assets are secured to such an extent that the granting of priority over simply pre-filing unsecured creditors offers new lenders little chance of recovery in any subsequent liquidation. In these circumstances, meaningful priority means priority over pre-filing secured creditors and § 364(d) expressly allows the court to authorise this, but only in narrowly defined circumstances. There are safeguards for affected secured creditors in that the debtor must prove that it cannot obtain the loan without granting such a security interest and that the pre-filing secured creditor is adequately protected against loss. Case law suggests that the statutory requirements are strictly applied and that the "priming" of prior secured lending should be permitted only on an infrequent and exceptional basis.

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45 (1985) 471 US 343 at 355.

46 The legislative statements in § 1104 that a trustee can be appointed only for cause such as fraud, dishonesty or gross mismanagement and that sheer size or large numbers of bondholders or shareholders are not enough have successfully warned the courts away from appointing trustees. It has been held that simple mismanagement is not a sufficient reason for an appointment – *Re Anchorage Boat Sales* (1980) 4 Bankr 635.

IX. A reorganisation plan

34 A successful Chapter 11 outcome generally results in a plan of reorganisation agreed by a majority of creditors. As was remarked by Stevens J in the Supreme Court in *Bank of America v 203 North LaSalle Street Partnership*:[47]

> Confirmation of a plan of reorganization is the statutory goal of every chapter 11 case. Section 1129 provides the requirements for such confirmation, containing Congress' minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations.

35 The confirmation of a reorganisation plan by the court discharges a corporate debtor from fulfilling all the legal obligations that have not been specified in the plan.[48] For the first 120 days after entry into Chapter 11, the DIP has the exclusive right to propose a reorganisation plan, but thereafter, any creditor may make such a proposal.[49] Superficially at least, it is a daunting prospect to try to obtain confirmation of a Chapter 11 plan for the proponent of the plan must affirmatively demonstrate that it has met all the various requirements specified in the statute for confirmation.[50]

36 Section 1129 enumerates a list of requirements but the list deliberately does not cover all the grounds. There are additional implicit requirements that have been omitted from the express list to avoid statutory complexity and also because they are the sort of conditions that would be found by a court to be fundamental to a fair and equitable treatment of a dissenting class of creditors. For instance, a dissenting class should be assured that no senior class receives more than 100% of its claims.[51] One explicit requirement is that the whole plan should have been proposed in good faith. It is procedurally cheaper and easier to knock out a plan on other grounds, however. If lawyers can present the issue as a question of law, there is no need for discovery to be taken on the motives of the plan proponent. Moreover, if dissenters can raise an objection on the basis, for example, that the classes of claimants have

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47 (1999) 526 US 434 at footnote 4 of his judgment.

48 Section 1141.

49 Section 1121

50 For example, § 1129(a)(9)(c) states that a plan must provide for the deferred cash payment of those taxes afforded priority by § 507(a)(8) including income, excise and withholding taxes. The cash payments have to be made within a six-year period and must have a value, as of the date of the plan, that is equal to the amount of taxes owing, whether or not the claim would have been paid in full under Chapter 7.

51 See the Congressional Record for 28 September 1978 (124 Cong Rec H11, 104).

been wrongly classified, then this can be done at the earlier disclosure statement stage rather than during the plan confirmation process.[52]

37 Every impaired class of creditors must approve the plan though "cramdown" – confirmation of a plan over creditor objections – is possible. Most confirmed Chapter 11 plans are consensual which means that classes of claims are unimpaired by the plan, or if impaired, have accepted the plan.[53] A class of impaired claims is deemed to accept the plan if at least one-half in number, and at least two-thirds of the dollar amount of the voted claims within the class vote to accept the plan. Majority rule prevails because "experience makes it certain that generally there will be at least a small minority of creditors who will resist a composition, however fair and reasonable, if the law does not subject them to a pressure to obey the general will".[54]

38 Objecting creditors are protected by the courts applying a "feasibility test" – a debtor must be reasonably likely to be able to perform the promises it made in the plan[55] and also a "best interests" test – sometimes called the "liquidation" test since each objecting creditor must receive at least as much under the plan as it would in liquidation. A dissenting creditor (even one in a consenting class) may defeat confirmation of a plan if he can show that he would receive less under the plan that in a liquidation of the company under Chapter 11 of the US Bankruptcy Code. Chapter 11 plans are principally structured around treatment of investors as members of classes but even if a class votes in favour of a plan, however, every single member of the class is entitled to insist on compliance with the "best interests" of creditors test.

39 At the confirmation stage, most courts will insist on being provided with a liquidation analysis in the disclosure statement accompanying the plan. The analysis will show whether the plan has passed the "best interests" test, but determining liquidation values, and how this equates to what is on the table at the moment, may not be an easy task however. In *Till v SCS Credit Corp*,[56] the Supreme Court

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52 See Bruce A Markell, "Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification" (1994) 11 Bankruptcy Developments Journal 1 at 38–39.

53 See, generally, L LoPucki & W Whitford, "Bargaining over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies" (1990) 139 U Pennsylvania Law Review 125; R Broude, "Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative" (1984) 39 Business Lawyer 441.

54 Cardozo J in *Ashton v Cameron County Water Improvement District* (1936) 298 US 513.

55 Save with respect to a plan of reorganisation that provides for liquidation, § 1129(a)(11) requires the bankruptcy court to establish that confirmation of the plan is not likely to be followed by liquidation or further financial reorganisation of the debtor.

56 (2004) 541 US 465.

adopted a formula approach for determining the appropriate interest rate to be used in calculating the present value of a stream of payments. The notional prime rate is used as a starting point and may be increased based on the risk of default in the particular case. The Supreme Court rejected other alternative approaches that were suggested for determining an appropriate interest rate such as a "coerced loan rate", "presumptive contract rate" and "costs of funds" method of calculation.

40 Essentially, Chapter 11 is a forum for structured bargaining among classes of investors. While it is important to attempt to gain consensus among creditors and shareholders with a view to minimising the administrative costs incurred by the company and also any loss of public confidence, the cramdown rules set the ultimate parameters for all Chapter 11 plan negotiations. A fundamental component of Chapter 11 is the ability to confirm a plan over objections of some classes of claims if the plan proponent provides fair and equitable treatment to such classes and does not discriminate against them.[57] The dissenting classes are said to be "crammed-down". The availability of cramdown limits the ability of a creditor to hold out for better treatment and also permits viable businesses to reorganise even if a few creditors object strenuously. While the size and complexity of the task in reorganising a large company may make it particularly desirable to avoid cramdown litigation, nevertheless, the cramdown rules can work to hold the interests of a small group of powerful creditors in check.[58]

41 Certain minimum standards are stated for meeting the fair and equitable test. With respect to a dissenting class of secured claims one of three requirements must be met.[59] Firstly, the plan may provide for a secured creditor to retain its lien and receive deferred cash payments totalling at least the allowed amount of the claim. The deferred cash payments must have a value, as of the effective date of the plan, that is at least equal to the value of the collateral. On the other hand, as far as the secured creditor is concerned, the ability of the court to impose its own rate of interest upon the deferred payments presents perils since a judicial view on the appropriate interest rate may not necessarily coincide with that of the secured creditor.[60] A consensual rather than a cramdown plan will mitigate the risk of an imposed rate of interest that is unsatisfactory to the secured party. The second alternative is for the sale of collateral free of the security interests with the security interests attaching instead to the proceeds of sale. The third possibility is where

57 See, generally, K Klee, "All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code" (1979) 53 American Bankruptcy Law Journal 133.

58 National Bankruptcy Review Commission Report, *Bankruptcy: The Next Twenty Years* (1997) at pp 546–547.

59 Section 1129(b)(1).

60 See the discussion in *Till v SCS Credit Corporation* (2004) 541 US 465 about what rate of interest should be imposed.

the plan provides the secured creditor with the "indubitable equivalent" of its claims.

42 Another component of the fair and equitable requirement is spelled out in §1129(b)(2) which provides that dissenting classes should be paid in full before any junior class receives, or retains, any property under the plan. In other words, pre-liquidation entitlements must be respected. This is the so-called "absolute priority" principle. The notion seems to be implicit in Chapter 11 that liquidation priorities are sacrosanct but the allocation of the going concern surplus at the heart of the reorganisation process may be the subject of bargaining among different creditor and other interest groups.

43 The absolute priority rule seeks to prevent collusive arrangements whereby certain creditors and shareholders conspire to distribute among themselves the value of a company's assets and leaving other creditors with little or nothing as a result.[61] The rule is designed to preserve the priority regime between senior and junior stakeholders. In this way, it maintains the assumptions and expectations of those who funded the business whether through debt or equity.[62] It is commonly the case, however, that consensual restructuring plans will leave something on the table for equity. In other words, shareholders in the old company will be given a stake in the restructured entity.

44 While some statutory gloss has been applied to the "fair and equitable" requirement, the Bankruptcy Code does not define the phrase "unfair discrimination". It is unclear what exactly is meant by the phrase and what standard it imposes. Nevertheless, it seems clear that it does not preclude distinctions in the methods of payment that ultimately result in similar treatment of creditors. For example, trade creditors might be paid off in cash, provision for tort claimants could be made out of a newly established trust fund and finance creditors may be issued with bonds by the company. To evaluate whether unfair discrimination exists, some courts use a multi-faceted test that would include considering whether the discrimination has a reasonable basis,

61 See, generally, W Blum & S Kaplan, "The Absolute Priority Doctrine in Corporate Reorganizations" (1974) 41 U of Chicago Law Review 651.

62 *Re Loewer's Gambrinus Brewery Co* (1948) 167 F 2d 318 at 320: "Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditors' interest, if the venture is successful; on the other hand the creditors have only their interest, but they come first in distribution of the assets … Every creditor rightly assumes that his risk is measured by the collective claims of other creditors, and by creditors he understands those alone, who like him, have only a stipulated share in the profits [calculated on the basis of their claims]. To compel him to divide the assets in insolvency with those who at their option have all along had the power to take all the earnings, is to add to the risk which he accepted."

whether the company could not confirm or consummate the plan without the discriminatory element, whether the plan is proposed in good faith and whether the degree of discrimination is related to the basis or rationale for the discrimination.[63]

45 It should be noted, however, that the prohibition on unfair discrimination applies only to the dissenting class and not to the plan in its entirety. Apparently, the drafters intended that a Chapter 11 plan could discriminate unfairly among various classes of claims, so long as all classes vote in favour of the plan. Section 1129(a)(7) provides appropriate protection for dissenters in a consenting class by requiring that every class member receive at least as much in property under the plan as would be received in a liquidation of the company under Chapter 7 of the US Bankruptcy Code.

X. Changes in Chapter 11 practice – The rise of prepacks

46 US Bankruptcy practice and innovations in the same did not come to a stop with the enactment of the Bankruptcy Code in 1978. In the 1980s, there was the rise of the "prepack" or "prepackaged" bankruptcy.[64] "Prepacks" were seen to have significant advantages over both a traditional Chapter 11 and corporate restructuring that took place fully out of court. A prepack permits a company to conduct restructuring negotiations outside of Chapter 11 and this has the effect of reducing the costs and disruption to all parties that are often associated with a long drawn out Chapter 11 process.[65] The prepack is a hybrid animal mixing elements from both private restructuring with the traditional Chapter 11 process. A "prepackaged" case should be disposed of quicker and more cheaply provided, of course, that the company has made adequate disclosure of its financial condition to creditors before the bankruptcy filing. A clearly pre-defined exit strategy will minimise the time that the company needs to be in Chapter 11 and definitely increase the company's chances of emerging from the process. With a prepack, an agreement can be reached that satisfies the majority of creditors and then Chapter 11 is used for the purpose of giving effect to and implementing the agreement. This takes away, or at least reduces,

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63 National Bankruptcy Review Commission Report, *Bankruptcy: The Next Twenty Years* (1997) at p 584.

64 See, generally, S C Gilson, "Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11" in *Corporate Bankruptcy: Economic and Legal Perspectives* (J S Bhandari & L A Weiss eds) (CUP, 1997) at p 321.

65 National Bankruptcy Review Commission Report, *Bankruptcy: The Next Twenty Years* (1997) at p 590. Prepackaged bankruptcies are also more likely to have financing arrangements in place. On this see, generally, S Dahiya, K John, M Puri & G Ramirez, "Debtor-in-possession Financing and Bankruptcy Resolution: Empirical Evidence" (2003) 69 Journal of Financial Economics 259 at 269–270.

the leverage of minority groups of creditors who could otherwise hold up, and prevent, an out-of-court workout. On the other hand, a prepackaged bankruptcy is not likely to be successful in resolving "complex, litigious disputes among hundreds of creditor groups with sharply divergent interests – the kind we often see in a traditional, highly contentious Chapter 11 reorganization".[66]

47 The process of obtaining creditor consent to a reorganisation plan is different, however, inside and outside bankruptcy and the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 ("BAPCPA") removed what may have been a significant procedural obstacle in the way of "prepacks". The BAPCPA adds a new § 1125(g) to the Bankruptcy Code and makes it clear that "an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if such holder was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law".

48 In a prepack, a company will file both the bankruptcy petition and the reorganisation plan at the same time, having first obtained at least the informal consent of creditors to the plan.[67] In practice, the voting on the prepackaged plan may take place either before or after the Chapter 11 filing has been made.[68] In a "pre-voted" prepack, the outcome of the vote is filed alongside the Chapter 11 petition and the reorganisation plan. Unless the court finds some fault with the voting process, the court can proceed directly to considering whether the plan should be confirmed.

49 Prepacks have their undeniable advantages but they also have their downsides. The process of soliciting acceptances to a prepack provides creditors with an opportunity to make a pre-emptive strike against the assets of the company in anticipation of an overall default by the company. Moreover, more so than a completely private restructuring, it broadcasts the financial problems of the company

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66 See J McConnell & H Servaes, "The Economics of Pre-packaged Bankruptcy" in *Corporate Bankruptcy: Economic and Legal Perspectives* (J S Bhandari & L A Weiss eds) (CUP, 1997) at p 323.

67 See S C Gilson, "Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11" in *Corporate Bankruptcy: Economic and Legal Perspectives* (J S Bhandari & L A Weiss eds) (CUP, 1997) at p 321.

68 The latter, "post-voted" prepacks with the vote being conducted under the auspices of the bankruptcy court, have always been permitted but the former, "pre-voted" prepacks, were first specifically allowed under the 1978 Bankruptcy Code – see, generally, E Tashjian, R C Lease & J J McConnell, "Prepacks An Empirical Analysis of Prepackaged Bankruptcies" (1996) 40 Journal of Financial Economics 135 at 138.

widely and, therefore, increases the likelihood that the business might wind up in the hands of competitors or other third parties.[69]

50 There are also procedural risks. A court may find that the disclosure statement is inadequate in some respects which means that the company will have to amend and redistribute the disclosure statement, and resolicit plan acceptances, resulting in lengthy delays in confirmation.[70] There is also the suggestion that some groups of creditors may receive more favourable treatment than others in a prepack. The requirement that similarly situated claimants should receive similar treatment is one of the fundamental features of the US Bankruptcy Code[71] but this principle may not have been strictly followed in some prepacks.[72] In a conventional Chapter 11 case, the company negotiates in the open, under the scrutiny of a bankruptcy court, with all types of creditors and their committees or representatives. But in a prepack, the negotiations typically take place in secret and the debtor may hand pick its negotiation partner at will.

51 Furthermore, it has been suggested in some empirical studies that companies with pre-packaged Chapter 11s[73] are more likely to go forum shopping and have a greater propensity to refile for Chapter 11 protection at some later stage.[74] "Forum shopping" could be defined as the filing of a Chapter 11 case in a court other than that which serves the location of the company's head office.[75] In recent decades, firstly, the southern district of New York and, secondly, Delaware have become popular as shopping venues.

XI. Changes in Chapter 11 practice – Small business bankruptcies

52 The use of Chapter 11 in small business cases has long been criticised as being too complex, expensive and slow. Throughout the 1980s and 1990s many observers commented that Chapter 11 adopted a one size fits all approach towards corporate reorganisation in which so-

69 T J Salerno & C D Hansen, "A Prepackaged Bankruptcy Strategy" (1991) Journal of Business Strategy 36 at 40.

70 "Adequate information" is defined in § 1125(a)(1) of the Bankruptcy Code.

71 Bankruptcy Code § 1123(a)(4).

72 Mark D Plevin, Robert T Ebert & Leslie A Epley, "Pre-packaged Asbestos Bankruptcies: A Flawed Solution" (2003) 44 Texas Law Review 883 at 913.

73 See T Eisenberg & L M LoPucki, "Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter11 Reorganizations" (1999) 84 Cornell L Rev 967 at 976–977.

74 *Ibid* and see also L M LoPucki & S D Kalin, "The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a 'Race to the Bottom'" (2001) 54 Vand L Rev 231.

75 T Eisenberg & L M LoPucki, "Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations" (1999) 84 Cornell L Rev 967 at 975.

called mom-and-pop stores followed the same reorganisational steps as large conglomerates. The "one size fits all" paradigm did not produce efficient results when applied to small businesses.[76]

53 Most Chapter 11 small business cases fail, although, typically, they die a lingering death and when the cases are finally converted to a liquidation under Chapter 7 of the Bankruptcy Code, unsecured creditors rarely receive a dividend. Professors Warren and Westbrook have calculated that on the standard criteria, small businesses comprised more than 80% of Chapter 11 filings[77] and for many of these cases an expeditious liquidation from the outset might have been the best way forward.[78] On the other hand, the small business cases, while looming large in terms of sheer numbers, are not nearly so significant in terms of financial importance. It seems that the total assets or liabilities of companies in this group are no more than 5% of those of all the companies in Chapter 11.

54 BAPCPA, while primarily concerned about redressing perceived abuses in the consumer bankruptcy sphere,[79] also makes significant amendments to Chapter 11.[80] In particular, Title IV, called the "Small Business Bankruptcy Provisions", aims to make Chapter 11 "work more efficiently in general and to decrease costs and delay in small business cases in particular".[81] The new provisions attempt to identify early on, and to weed out, cases for which there is no reasonable likelihood of reorganisation. In other words, it is to prevent "dead on arrival" debtors from languishing in Chapter 11 to no good end.

55 A "small business" debtor is now defined as one engaged in commercial or business activities that, at the date of the commencement

76 James B Haines & Philip J Hendel, "No Easy Answers: Small Business Bankruptcies after BAPCPA" (2005) 47 Boston College Law Review 71 at 73.

77 E Warren & J L Westbrook, "Financial Characteristics of Businesses in Bankruptcy" (1999) 73 Am. Bankr LJ 499 at 543–544, and footnotes 80–82.

78 D G Baird, "Revisiting Auctions in Chapter 11" (1993) 36 Journal of Law and Economics 632 at 636–637.

79 See Harvey R Miller & Shai Y Waisman, "Is Chapter 11 Bankrupt" (2005) 47 Boston College Law Review 129 at 161: " The legislative history of the Abuse Act indicates several motivations for reform: (1) an increase in the number of consumer bankruptcy filings and alleged associated creditor losses, as well as adverse financial consequences for the economy as a whole; (2) the use of loopholes and other abusive practices; and (3) the lack of a clear mandate for debtors to repay their debts to the best of their abilities."

80 R Levin & A Ranney-Marinelli, "The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" (2005) 79 Am Bankr LJ 603 at 603.

81 T E Carlson & J F Hayes, "The Small Business Provisions of the 2005 Bankruptcy Amendments" (2005) 79 Am Bankr LJ 645 at 645. The provisions are based largely on the recommendations contained in the Bankruptcy Review Commission report, *Bankruptcy: The Next Twenty Years* (1997) <http://govinfo.library.unt.edu/nbrc/>.

of the bankruptcy, has aggregate non-insider, non-affiliate, non-contingent liquidated secured and unsecured debts of not more than \$2m, provided that there is no active creditors' committee. It seems that this figure puts the vast majority of Chapter 11 cases within the framework of the small business provisions.[82] The BAPCPA, for the first time, creates mandatory deadlines for the filing and confirmation of a reorganisation plan by small business debtors. The debtor must file a plan and a disclosure statement, if any, within 300 days of the order for relief and the court shall confirm the plan within 45 days thereafter. In standard Chapter 11 cases, the debtor in possession is given the exclusive right to file a plan for the first 120 days following the order for relief but there is a longer 180-day exclusivity period for small business debtors. A small business debtor is also faced with the requirement to increase the amount of financial information made available. The amended § 308 of the Bankruptcy Code lays down supplemental reporting requirements for small business debtors who are now obliged to file periodic financial and other reports containing financially sensitive information as prescribed.

56 There is also an expanded role for the US Trustee which is heavily relied upon to provide the close oversight of the debtor that has not typically been provided by creditors' committees. Before the first meeting of creditors, the US Trustee is now required to hold an "initial debtor interview" which aims at investigating the debtor's viability. The US Trustee monitors the debtor's activities, identifies cases where there is unlikely to be a confirmed plan and generally expedites the administration of cases. Perhaps the most important role of the US Trustee is to move under an amended §1112, where appropriate, either for dismissal of the case, conversion of the case into a Chapter 7 liquidation or the appointment of an outside trustee or examiner to displace existing management. Bankruptcy judges are also given authority to combine the hearings on the adequacy of the disclosure statement and on whether to confirm the plan.[83] In addition, there are standard-form disclosure statements, although the use of these official forms is not made mandatory.[84]

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82 The National Bankruptcy Review Commission suggested in its 1997 report that under the \$5m debt limit it proposed, small business treatment would apply to approximately 85% of all Chapter 11 cases. National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years* (E Warren, Reporter, 1997) at p 632, available at http://govinfo.library.unt.edu/nbrc/.

83 The BAPCPA amendments grant the courts broad authority to approve conditionally a disclosure statement and to combine the hearing on the adequacy of disclosure with the hearing on plan confirmation. Courts also have options: (1) to approve a standard-form disclosure statement – § 1125(f)(2); or (2) to dispense with the disclosure statement altogether when the plan itself provides adequate information – § 1125(f)(1).

84 According to the conclusion of the National Bankruptcy Review Commission, the drafted-from-scratch disclosure statement and plan typical in previous Chapter 11

(*cont'd on the next page*)

57 In summary, by imposing plan filing and confirmation deadlines, additional financial reporting requirements and expanding the role of the US Trustee, the new small business provisions are designed to increase oversight of the debtor and to filter out cases where there is no genuine prospect of a successful reorganisation. Coupled with provisions simplifying the process, the objective is to reduce cost and increase efficiency. The reforms introduced by the BAPCPA have not met with universal support, however. Some observers have argued that the value of the reforms is outweighed by the procedural burdens that the statute imposes on small business debtors.[85] It has been suggested that large public companies and small businesses are like apples and oranges and that it would be appropriate to create an entirely separate reorganisation regime for small businesses. The BAPCPA provisions have been criticised for failing to offer truly innovative reforms that could streamline small business reorganisations. The US Congress, however, has consistently rejected the idea of having two business reorganisation chapters with different substantive rules. The fear is that this would provoke wasteful litigation and "gaming" of the system. Previous bankruptcy legislation in the US (the Chandler Act) contained two separate reorganisation chapters but this approach was considered to be a failure because it generated uncertainty and invited dispute about where a case properly belonged. The 1978 Bankruptcy Code collapsed the previous provisions into a single reorganisation chapter – Chapter 11.[86]

XII. Changes in Chapter 11 practice – Increased role of creditors

58 Another Chapter 11 development that should be noted is the increased emphasis now placed on maximising returns to creditors rather than corporate rehabilitation. When the Bankruptcy Code was first enacted in 1978, considerable attention was paid to employment preservation and the reorganisation and rehabilitation of the debtor.[87]There were a lot of concerns about helping troubled businesses and the community impact of bankruptcy. The tone of the debate has now changed with creditor concerns gaining the ascendancy. This change in emphasis has been acidly observed by one commentator:[88]

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practice are a major cause of the high cost of the process (at pp 635–637 of the report).

85 James B Haines & Philip J Hendel, "The Future of Chapter 11: No Easy Answers: Small Business Bankruptcies after BAPCPA" (2005) 47 Boston College Law Review 71.

86 See James B Haines & Philip J Hendel, "No Easy Answers: Small Business Bankruptcies after BAPCPA" (2005) 47 Boston College Law Review 71 at 96.

87 US House of Representatives HR Rep No 95-595, p 220 (1977).

88 J White, "Death and Resurrection of Secured Credit" (2004) 12 American Bankruptcy Institute Law Review 139.

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

59 The ailing company and its incumbent management no longer seem to dominate the bankruptcy picture as they did once upon a time for creditor issues have come to the fore. Chapter 11 is no longer an anti-takeover device for managers. In its new dynamic, it has become part of the market for corporate control and this is coupled with asset sales and faster turnaround of cases.[89] There are a number of factors to explain this transformation. The rise of distressed debt trading is one such phenomenon and it has grown to dimensions that were not seriously contemplated when the 1978 Act was enacted.[90] It is connected with globalisation and the development of financial markets. Institutions that buy up the debt of financially distressed companies have no real interest in sustaining a long-term relationship with the company. In the past, and in a more intimate and interdependent world, suppliers may have valued the preservation of a particular company because of the trading links that had grown up between them. Also, suppliers may have seen little alternative but to nurture an ailing company through a complicated Chapter 11. Now they have the option of getting an immediate, albeit discounted, return from a distressed debt trader. On the other hand, distressed debt traders are sophisticated participants in financial markets who are generally unwilling to sacrifice speedy recovery of their investment for the sake of a company's rehabilitation. As one commentator remarks:

> Distressed-debt traders have different motivations from commercial creditors providing goods and services or lenders. They buy claims of all types at substantial discounts. Rather than nurture long-term relationships, distressed-debt traders purchase debt claims to reap

89 See David A Skeel Jr, "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11" (2003) 152 U Pa L Rev 917 at 918.

90 See, generally, Harvey R Miller & Shai Y Waisman, "Is Chapter 11 Bankrupt" (2005) 47 Boston College Law Review 129 at 152–154.

> material profits and, in certain situations, to obtain control of the debtor and dominate the administration of the reorganization case …

60 Put another way, the focus of the distressed debt trader is on profit maximisation. Time equals money and the longer that a debtor lingers in Chapter 11 the longer that the trader is prevented from reaping a return on its investment. The entry by distressed debt traders into the world of Chapter 11 may have turned the chapter into something that was not originally intended. Instead of being focused on rehabilitation, it has become a vehicle for the "fulfilment of *laissez-faire* capitalism focused on the realization of substantial profit-taking".[91]

61 This has meant pressure for speedier cases. It has also meant more emphasis on asset sales. Sales of assets outside the ordinary course of business requires judicial authorisation under § 363(b) of the Bankruptcy Code but such consent is generally forthcoming. A § 363(b) sale also comes "free and clear" of existing claims and this may be a significant incentive that encourages recourse to the Chapter 11 process. "This unique ability to cleanse the assets of a distressed company attracts potential purchasers because it potentially removes the uncertainty of successor liability, fraudulent transfer claims, and lien issues that often accompanies asset purchases. Chapter 11 thus facilitates the creation of a market for the sale."[92]

62 Creditors have also converted two existing contractual tools into important governance levers. The first is debtor-in-possession ("DIP") financing.

> Before they even file for bankruptcy, corporate debtors must arrange an infusion of cash to finance their operations in Chapter 11. To an increasing extent, lenders are using these loan contracts to influence corporate governance in bankruptcy … The second is that key executives are increasingly given performance-based compensation packages in Chapter 11. The most common strategy is to promise the executives a large bonus if they complete the reorganisation quickly; likewise, executives face ever-smaller bonuses if the case takes longer.[93]

63 Certainly by means of provisions in the DIP loan agreement, lenders can bring about changes in management structures. The refusal to implement management changes brings about a denial of necessary funds to the company. The control by lenders of the company's cash lifeline can be used to produce what is effectively a slow liquidation. The amount of cash made available to the company is decreased in

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91 Harvey R Miller & Shai Y Waisman, "Is Chapter 11 Bankrupt" (2005) 47 Boston College Law Review 129 at 153.

92 See *id*, at 156.

93 See David A Skeel Jr, "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11" (2003) 152 U Pa L Rev 917 at 918–919.

succeeding disbursements. In consequence, the company is forced to sell assets to satisfy cash flow needs.[94]

64 There is no doubt that DIP financing has emerged as a major governance lever in many Chapter 11 cases but its side features have not escaped criticism. For instance, the personal interests of senior company managers may often be in acute conflict with the interests of the company itself when the company is teetering on the brink of collapse.[95] The potential conflict with the interests of company employees may be even sharper. Corporate executives may, for example, negotiate a "sweetheart" deal with a DIP lender under which the executives receive substantial financial inducements if the company cuts costs through shedding much of its workforce or by forcing wage levels downwards. The BAPCPA attempts to curtail the abuse, however, by amending § 503 of the Bankruptcy Code and limiting the amount that may be paid in retention bonuses to existing staff.

65 There is also the fear, however, that DIP lending agreements will tighten the screws on the company too much and discourage even appropriate risk-taking. Too may companies may be pressurised to liquidate assets rather than to reorganise.[96]

XIII. Possible pointers for Singapore – More flexible entry points into restructuring procedures

66 Chapter 11 contains many features that may be considered for possible adoption in Singapore in the context of amendments to, or possible replacement of, the judicial management legislation. For instance, a court order is necessary before a company can go into judicial management and generally the holder of a comprehensive floating charge has an effective veto on the making of a judicial management order though this can be overridden if the public interest so requires.[97] Judicial management in Singapore entails a statutory

94 See, generally, on the importance of control during the bankruptcy process Jay Lawrence Westbrook, "The Control of Wealth in Bankruptcy" (2004) 82 Texas Law Review 795.

95 See David A Skeel Jr, "The Past, Present and Future of Debtor-in-Possession Financing' (2004) 25 Cardozo Law Review 101 at 118.

96 *Id*, at 120. If too many firms liquidate rather than reorganise, industry may become concentrated in the hands of a few major players.

97 The relevant law is contained in Pt VIIIA of the Singapore Companies Act and rules found in Pt V of the Companies Regulations. See, generally, on judicial management in Singapore, Choong & Rajah, *Judicial Management in Singapore* (Butterworths, Singapore, 1990); *Walter Woon on Company Law* (Tan Cheng Han general ed) (Thomson Sweet & Maxwell, 3rd Ed, 2005) at pp 657–679. The courts in Singapore have interpreted the public interest override on the secured creditors'

(*cont'd on the next page*)

moratorium on creditor enforcement actions that is similar in concept and effect though not in details to the automatic stay that is a feature of Chapter 11. To get the full benefits of the moratorium, however, a court order is necessary and the directors of the company may be reluctant to go down this route. Companies in financial difficulties may leave it too late before seeking remedial measures and the fact that the benefits of the statutory moratorium only come with a court order accentuates this tendency. Lessons might be drawn from Chapter 11 about easing the passage into judicial management and creating more flexible entry points.

67 Should the secured creditor have an effective veto on the company coming under judicial management? In Chapter 11, there is no such power of veto though secured creditors are entitled to "adequate protection" of their security interest. Singapore might embody this concept of "adequate protection" in legislation. It might also look to the English Enterprise Act for ways of making the benefits of judicial management more widely available. In the new English administration procedure, there are a variety of routes into administration (equivalent to judicial management) including out of court appointment either by the company or a general floating charge holder as well as court appointment.[98] In England, the secured creditor no longer has the right to appoint a receiver over the whole, or substantially the whole, of a company's assets in most cases.[99] Instead, the secured creditor must seek to enforce the security through the appointment of an administrator but the administrator has much wider duties to perform (including business rescue) than merely catering exclusively to the interests of the appointing creditor.[100]

XIV. Management displacement

68 As we have seen, Chapter 11 is based on debtor in possession – the existing management team remains in place although legally transformed into a quasi-trustee in bankruptcy and called the debtor in possession. In Singapore, on the other hand, the board of directors lose their management powers and functions to a judicial manager – an insolvency practitioner normally appointed by the principal creditor.[101] It should be noted, however, that Singapore is not alone in having a

veto restrictively – see *Re Cosmotron Electronics (Singapore) Pte Ltd* [1989] SLR 251; *Re Bintan Lagoon Resort Ltd* [2005] 4 SLR 336.

98 The law on administration in England is now contained in Sched B1 of the Insolvency Act 1986 which was inserted by the Enterprise Act 2002.

99 See, generally, s 72A of the Insolvency Act 1986 as inserted by the Enterprise Act 2002.

100 Insolvency Act 1986 Sched B1 para 3.

101 Section 227G(2).

management displacement corporate rescue procedure.[102] The Singaporean position mirrors the effect of administration in the UK. Moreover, other jurisdictions tend to conform to this norm rather than the US model.

69 Why is the US different in this respect from most other jurisdictions in this respect including Singapore? Various reasons have been put forward to explain the variation. These reasons relate to different attitudes towards entrepreneurship and risk-taking; a different jurisdictional mix of carrots and sticks in encouraging early invocation of corporate rescue procedures; different conceptions of Chapter 11 and restructuring procedures in other jurisdictions as well as their aims and objectives; path dependency and the continued gravitational pull of historical circumstances; and, finally, differences in the nature of the equity and bond markets between the US and many other jurisdictions.

70 On different attitudes on different sides of the Atlantic towards entrepreneurship and risk-taking, Prof Sir Roy Goode has commented that insolvency law in the UK is predicated on the assumption that where a company becomes insolvent this is usually due to a failure of management and the last people to leave in control are those who were responsible for the company's plight in the first place.[103] These arguments have been developed by a leading QC, Gabriel Moss, who suggests that having a debtor-in-possession regime could be equated with leaving an alcoholic in control of a pub.[104] He takes the view that in England, insolvency, including corporate insolvency, is regarded as a disgrace. While the stigma may have worn off to a degree, it was nevertheless still there as a reality.[105] He speaks of a general English judicial bias towards creditors which reflects a general social attitude that is inclined to punish risk takers when the risks go wrong and side with creditors who lose out. Creditors tend to feel very strongly that once disaster strikes, the management of the company's business should

102 In Australia, leaving management in control of an ailing company has been likened to leaving the fox in charge of the henhouse. It has been that Australian laws on corporate reorganisation are even more stringent towards existing management than those of the Mother country. The attitude appears to be that if a business fails, it should be pushed aside so that others can fill the gap – see, generally, Paul B Lewis, "Trouble Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide" [2001] Utah Law Review 189 at 223–225.

103 See Roy Goode, Principles of Corporate Insolvency Law (Thomson, 3rd Ed, 2005) at p 328.

104 G Moss, "Chapter 11: An English Lawyer's Critique" (1998) 11 Insolvency Intelligence 17 at 18–19.

105 See also B Carruthers & T Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Clarendon Press, 1998) at p 246.

be taken out of the hands of the management and given to a professional person chosen by the creditors.[106]

71 Similar sentiments have been articulated by US commentators.[107] In one study of common law bankruptcy systems, it is remarked that while the UK certainly has more bankruptcies than the rest of the EU, these are still considered major embarrassments, even if they result from the failure of a business.[108] While empirical evidence may be lacking, what has been said on this point in relation to the UK may hold equally true in Singapore, or at least Singapore is more on the UK side of the spectrum than the US.

72 On the second point about encouraging directors of companies to face up to financial difficulties at an appropriately early stage, the US adopts a "carrot" or "inducement" approach. It is recognised that it may be critical to the outcome that a company seeks Chapter 11 relief at an early stage where there is a realistic prospect of a sensible reorganisation. Directors of US companies know that filing for Chapter 11 protection will safeguard their position as well as providing them with the exclusive right to propose a reorganisation plan. If managers believe that their jobs will be preserved in a Chapter 11 context, then they will be more likely to put their company into Chapter 11 at an early stage while the company may still be viable. As a bonus, those most familiar with the company will continue managing it. Singapore, like the UK, takes a stick approach. Although the legislative framework differs somewhat between Singapore and the UK, in both countries, there are potentially severe penalties for directors who allow the company to continue to trade while it is insolvent.

73 A third reason why debtor in possession is the Chapter 11 norm yet management displacement is a feature of judicial management in Singapore may lie in different conceptions of the two processes. It may be that in Singapore there is much more emphasis on asset sales and

106 See, generally, G Moss, "Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law – England" (1997) 23 Brooklyn Journal of International Law 115.

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

108 Nathalie Martin, "Common-Law Bankruptcy Systems: Similarities and Differences" (2003) 11 American Bankruptcy Institute Law Review 367 at 374.

preserving jobs and wealth through that route, rather than through the preservation of existing corporate structures which is the traditional Chapter 11 prototype. A speedy sale of company assets to a purchaser who will put them to better use and, in the process, maintain employment is often seen as the better result than the tedious process of restructuring the existing corporate vehicle and getting the restructuring deal approved. Maybe judicial management has somewhat of a different mission to Chapter 11. Judicial management can be likened to UK-style administration and the contrast between administration and Chapter 11 has been noted by one US commentator:[109]

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

74 If judicial management/administration is really very different from Chapter 11, then this could explain the differences as to who runs the respective procedures. Having an accountant at the helm makes sense if the process is really about valuation and asset sales rather than running the business with a view to bringing about the return of profitable trading.

75 A fourth factor or theory that may go partly towards explaining the difference between the debtor in possession regime in the US and the manager displacing judicial management regime in Singapore is that of path dependency. In other words, because procedures have historically developed in different ways, these differences will remain even though the reasons for the differences no longer exist. Path dependency theory has been used in the corporate governance context to explain the persistence of different conceptions of corporate ownership and accountability. Some commentators consider the Anglo-American shareholder oriented model under which directors and corporate managers owe their duties primarily to shareholders to be normatively superior than other models where the constituencies that benefit from such duties are more diffuse.[110] Nevertheless, other models

109 See the comment by Nathalie Martin, "Common-Law Bankruptcy Systems: Similarities and Differences" (2003) 11 American Bankruptcy Institute Law Review 367 at 397.

110 See, generally, Henry Hansmann & Reinier Kraakman, "The end of history for corporate law" in *Convergence and Persistence in Corporate Governance* (Jeffrey Gordon & Mark Roe eds) (Cambridge University Press, 2004) at p 33. See,

(*cont'd on the next page*)

of corporate governance survive in many parts of the world, partly because of inertia and partly because the historical circumstances that produced them exert a continued gravitational pull.[111]

76 The corporate restructuring regimes in the US and Singapore are each the product of a different conjunction of circumstances. Administration grew out of receivership which was essentially a creditor-oriented procedure though often viewed through rose-tinted corporate rescue spectacles. In the US, the antecedents of Chapter 11 of the 1978 Bankruptcy Code can be traced back to the railroad receiverships of the 19th century.[112] History shows that the idea of leaving the old management at the steering wheel and allowing it to navigate the corporate debtor through the reorganisation process can be traced back to these 19th century cases. In these authorities, the judiciary formulated principles entirely outside the framework of the federal bankruptcy laws. Perhaps the most celebrated of all the railroad receiverships is that of the Wabash railway in 1884. This case is notorious because the railroad's managers dispensed with the pretence of creditor action and simply requested the receivership themselves. The judge in the case, the aptly-named Judge Treat, said that in the absence of judicial intervention you would have nothing but a "streak of iron-rust on the prairie".[113] The Wabash railway receivership is widely regarded as a turning point in the development of corporate insolvency law by creating a new-fashioned procedure which enabled debtors to initiate, and, to a great extent, control receiverships, as well as facilitating reorganisations of the insolvent firm at the expense of creditors' rights.[114]

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

111 On "path dependency" see, generally, "Corporate Governance and Economic Efficiency: When Do Institutions Matters? (1996) 74 Washington University Law Quarterly 327; Mark J Roe, "Chaos and Evolution in Law and Economics" (1996) 109 Harv Law Rev 641; Lucien A Bebchuk & Mark J Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stanford Law Review 127.

112 See, generally, David S Skeel Jr, "An Evolutionary Theory of Corporate law and Corporate Bankruptcy" (1998) 51 Vand L Rev 1325; David S Skeel Jr, *Debt's Dominion* (Princeton University Press, 2001); John Armour, Brian R Cheffins & David A Skeel Jr, "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom" (2002) 55 Vand L Rev 1699.

113 *Central Trust Co v Wabash* (1886) 29 Fed 618 at 626.

114 Bradley Hansen, "The people's welfare and the origins of corporate reorganization: The Wabash receivership reconsidered" (2000) 74 Business History Review 377.

77 Finally, the fact that share ownership, particularly in large companies, may be much more widely dispersed in the US compared with Singapore may have some relevance to the present debate. Normatively, it has been argued that in jurisdictions where there is a separation of ownership and control, management can be relied upon to continue controlling the company though the restructuring process and to co-operate with the creditors. The relative independence of management *vis-à-vis* shareholders may serve the interests of creditors. Management is not so clearly and generally identified with shareholders' interests and the normative shift of management's fiduciary duties from shareholders to creditors in insolvency can comport easily with the factual realities. On the other hand, where there are concentrated shareholdings, allowing management to keep control of the company jeopardises the creditors and leaves then vulnerable to manipulation by shareholders.[115] It is suggested that a manager-displacing insolvency framework aligns well with concentrated ownership companies since in these companies management is subject to manipulation by shareholders and more likely to respect shareholders' interests to the detriment of creditors. In the UK, however, the Insolvency Act 2000 introduced, in effect, a stand-alone debtor-in-possession procedure for smaller companies proposing a restructuring plan, namely, the company voluntary arrangement ("CVA") with a moratorium. The moratorium lasts for 28 days, bars creditor recovery actions during this period and is designed to facilitate shareholder and creditor approval of the plan. The existing management remains in control but to obtain the moratorium they must persuade an insolvency supervisor who is going to act as supervisor of the CVA that the proposal is likely to be approved and that the company will have sufficient funds to carry on business during the period. Only smaller companies may avail of the procedure and these smaller companies are the very ones where there is more likely to be a convergence, rather than a divergence, of ownership and control.

78 By way of conclusion on this section of the article, various reasons can be put forward to explain why judicial management in Singapore involves management yet Chapter 11 in the US is based on debtor in possession. Individually, these purported explanations may be open to criticism but collectively they may have some force. Nevertheless, they do not necessarily tell the whole story. For example, there may be flourishing out of court restructuring mechanisms in Singapore that involve debtor in possession restructuring though there are no published guidelines from the Monetary Authority of Singapore that explain their operation. Nevertheless, the basic approach is unlikely to be fundamentally different from the so-called "London approach" followed by the Bank of England in the UK. In the 1980s, the Bank of

115 See D Hahn, "Concentrated Ownership and Control of Corporate Reorganisations" (2004) 4 JCLS 117 at 120.

England developed a set of principles – the "London approach" – for multi-lender corporate workouts. The Bank of England's interest in corporate workouts is linked directly to its core responsibilities relating to the maintenance of financial stability and the promotion of an effective and efficient financial system.[116] The key features of the London approach are a willingness by the main creditors to consider a non-statutory resolution of a company's financial difficulties, the commissioning of an independent review of the company's long-term viability and the operation of an informal moratorium on creditor enforcement procedures during the review period.

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

80 The London approach is an example of a debtor-in-possession restructuring process but it would be unwise to exaggerate the similarities between it and Chapter 11. A company in Chapter 11 enjoys a great deal of autonomy whereas a company undergoing a London approach restructuring is subject to the dictates and actions of its lender banks. The lenders determine whether the company shall enter the restructuring and, at any stage during the course of the workout negotiations, they may decide to withdraw from them and initiate

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

formal manager displacing administration or liquidation proceedings. The existence of the London approach, however, may have acted as something of a safety valve and muted to some degree any momentum in favour of the introduction of Chapter 11 type procedures in the UK.[117] The concentrated nature of UK corporate debt has also helped to create the right conditions for London approach rescues to flourish. These factors are likely also to operate in Singapore.

81 Some jurisdictions also have formal legislative procedures that may go half-way towards debtor-in-possession corporate restructuring. Singapore, for example, has the s 210 scheme of arrangement procedure.[118] The UK has the CVA with a moratorium procedure for smaller companies, though the procedure has not been widely used since its introduction. The "examinership" procedure in Ireland also bears scrutiny.[119] Under this procedure, an examiner may be appointed by the court to an ailing company to investigate and report and to prepare a restructuring plan but there is a presumption that the existing management should continue to direct the affairs of the company during the period of examinership. The Irish procedure is one that Singapore might draw upon though one must also be conscious of the risks associated with co-determination models like the Irish one. For example, the partition of authority caused by the dual decision-making structure may create an arena for clashes of opposing egos and interests:[120]

> First, one of the fallibilities of shared authority and collective decision-making is human miscommunication. The flow of information between the various decision-makers is susceptible to errors, miscommunication and hence distortion. Secondly, between management and the trustee, the former enjoys superior access to information concerning the debtor. Because the two decision-makers represent different interest groups, management has an incentive to withhold information from the other representative (the trustee), undermine the latter's effective decision-making and thus tip the scale of power and risk taking in favor of its own constituency, the equityholders.

117 See Armour, Cheffins and Skeel, *supra* n 112, at 1774.

118 On schemes of arrangement in Singapore, see *Walter Woon on Company Law* (Tan Cheng Han general ed) (Thomson Sweet & Maxwell, 3rd Ed, 2005) at pp 649–657.

119 The relevant law is contained in the Companies (Amendment) Act 1990. There was some American influence on the legislation – on this see "Foreword" to Weil, Gotshal & Manges LLP, *Reorganizing Failing Businesses* (American Bar Association, 1999): "Weil, Gotshal & Manges LLP was privileged to help the country of Ireland draft its Companies Act of 1990 to help attract investment by assuring investors a reorganization statute that would help businesses, notwithstanding defaults, if a healthy core business could emerge."

120 D Hahn, "Concentrated Ownership and Control of Corporate Reorganizations" (2004) 4 Journal of Corporate Law Studies 117 at 152.

XV. Financing of companies undergoing restructuring

82 New finance from whatever source is often critical to enable a company to carry on business during the restructuring period and ultimately to survive. In Singapore, there is no specific statutory procedure to facilitate the financing of companies that are in judicial management. A judicial manager, however, can borrow money on behalf of the company and use the unencumbered assets of the company as security as well as granting lower-ranking securities on already encumbered assets.[121] It could be argued moreover that the statutory provisions on a judicial manager's expenses are sufficiently flexibly drafted to permit a form of super-priority new financing. The legislation could be interpreted so that debts incurred by the judicial manager on behalf of a company – including those under loan facilities – have priority to existing loans that are secured by a floating charge.[122] Nevertheless, the "new finance' lending market, however, does not appear to be fully developed nor is the proper interpretation of the legislation free from difficulty.

83 In the US, by way of contrast, the "debtor in possession" lending market is highly developed and there is specific legislative authority for super-priority new financing. Section 364(d) of the Bankruptcy Code expressly allows the court to authorise this, but only in narrowly defined circumstances. There are safeguards for affected secured creditors in that the company must prove that it cannot obtain the loan without granting such a security interest and that the pre-filing secured creditor is adequately protected against loss. It seems that the statutory requirements are strictly applied.[123] In one case, for example, it was held that a company was ineligible for priming financing despite the over-secured status of existing secured creditors when the latter's equity

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121 Section 227G(3) and Eleventh Schedule and see the discussion in Choong & Rajah, *Judicial Management in Singapore* (Butterworths, Singapore, 1990) at pp 82–83.

122 See Choong & Rajah, *Judicial Management in Singapore* (Butterworths, Singapore, 1990) at p 85: "In practice, the priority conferred on the holder of the prior charge is likely to be withered away as there is nothing to prevent a judicial manager from creating a second floating charge over the charged assets expressly to rank in priority to the first charge. Although the provisions do not expressly provide for this, the inarticulate premise on which the foundations of the scheme are founded would indicate an affirmative answer."

123 See the comment in William D Warren & Daniel J Bussel, *Bankruptcy* (New York: Foundation Press, 7th Ed, 2006) at p 637: "Section 364(d) embodies a paradox. It provides that "priming" liens that subordinate prepetition secured lenders are permitted only when two conditions are satisfied: first, that money necessary to fund reorganization is not otherwise available; and, second, that the subordinated prepetition lenders be 'adequately protected.' How can both conditions be simultaneously satisfied? If the protections being offered the prepetition lender are truly adequate, why aren't those same protections sufficient to induce a postpetition lender to provide credit without subordinating the prepetition lender?"

cushion was rapidly eroding due to the company's history of operating losses in an industry that was suffering from a structural and not a cyclical downturn.[124] In general terms, a priming loan may not be granted unless the court concludes there is sufficient value in the collateral to protect fully both old and new lenders.[125] The rationale behind this notion of adequate protection is to provide an ailing business with the flexibility necessary to reorganise while, at the same time, protecting the interests of secured creditors.[126]

84 Often the DIP lender is an existing lender but it is not inconceivable that a completely new lender may emerge on the scene during the restructuring period. In the main, banks are looking for a low-risk, high-yield venture and DIP financing is a prime candidate. Chemical Bank led the way in DIP financing by starting a specialist DIP financing unit in 1984 and, at one stage, many years into its operations, it suggested that it had "never lost a penny" on this form of financing.[127] DIP lending can be extremely lucrative because, to compensate for the extra risk, the interest rates may be considerably higher than for ordinary loans. Moreover, there may be large transactional fees levied by the lender and the lender gains a valuable relationship when the company emerges from the restructuring process. [128]

85 The empirical evidence suggests that DIP financing can be value enhancing. One business school study which examined the reorganisation plans of a sample of large Chapter 11 cases with and without DIP financing found that successful restructurings benefited from DIP financing despite DIP companies being more "solvent" prior to filing for Chapter 11.[129] (Insolvency is not a prerequisite for a

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124 *In re Shaw Industries Inc* (2003) 300 BR 861.

125 See also *In re Qualitech Steel Corp* (2001) 276 F 3d 245 where prepetition secured creditors were granted a postpetition replacement lien to the extent that they were harmed by a postpetition loan granting DIP lenders superpriority under § 364(d).

126 See *Resolution Trust Corp v Swedeland Dev Group Inc* (1994) 16 F 3d 552 at 564. The court also said (at 567): "There, of course, is no doubt that the policy underlying Chapter 11 is important. Nevertheless, Congress did not contemplate that a creditor could find its priority position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects. We trust that in the future bankruptcy judges in this circuit will require that adequate protection be demonstrated more tangibly that was done in this case."

127 See, generally, Darla D Moore, "How to Finance a Debtor in Possession" (1990) 6 Com Lending Rev 3 at 8; Joseph U Schorer & David S Curry, "Chapter 11 Lending: An Overview of the Process" (1990) The Secured Lender 10 at 12–13.

128 See James J White, "Death and Resurrection of Secured Credit" (2004) 12 American Bankruptcy Institute Law Review 139 at footnote 143.

129 Maria Carapeto, "Does Debtor-in-Possession Financing Add Value? (London Business School Working Paper No 294-1999, 2004). See also Sandeep Dahiya *et al*, "Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence"

(*cont'd on the next page*)

Chapter 11 filing.) DIP financing was associated with the greater probability of a successful reorganisation, thus favouring larger recovery rates. The positive impact was reduced though when the new loans were "priming" loans, *ie*, gained priority over existing security or where there was cross-collateralisation. There was evidence of larger management turnover in firms with DIP financing and this finding suggested that the DIP lender played an important management and disciplining role in the corporate governance process – a trend that appears to have accelerated in recent times.[130]

86 The US is not alone in having a legislative framework that permits super-priority new financing. In Canada, a mechanism for super-priority new financing was originally developed by the courts and has now been put on a statutory footing. It should be noted, however, that Canada uses a "balance of prejudices" test which appears wider, less tightly controlled and less respectful of existing securities than that employed in the US under §364 of the Bankruptcy Code. The US regime in effect requires that existing creditors should not stand to lose under the new lending arrangements. The Canadian approach authorises DIP financing even when the existing creditors might lose if others stand to gain even more, does not require the same protection to existing creditors and uses a net benefit assessment. The courts can evaluate the benefit and risks of DIP financing and, based upon that, determine whether the financing is appropriate, without having to ensure any protection for the existing creditors.[131]

87 In Ireland, under the "examinership" procedure, there are also special statutory provisions in place to facilitate the financing of companies in financial difficulties.[132] The relevant legislation allows the examiner – a court-appointed official, normally an accountant – to certify liabilities that are essential to ensure the survival of the company as a going concern.[133] The liabilities so certified then rank with the examiner's own expenses ahead of all other liabilities, including pre-examinership secured liabilities. The "certification of liabilities" procedure can be used to cover borrowings made by the company during the period of examinership. In the leading case – *Re Atlantic*

(2003) 69 J Fin Econ 259 at 270–276 where it is found that DIP financing increases a firm's chances of emerging successfully from Chapter 11.

130 It has been suggested that 90% of DIP loans impose explicit restrictions on the debtor's operating activities – see David A Skeel Jr, "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11" (2003) 152 U Pa L Rev 917 at 929.

131 For criticism see David Light, "Involuntary Subordination of Security Interests to Charges for DIP Financing under the Companies' Creditors Arrangement Act" (2002) 30 CBR (4th) 245.

132 See, generally, on this procedure, T Courtney, *The Law of Private Companies* (Butterworths, Ireland, 2002) ch 23.

133 Irish Companies (Amendment) Act 1990 s 10.

Magnetics Ltd[134] – the Irish Supreme Court interpreted the original legislation to mean that assets already secured by fixed charges may be used for the purposes of fresh borrowings. As a result largely of protests by banks, however, the legislation has been amended to provide that liabilities certified by the examiner should rank after the claims of fixed charge holders although still ahead of floating charges.

88 The US practice has thrown up some undesirable features of DIP financing that Singapore may want to consider expressly prohibiting. A DIP lender can seek to use the new loan to buttress the status of an earlier loan either through "roll-ups" or cross-collateralisation.[135] With a "roll-up", an old unsecured loan is rolled up into a new secured loan which assures that the old loan is paid in full. Cross-collateralisation is also used to elevate the status of the lender's earlier unsecured debt in that the security package supporting the new loan serves simultaneously as security for the earlier debt. There is a strong argument that cross-collateralisation and roll-ups run counter to the overall philosophy and distribution scheme of general bankruptcy laws which mandate equal treatment of similarly situated creditors. The bankruptcy scheme tries to further the ideal of equal treatment of unsecured claims but cross-collateralisation seems diametrically opposed to this ideal.[136]

XVI. Cramming down creditors and approving a reorganisation plan

89 As we have seen earlier, Chapter 11 contains elaborate mechanisms whereby a class of creditors, including a class of secured creditors, can be "crammed-down" or forced to accept a reorganisation plan against their wishes. Before this can happen, however, there must be at least one impaired class of creditors who have accepted the plan. Also, a class of secured creditors must be promised the full value of its collateral over time and the court has to judge that the reorganisation plan is "feasible", *ie*, the debtor's promises are realistic in this regard. In general, the Chapter 11 plan confirmation rules are quite elaborate and complex.

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134 [1993] 2 IR 561.

135 See, generally, Charles J Tabb, "A Critical Reappraisal of Cross-Collateralization in Bankruptcy" (1986) 60 S Cal L Rev 109.

136 For a general discussion see Charles J Tabb, "A Critical Reappraisal of Cross-Collateralization in Bankruptcy" (1986) 60 S Cal L Rev 109 at 145–147. The US Supreme Court has stated that "if one claimant is to be preferred over others, the purpose should be clear from the statute" – *Nathanson v NLRB* (1952) 344 US 25 at 29.

90 In Singapore, the better view seems to be that, at least in the normal run of events, a secured creditor cannot be bound by a s 210 scheme in the judicial management context. If it is considered that secured creditors are unjustifiably holding up desirable corporate restructurings, then perhaps the US cramdown mechanism might be considered for adoption in a modified version. As presently constructed, it seems overly complicated. The basic notion, however, of allowing the objections of secured creditors to be overcome so long as these creditors receive the full value of their security over time is worth exploring.

XVII. Conclusion

91 There is often the adage that Singaporean (as well as UK) law in the area of insolvency and corporate restructuring is pro-creditor whereas US law is pro-debtor. This may be something of an over-simplification but, like many generalisations, it may contain a grain of truth. In Singapore, traditionally, the emphasis in corporate insolvency procedures, if they are concerned with "rescue" at all, may have been about saving the business, rather than the company shell. Receivership exemplifies this point above all else in that it is basically an auction procedure, followed by the distribution of realisations to the secured creditor who appointed the receiver, after which the company usually goes into liquidation. Judicial management may also be employed, however, as a delayed break-up and liquidation of the business in practice. In Chapter 11 of the US Bankruptcy Code, on the other hand, a different social policy appears to be implemented. Society is seen as having an interest in the preservation or rehabilitation of the corporate entity. In keeping with this approach, shareholders under Chapter 11 are regarded as interested parties with a stake, though subordinate to that of creditors, in the reorganisation. In judicial management (as well as in receiverships), shareholder claims are not formally considered at all. There is no provision for meetings of shareholders, and creditors alone are involved in the approval of proposals. Where judicial management in Singapore is coupled with a scheme of arrangement, it may possibly be used to negotiate a rehabilitation plan between creditors and shareholders. In practice, however, judicial management may not in fact involve reorganisation of the company but instead focus on going-concern sales or disposal of particular assets. The so-called rescue system in Singapore appears, therefore, quite market-oriented, tending to centre on saving businesses rather than corporate entities as such.

92 Singaporean practitioners, it seems, have become adept at using judicial management and schemes of arrangement as more efficient liquidation tools rather than rehabilitation regimes in practice. This, however, would not be considered a "reorganisation" in the traditional

American sense of the word.[137] By way of contrast, Chapter 11 of the US Bankruptcy Code may be described as a bargaining-oriented rather than a market-oriented procedure. The emphasis is on classes of creditors and shareholders working to resolve their differences through a process of bargaining and negotiation and coming up with a reorganisation plan for the survival of the company which then goes before the court for its blessing. The court evaluates the feasibility of the plan on the table and generally plays a central role in the process through holding the ring between the various participants.

93 Chapter 11, however, has become more market-oriented in recent years with more of an emphasis on asset sales and the speedier throughput of cases rather than on reorganisations in the traditional sense. Creditors have gained more influence over the process and over the terms of any restructuring by means of provisions in debtor-in-possession financing agreements. Lenders may control the release of necessary funds to the company depending on the speed at which restructuring is implemented. Companies come under pressure to sell off assets to meet funding needs if agreed restructuring proposals are not carried through. Company executives may also be offered financial inducements to move the company through Chapter 11 quickly.

94 It should also be noted that there are important differences in the institutional arrangements governing insolvency and corporate rescue in Singapore and the US. The management of insolvency cases in Singapore is dominated by insolvency practitioners while in the US the bankruptcy courts play a more central role in bankruptcy administration. Lawyers largely dominate the insolvency sector in the US.[138] Because of the courts' general jurisdiction over bankruptcy administration and their close supervision of all aspects of corporate bankruptcy, reorganisation in the US is largely lawyer-driven. Accountants exercise far less direct control over the governance of insolvency than their Singapore counterparts.

95 All these points notwithstanding, it is suggested that there are areas where Singapore may usefully borrow from Chapter 11. Although diluted in recent years, it is suggested that the emphasis in Chapter 11 on corporate rescue is a good one and could usefully be adopted. There

137 N Martin, "Common-Law Bankruptcy Systems: Similarities and Differences" (2003) 11 Am Bankr Inst L Rev 367 at 397.

138 "In the UK insolvency is largely accountant-driven: they become the office-holders – that is, the receivers and liquidators. Lawyers mainly act as advisers to office-holders. Accountants are the lawyers' handmaidens." See John Flood & Eleni Skordaki, "Normative Bricolage: Informal Rule-making by Accountants and Lawyers in Mega-insolvencies" in *Global Law Without A State* (G Teubner) (Dartmouth, 1997) at 112.

are also specific features of Chapter 11 that might be imported. For instance, it is suggested that there should be easier, more accessible routes by the company into judicial management or similar formal restructuring procedures. The interest of secured creditors should, however, be adequately protected, perhaps by giving them a veto on the identity of the person appointed as judicial manager. It is also suggested that there should be a clearer, more direct mechanism for the financing of companies during the restructuring period. This may entail giving new lenders super priority but this should be coupled with carefully drawn up safeguards for existing secured creditors. The new legislation might consider the concept of debtor in possession though it may be thought that this is a step too far. What might be worth exploring more fully are "half-way house" solutions such as the Irish examinership procedure. The Chapter 11 provisions for binding secured creditors to a reorganisation plan may be too cumbersome and complex for direct importation but might be modified for use in a Singaporean context provided that secured creditors receive the full value of their security over time.