Companies’ and creditors’ distress: how to untie the Gordian knot in the non-controlling unsecured creditors’ interests?

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Abstract

The analogy that exists between corporate (solvency) and insolvency governance gives further insight into the restructuring and liquidation of insolvent debtors. Whilst a lot of scholarly attention, especially after the financial crisis in 2008, has been dedicated to corporate governance and the potential economic conflicts between shareholders and directors on the one hand and between majority and minority shareholders on the other hand no such research has been undertaken regarding insolvency governance.

Nonetheless, once a company is on the brink of insolvency, unsecured creditors take over the economic position as residual risk bearers formerly (during the company’s solvency) held by shareholders. Subsequently, this research critically assessed whether similar conflicts akin to the majority v. minority conflict between shareholders during the company’s solvency could also occur between unsecured creditors during or in the run-up to the company’s insolvency.

After having illustrated through recent cases that such conflicts between ‘majority’ (controlling) and minority (non-controlling) unsecured creditors could indeed arise and whereby some controlling factions of unsecured creditors might attempt to exploit their controlling position at the expense of the weaker/non-controlling factions of unsecured creditors, it was assessed how control, or the lack thereof, needed to be ascertained. This research hereby determined that more emphasis must be placed on the unsecured creditor’s actual/concrete legal position rather than merely having regard to abstract factors.

Allied to the determination of the non-controlling position of unsecured creditors, this research then critically assessed what the currently still existing legal and economic pitfalls and challenges are that non-controlling unsecured creditors risk to endure pursuant to the regulatory framework at present.

After having done so, the research focused on the insolvency values – efficiency, fairness and accountability – which, according to this research, ought to underpin the regulatory framework. Assessing what these insolvency values are and how they interact with one another was critical to be able to provide regulatory suggestions which would improve the regulatory position of non-controlling (i.e. weaker) unsecureds. As part of the suggestions, this research ended by focusing on both non-governance and governance-related suggestions. As part of the governance-related suggestions, a further distinction was made between private and public enforcement measures. Nonetheless, all the suggestions were measured against and based upon the aforementioned insolvency values.
Table of Contents

ACKNOWLEDGMENTS ............................................................................................................. I

ABSTRACT ............................................................................................................................. II

TABLE OF CONTENTS ........................................................................................................... III

CHAPTER I .................................................................................................................................. 1

I. BACKGROUND ..................................................................................................................... 1
   1.1. CORPORATE INSOLVENCIES ................................................................................. 1
   1.2. OPPORTUNISM ......................................................................................................... 2
   1.3. FACTIONS OF UNSECURED CREDITORS .............................................................. 7
   1.4. VULNERABLE POSITION OF (NON-CONTROLLING) UNSECURED CREDITORS? ................................................................................................................. 8
   1.5. INFLUENCE OF CREDITORS’ PROTECTION ON THE COMPANY AND MARKET TRUST? ......................................................................................... 10

II. RESEARCH QUESTIONS ...................................................................................................... 12

III. AIMS .................................................................................................................................... 12

IV. METHODOLOGY ............................................................................................................... 12

V. NATIONAL AND INTERNATIONAL SIGNIFICANCE ........................................................... 14

VI. CONCLUSION .................................................................................................................... 15

CHAPTER II ............................................................................................................................ 17

I. INTRODUCTION .................................................................................................................. 17

II. MEANING OF INSOLVENCY ........................................................................................... 18
   2.1. CORPORATE FAILURE: TESTS FOR INSOLVENCY ........................................... 18
   2.2. DIFFICULTIES WITH THESE TESTS .................................................................... 19

III. GOALS AND FUNDAMENTAL INSOLVENCY PRINCIPLES ........................................... 22
   3.1. GOALS ....................................................................................................................... 22
   3.2. COLLECTIVISATION .................................................................................................. 24
       3.2.1. Fundamental principles ....................................................................................... 24
       3.2.2. Real and false exceptions .................................................................................... 25

IV. INSOLVENCY THEORIES .................................................................................................. 28

V. CONCLUSION ....................................................................................................................... 34

CHAPTER III ........................................................................................................................... 36

I. INTRODUCTION .................................................................................................................. 36

II. VULNERABILITY OF UNSECURED ................................................................................. 36
   2.1. PRACTICAL ILLUSTRATIONS OF SUBCLASSES WITHIN GROUP OF UNSECURED ........................................................................................................... 36
   2.2. DETERMINING “CLASSES” OF (VULNERABLE) UNSECURED ............................................................................................................. 39
   2.3. CRAM-DOWN PROVISIONS ......................................................................................... 42

III. CONCLUSION .................................................................................................................... 45

CHAPTER IV ............................................................................................................................ 46

I. INTRODUCTION .................................................................................................................. 46

II. UNSECURED’S RATES OF RETURN ............................................................................... 47

III. REMEDIES EX POST: SWELLING THE ASSET POOL ..................................................... 48
IV. MONITORING AND CONTROL RIGHTS OF UNSECURED CREDITORS ......................................... 60

3.3. WHY IMPROVE THE INSOLVENCY GOVERNANCE MODEL? ........................................... 60

3.3.1. Meaning ......................................................................................................................... 60

3.3.2. Importance of monitoring power ................................................................................... 62

3.3.3. Contemporary monitoring rights of unsecured creditors ............................................... 64

V. CONCLUSION ....................................................................................................................... 81

CHAPTER V ............................................................................................................................... 83

I. INTRODUCTION ..................................................................................................................... 83

II. DETERMINATION OF THE (NON-)CONTROLLING CHARACTER ........................................ 84

2.1. RELEVANCE OF THE QUESTION ..................................................................................... 84

2.2. ABSTRACT/GENERAL FACTORS ...................................................................................... 85

2.2.1. Voting power .................................................................................................................. 85

2.2.2. Lack of information, knowledge, funds bargaining power, interest and nature of creditor’s claim 86

2.3. PRACTICAL FACTORS. ...................................................................................................... 88

2.4. PRIVATE BENEFITS OF CONTROL? .................................................................................. 91

2.4.1. Notion ............................................................................................................................... 91

2.4.2. Kapoor-case ...................................................................................................................... 92

2.4.3. Impact of control .............................................................................................................. 93

2.4.4. Class divisions .................................................................................................................. 95

2.5. CONFLICTS OF INTERESTS ............................................................................................ 96

2.5.1. General remarks .............................................................................................................. 96

2.5.2. Exploitative behaviour? ................................................................................................. 98

2.5.3. Inefficient behaviour? .................................................................................................... 103

III. REMEDIES FOR UNSECURED WITH REGARD TO INTER- AND INTRA-GROUP CONFLICTS ........ 107

3.1. UNFAIR PREJUDICE / UNFAIR HARM ........................................................................... 108

3.1.1. IVA and CVA ................................................................................................................... 108

3.1.2. Administration and liquidation ....................................................................................... 108

3.1.3. Risks or pitfalls ............................................................................................................... 109

3.2. MATERIAL IRREGULARITY ............................................................................................... 112

3.2.1. Notion .............................................................................................................................. 112

3.2.2. Conditions ..................................................................................................................... 113

3.2.3. Critical analysis ............................................................................................................. 113

IV. CONCLUSION ....................................................................................................................... 115

CHAPTER VI ............................................................................................................................. 117

I. INTRODUCTION ..................................................................................................................... 117

II. WHY IMPROVE THE INSOLVENCY GOVERNANCE MODEL? ........................................... 118

III. PRINCIPLES ......................................................................................................................... 119

3.1. EFFICIENCY ....................................................................................................................... 121

3.1.1. Importance of the notion ............................................................................................... 121

3.1.2. Economic notion(s) of efficiency ................................................................................... 123

3.1.3. Importance and benefits of an ‘efficiency’-principle ....................................................... 125

3.1.4. Criticisms of an ‘efficiency’-approach ......................................................................... 127

3.2. FAIRNESS .......................................................................................................................... 132

3.2.1. What is fairness? ............................................................................................................ 132

3.3. ACCOUNTABILITY ............................................................................................................. 138

3.3.1. Definition ....................................................................................................................... 138
1. INTRODUCTION .................................................................................................................. 182

II. REGULATORY SUGGESTIONS TO IMPROVE THE INSOLVENCY FRAMEWORK .................................................... 182
   2.1. NON-GOVERNANCE SUGGESTIONS .................................................................................. 182
       2.1.1. Preferential position .................................................................................................. 182
       2.1.2. Insurance and trust mechanisms ............................................................................. 185
   2.2. GOVERNANCE-RELATED SUGGESTIONS ......................................................................... 192
       2.2.1. Creditor control and engagement ......................................................................... 193

III. CONCLUSION .................................................................................................................. 253

CHAPTER IX ......................................................................................................................... 255

II. UNDERLYING INSOLVENCY PRINCIPLES ........................................................................ 255

III. SIMILARITY BETWEEN CORPORATE (SOLVENCY) AND INSOLVENCY GOVERNANCE: KEY ACTORS AND ECONOMIC RELATIONS ................................................................................................. 256

IV. DETERMINATION OF UNSECURED CREDITOR'S NON-CONTROLLING POSITION ................................. 257

V. CONTEMPORARY CHALLENGES AND REGULATORY SUGGESTIONS ................................................. 258

VI. CONCLUSION .................................................................................................................. 262

BIBLIOGRAPHY ..................................................................................................................... 264
I. Background

1.1. Corporate Insolvencies

In a free trading community, companies can rely on, in order to operate, credit provided by corporate lenders and suppliers, thus creating a relationship between the debtor-company on the one hand and the creditor-lender on the other.\(^1\) Being able to grant and receive credit creates the possibility of (the occurrence of) the insolvency of the borrower, namely in cases where the debtor-borrower cannot repay its debts to its creditors when they become due.

In this regard, figures clearly show that insolvencies happen quite often, proving that there is an inherent risk a company might become insolvent. Although the total amount of insolvency procedures slightly decreased to 3883 in the first quarter of 2020, the total amount of companies entering insolvent regimes is expected to increase.\(^2\) When looking into the full figures of 2019\(^3\) published by the Insolvency Service, it can be observed that throughout 2019, the total number of new corporate insolvencies reached 17,196 which is equivalent to one company in every 238 companies having ended up insolvent in that year.\(^4\) This is said to be the highest number of insolvencies since 2013.\(^5\)

The insolvency of a company does not only have an impact on the creditors who granted credit to the debtor-company, but it also affects many other stakeholders such as consumers who may not be able to obtain the goods or services they have paid for\(^6\), employees who may not only face the risk of not receiving their wages but who may also end up losing their jobs\(^7\), and involuntary creditors who may not have voluntarily granted credit to the company but to whom

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\(^3\) Due COVID-19, the unprecedented measures that were taken and its impact on the markets, the figures for 2020 and 2021 are distorted which is why 2019 is the last year of credible figures.


\(^5\) Ibid.

\(^6\) The Law Commission, Consumer Prepayments on Retailer Insolvency: Summary (Law Com No 368 2016) 9-11.

the debtor-company owes the payment of damages etc. Also, besides the micro-impact of the insolvency of a company on these various stakeholders, there may also be a broader macro-risk because other companies and/or entrepreneurs may also end up in financial difficulties following the insolvency of their debtor, potentially causing a broader ripple-effect. Nonetheless, the negative consequences of this string of insolvencies will again be felt ultimately by similar stakeholders (inter alia) akin to the ones already being mentioned.

1.2. Opportunism

The wide variety of stakeholders being affected by the insolvency of a company illustrates the great many relationships (i.e. often through contracts) being entered into by the financially distressed company. This large web of relationships between and within several companies led, according to some scholars, to the creation of the economic “nexus of contracts” (a variety of the contractarian) theory which states that a company can be described as a mere chain of contracts. This is often seen as related to the agency theory which aims to conceptualise the contexts in which a self-interested agent may act to the detriment of its principal in a solvent company. The agency theory, hereby, submits that directors are the agents of the shareholders who are seen as the economic principals. As directors are managing the company in the interests of shareholders, it is thus shareholders that are deemed best suited to monitor the directors’ performance and, if necessary, to hold them to account in case of underperformance according to this theory.

However, although a company cannot be seen as a mere nexus of contracts due to its separate legal personality and despite the fact that the various relationships the company has got with its shareholders, creditors and other stakeholders, it cannot be seen as agency-relations from a legal point of view (due to the lack of an endowment of authority by a principal on an agent), commentators favouring the agency theory argue that these various corporate relations can be compared with agency relations from an economic, as opposed to a legal, viewpoint. According to them, this would be because there is, arguably, always an alleged risk that one self-interested party may be acting opportunistically, by putting its own interests ahead of the interests of the other party, even if this would be detrimental for

10 A. Keay, Board Accountability in Corporate Governance (Routledge, 2015) 73-74.
11 Ibid.
12 Salomon v A Salomon & Co Ltd [1897] AC 22.
13 Ibid (n 10) 76.
the latter party. Without elaborating too much on the positives and negatives of the agency theory (for that would be beyond the scope of this introductory chapter), this thesis submits that, in spite of the valid criticism against the agency theory, it can still provide some economic insights deemed important in understanding the various economic relations corporate actors are engaged in.

In this regard, agency theorists argue that this gives rise to three opportunistic problems arise in a solvent company. First, they argue that there may be a risk of opportunism between the majority and minority shareholder(s) whereby the majority shareholders are argued to be (potentially) able to abuse their ‘majority’ to the detriment of the ‘minority’ shareholders. Secondly, it has been argued that there may also be a risk of opportunistic behaviour by the company’s managers/directors if their interests differ from the interests of the shareholders and the former ones do not act in the interests of the company for the benefit of these shareholders despite being required to do so. Thirdly, one is able to argue that there may be an opportunistic issue between the company itself (and particularly the wishes of the shareholders/investors) and the expectations of other parties with whom the company has contracts. This would be because the company (and its members) may prefer a strategy whereby the company’s contracted parties (e.g. consumers or employees) may risk being exploited and/or misled.

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As the agency theory has been discussed both as regards solvent\textsuperscript{18} and distressed\textsuperscript{19} companies, it is, for the purposes of this research, deemed critical to identify the opportunistic problems which may arise in a financially distressed company and which are analogous to the agency problems occurring during the company’s solvency. This analogy/similarity in terms of potentially occurring agency problems can be seen through the following points.

First, in a company being insolvent or near the brink of insolvency the unsecured creditors can be compared with the company’s shareholders as from that moment the unsecureds become the residual risk-bearers (as there is normally nothing left for the shareholders anymore and what is being owed to the company should be distributed amongst these unsecured creditors).\textsuperscript{20}

In relation to secured creditors, Jackson claims that they also can be seen as “owners of the firm” because they have rights in the assets\textsuperscript{21} (albeit in a different way than the unsecured creditors). Unless to the extent that their security interest does not cover all the debts owed to the secured creditor (which means that there is a shortfall), they cannot be seem as “residual risk-bearers” and are basically not even part of the insolvent firm anymore as they have power over the company’s assets in which they have got a right \textit{in rem}, meaning that these assets do not belong to the firm anymore either. Unless the transaction relating to the creation of a security is challenged for some reason, the encumbered assets are basically economically and legally owned by the secured creditor and not by the firm/company which is insolvent and needs to be rescued/liquidated.

Secondly, unless the management of the company remains in office during the financially distressed period, an office-holder (such as a liquidator or an administrator) who is a qualified individual will be appointed to act as a fiduciary and agent of the financially distressed company in the interests of the latter company for the benefit of all its creditors.\textsuperscript{22} As this office-holder is in control of the affairs of the company his or her duties can, \textit{mutatis mutandis}, be compared

\begin{thebibliography}{99}
  \bibitem{Jackson01} T.H. Jackson \textit{The Logic and the Limits of Bankruptcy Law} (Beardbooks Washington D.C. 2001) 32-33.
\end{thebibliography}
with the duties of the directors of the company. Subsequently, both the office holder and the managers of a company act as agents of that company once appointed.

Thirdly, although it is very likely that the company will lack sufficient financial resources once it becomes financially distressed, even a financially distressed company may well continue or enter into fresh contracts with third parties both before and after entry into a formal insolvency regime. For instance, the office-holder of the insolvent company may need to appoint agents with specific expertise in relation to aspects of the liquidation (e.g. solicitors) or he may need to continue paying the wages of employees. From a legal perspective, these third parties will also be ‘creditors’, however, due to their different economic relation to the debtor (i.e. their expertise is often needed to be able to wind-up the company or to ensure a company can continue operating during corporate rescue procedures), they will be granted a certain preferential position and, hence, the reason why they can be distinguished from the ‘ordinary’ unsecured creditors which are mentioned above and who rely on contracts/agreements entered into before the debtor became insolvent.

Having compared the “roles” of the important players in a financially distressed company with the players in an active company, one can now see that, from an economic point of view, similar opportunistic problems may also be identified in a company that is insolvent or on the brink of insolvency. Therefore, we now turn to the opportunistic problems which may arise during on insolvency.

First, there may arise a conflict between the interests of the unsecured creditors and either the incumbent debtor company’s management or the office-holder. The fewer assets being available in the financially distressed company, the more risks unsecured creditors may want to take provided they believe that by taking this risk the benefits will outweigh the costs of this risk and they are, if nothing is done, likely to get nothing. However, the management or office-holder can be expected to be more likely to act in a risk-averse manner trying to avoid wasting the scarce financial resources knowing that if he/she takes the wrong decision he/she may be held liable.

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24 In relation to liquidation: Knowles v Scott [1891] 1 Ch 717 (Ch); in relation to administration: Insolvency Act 1986, Schedule B1, Paragraph 69; in relation to CVA, this is meant to be determined in the terms of the CVA: H. Anderson, *The Framework of Corporate Insolvency Law* (Oxford University Press 2017) 121.
26 Ibid, 320.
27 Ibid, 516.
28 This research will elaborate on this in chapter 2.
Secondly, like the opportunistic conflict that exists between the majority and minority shareholders, also in insolvency one subset of unsecured creditors (who are then claimed to have assumed the position of shareholders as residual risk bearers)\(^{30}\) may be more able to control decisions than other unsecured creditors\(^{31}\). For instance, this would be the case if (in a simplified example) one unsecured contains the majority of the votes needed to approve a plan or decision whilst the other unsecured creditors may lack the ability to block a harmful outcome. The former unsecured creditor having the majority of the votes because of the value of its debt may use his majority in a way to act in his own self-interest even if this would be detrimental for the other unsecured creditor(s) or even to the company as a whole.

Thirdly, there is also a potential issue between the (now financially distressed) company (managed in the interests of the unsecured creditors) and the third parties with whom the company may contract. Such an issue would appear when the interests of the existing unsecured creditors would conflict with the interests of the third parties such as the interests of employees which might differ from the other unsecureds. For instance, this would be the case if most unsecureds would not be willing to continue with the business of an insolvent company although this might create the risk of employees, who are likely also unsecureds, losing their jobs as a result of the discontinuation of the company’s business.\(^{32}\).

All this can be summarised in the following table:

<table>
<thead>
<tr>
<th>Active company</th>
<th>Distressed company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Shareholders</td>
<td>Unsecured creditors</td>
</tr>
<tr>
<td>2 Management</td>
<td>Management or Office-holder</td>
</tr>
<tr>
<td>3 Third party constituents</td>
<td>Third party constituents</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunistic conflicts active company</th>
<th>Opportunistic conflicts distressed company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Shareholders vs. management</td>
<td>Unsecured creditors vs. incumbent management / office holder</td>
</tr>
<tr>
<td>2 Majority (controlling) shareholders vs. minority (non-controlling) shareholders</td>
<td>Controlling unsecured creditors vs. non-controlling unsecured creditors</td>
</tr>
<tr>
<td>3 Company (particularly its shareholders) vs. third parties</td>
<td>Company (particularly its unsecured creditors) vs. third parties</td>
</tr>
</tbody>
</table>

Table 1. Opportunistic risks in active and financially distressed companies


\(^{32}\) Cf. chapter 2.
The existence of similar opportunistic problems at a moment when the company becomes financially distressed provides a useful guidance vis-à-vis the evaluation of the position of the unsecured creditors.

1.3. Factions of unsecured creditors

Although the second chapter will elaborate further on the fundamental principles of insolvency law, it is appropriate here to note, generally, the law makes a clear distinction between the secured creditors and the unsecured creditors. In general, the secured creditors are the creditors having bargained for a property right granting a priority over some of the debtor-company’s assets while the unsecureds do not have a similar protection leaving them with only contractual rights and thus fewer chances of getting (fully or even partially) repaid.

Although this minimal separation between secured and unsecured is already a common feature of insolvency law in many countries, including the United Kingdom, it has now also been enshrined as a requirement under EU Law according to recital 44 of the EU Directive on restructuring and insolvency.

However, it is questionable whether such a minimal division between secured and unsecured will be able to grant satisfactory protection for all unsecureds as this would leave all unsecured creditors together in one group. Having said that, there may also be different factions within this (large) group of unsecured creditors. This latter point is what this research will elaborate on.

During corporate rescue procedures, it is generally expected that making a distinction between several factions of unsecureds may increase the chances of rescuing a failing company as one would be able to deal with creditors’ different commercial interests which are being grouped together in one class based on the similarity of the claim/interests. It would, however, go beyond the scope of this chapter to explore this into detail. This will be dealt with in chapter 3.

Secondly, it has already been mentioned that some unsecureds, compared with others, may have a weaker bargaining position lacking more financial resources and understanding of their rights which may lead to them having less influence prior to and during the insolvency of a

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company. For instance, one class of unsecured creditors which has already been claimed to be in need of more protection are the consumers. Although individually, all consumers have got the same voting and distributional rights as all other unsecureds, they may still be worse off than some other unsecureds due to their weaker position prior to and during the insolvency procedure (inter alia due to their weak bargaining position, insufficient information and generally small claims giving them often only few voting rights). This rather weak consumer position had explicitly been acknowledged in Re Kayford Ltd where the court stated that consumers are “members of the public, some of whom can ill afford to exchange their money for a claim to a dividend in the liquidation”. Furthermore, on some occasions the law has given a preferential position to some unsecureds granting them the privilege of being paid ahead of other unsecureds. This is, for example, the case for employees and in a limited way HMRC.

1.4. Vulnerable position of (non-controlling) unsecured creditors?

The existence of different factions of unsecureds resembles the existence of different factions of shareholders and more in particular, the difference between controlling and non-controlling groups of shareholders. Likewise, among unsecureds one can also differentiate between those factions who are stronger (i.e. controlling unsecureds) and those who are weaker/more vulnerable (i.e. the non-controlling unsecureds). This research will, hereby, use the words “vulnerable”/“weak”/“non-controlling” in an interchangeable way for it is submitted that those unsecureds who are non-controlling are not able to influence the decision-making process of the insolvency procedure leaving them in a weaker or, thus, more vulnerable position compared to those unsecureds who are in a controlling position and can, in contrast to the non-controlling factions, exercise more influence over the debtor’s management and the decision-making process during an insolvency procedure. The stronger unsecureds are usually those who have more voting and/or bargaining power, large claims and more financial/legal knowledge. They are more able to properly monitor the debtor and influence the company’s management (incl. the debtor’s insolvency procedure) and, in doing so, advance their own interests whilst those who are weaker, in principle, lack the power to do so and may, potentially, be subject to

39 Cf. Chapter 2 on “pari passu”.
40 The Law Commission, Consumer Prepayments on Retailer Insolvency (Law Com No 368 2016) 89-93.
41 Re Kayford Ltd [1975] 1 WLR 282.
42 Ibid.
43 Cf. infra chapter 2.
45 Cf. see chapter 5 for the determination of the non-controlling (i.e. vulnerable/weaker) position of unsecureds.
inefficient or exploitative behaviour by the controlling unsecureds. Similar to minority/non-controlling shareholders, non-controlling unsecureds are, arguably, more vulnerable.

The differentiation between controlling and non-controlling unsecureds is therefore related to the question ‘who’ all these more vulnerable non-controlling unsecureds really are and how their vulnerability could be determined. Although chapter 5 will elaborate extensively on this issue, this research submitted that non-controlling unsecureds can be described as those unsecureds who are unable to control or influence the restructuring (in a corporate rescue-phase) or liquidation procedure (if rescue has failed or not been proposed).

As already shown above, these non-controlling unsecureds are often those who are unable to properly influence/control the insolvency process (unlike the secured creditor or perhaps a strong/controlling unsecured) are in a potentially even more disenfranchised position than other unsecureds.

This more vulnerable position of certain (classes of) unsecureds can be examined from generally two angles which both relate to the way in which the insolvent company is governed ("insolvency governance").

On the one hand, this can be considered from the monitoring/investigative position of weaker unsecured creditors. This angle covers issues related to the voting power and voting rights of these creditors but also to their attendance at creditors’ meetings (if meetings are being held) and particularly to their ability to control and examine the work undertaken by either the incumbent management of the insolvent company or the office-holder, if the company becomes subject to an insolvency procedure.

Therefore, consideration of governance from a distributional perspective ought to address issues in relation to the amount of dividends unsecureds would receive. Not only is it worthwhile examining whether an increased control by the (weaker factions of) unsecured creditors may be expected to lead to an increased dividend for these creditors, issues in relation to managerial accountability, the office holders’ performance, the potential pitfalls with procedures intended to swell the asset pool for the benefit of unsecured creditors also need to be taken into account as increased dividends for the whole group of unsecured creditors would also benefit the weaker factions within the unsecureds’ group. Chapters 4 and 5 will extensively elaborate on this.

Furthermore, allied to this, the question how the protection of such vulnerable groups of creditors (such as e.g., consumers) will be given extensive thought in chapter 8.
1.5. Influence of creditors’ protection on the company and market trust?

Critical research in relation to the protection of the non-controlling unsecureds will not only need to take the creditors and the office-holder into consideration but it will also need to consider the position of the financially distressed company itself due to fact that an altered protection of (certain classes of) creditors may also have an impact on the financially distressed company itself, no matter whether the company is being managed by the incumbent management or an office-holder.

The (altered) influence of certain unsecureds on the company is twofold. First, a different level of control exercised by unsecureds may grant a different level of managerial freedom to the company’s managers/directors/office-holders while potentially also having an influence on the level of risk-aversion of the managers/office-holders. Empirical studies have already shown that the remuneration of office-holders was lower in corporate insolvencies where secured creditors who were controlling the insolvency procedure had put pressure on the office-holder to reduce it which may not only provide a windfall for floating charge-holders but also unsecureds. However, although this might stress the impact control of creditors can have, unsecureds tend not to be able to put similar pressure on the office-holder for several reasons: inter alia their lack of knowledge about insolvency procedures and the small size of their claims. If the secured creditor does not adequately control the management or the office-holder or if there are no secured creditors to control either the management or the office-holder, then the position of unsecureds may become worse.

Secondly, a higher level of unsecureds’ protection may also enhance creditors’ interests and market trust from which the financially distressed may reap the benefits. To illustrate this, while examining what changes had to be made to the directors’ disqualification regime in order to foster market trust, the UK government stated that “there is an argument that, where vulnerable and unsophisticated consumers are involved, or where the business of the company involves the taking of a high volume of deposits or pre-payments, directors ought to be more aware of the social impact of their actions and should pay more regard to the interests of such creditors when the company encounters financial difficulties.” Although the government seemed to be

47 Companies Act 2006, section 1282.
48 Ibid (n. 43).
more concerned about ‘consumers’ in this discussion paper, there is also a question to what extent other vulnerable unsecureds may also need to be considered and what impact an altered protection of them would have on the company itself.

However, although increased creditor protection may have the benefit of increasing managerial performance and market trust leading to creditors being more willing to grant credit towards companies, there are also some particular risks which need to be taken into account. First, a distinction should be made between companies in the vicinity of insolvency or insolvent (but not yet subject to an insolvency procedure) and companies already subject to an insolvency procedure. To what extent does the commencement of an insolvency procedure or the knowledge that their debtor will become subject to an insolvency procedure lead to a turning point in the creditors' behaviour? And will the giving of a higher level of protection to unsecured creditors prior to and during these insolvency procedures lead to a greater chance of granting more credit to financially distressed companies, given the fact that due to the insolvency of their debtor they may have more to lose than to win anyway? Secondly, granting more rights to unsecured creditors while making them more aware of their rights may also lead to (some) unsecured creditors becoming more assertive which may have an impact on the behaviour of managers/office-holders who may start acting in a more risk-averse way as they may be deterred by the risk of (potentially) looming accountability claims. Surely, one does not want to prevent managers/office-holders from doing their job properly as this would also have a negative impact on the going concern or liquidation value of the (financially distressed) company. This could, for example, be the case if the asset pool of the debtor is (almost) empty. In such situation, apart from the monitoring costs vis-à-vis the office-holder, unsecureds have nothing to lose and may want to press the office-holder to start a liability claim against the former directors. Surely, the risks (and economics costs) of initiating and pursuing a claim would largely fall on the office-holder while the unsecureds can only gain. This is because, if the procedure is successful, unsecureds would have more dividends. If the procedure is not successful, they did not lose more than they would have lost anyway (namely, the lack of getting their fixed claim repaid).\(^{50}\)

For these reasons, not only the protection of unsecureds but also the impact on the company will be examined (for a negative impact on the company will also negatively impact the position of unsecureds).

II. Research questions
Taking into consideration the foregoing background, several research questions can be identified.
1. Who are unsecured minority creditors and what are the problems they could face when a company is insolvent?
2. Should there be better protection of unsecured minority creditors in insolvencies in terms of (i) their monitoring rights and their rights to influence the insolvency procedure, (ii) their recovery/dividend rights and (iii) their rights to hold the office-holder accountable?

III. Aims
In order to be able to address the questions just posed the following specific aims will be addressed.
1. To determine who the vulnerable / non-controlling unsecured creditors (generally) are in an insolvency.
2. To identify and explain how the unsecured minority (or non-controlling) creditors are currently protected under the laws of the UK?
3. To ascertain what the primary goals of insolvency law are.
4. To undertake a critical analysis of the legal/economic/social theories which may underpin Insolvency Law.
5. To examine whether the current rights of some classes of vulnerable unsecured creditors should be improved and in what way.
6. To examine whether insolvency governance should be improved.
7. To analyse the effect of an altered creditors’ protection on the stakeholders and to examine how the (perhaps?) changed attitude of these stakeholders will influence the financially distressed company.

IV. Methodology
In order to examine the research questions mentioned above, this research opted for a desk-based analysis of case-law, legislation and legal doctrine. Doctrinal research allows one to critically examine the research questions from a legal and practical point of view by analysing case-law, legislation, government reports, book(s), book chapter(s) and legal journal articles. As part of this doctrinal research, this thesis will also make use of comparisons from other jurisdictions, and it will draw on conclusions drawn by law and economics scholars.
On the one hand, the thesis will engage in an internal comparison of law by *mutatis mutandis* comparing the rights and protection being granted towards unsecureds with the rights being given to minority shareholders flowing from the fact that unsecureds (in an insolvent company) can be compared with shareholders in a solvent company. This may provide interesting insights as to how unsecureds should (not) be protected.

One the other hand, one will also use an external comparison of law where English law will be compared with EU law, Canadian and Australian Law. Although the latter two countries are both also common law jurisdictions belonging to the same legal family and may therefore have some correlations with the jurisdiction and corporate culture of the UK (such as dispersed ownership, managerial duty shift in favour of the interests of creditors once the company is in the vicinity of insolvency etc), they often still provide totally different solutions for similar problems. Some reference will also be made to the EU Directive on restructuring and insolvency law which, to some extent, aims to harmonise substantive insolvency law of EEA countries. However, most EEA countries are – in contrast to the UK, Canada and Australia, Civil Law jurisdictions and the provisions enacted in the EU Directive may, therefore, differ from the approach taken in aforementioned Common Law jurisdictions.

Although there is no generally accepted legal definition of “comparison of law” describing what “a comparative method” exactly entails, this research will approach a comparative study as a way to learn and examine the applicable (corporate governance and insolvency) law of foreign jurisdictions in order to get a broader and better understanding of the current English law and more importantly what the practical and legal issues may be which ought to be addressed now.

In addition, this doctrinal method will also draw on conclusion reached by law and economics scholars. In this regard, the transaction-cost-theory will be examined. This measures the efficiency of legal rules by examining whether the aggregate benefit of a rule outweighs the costs of it. This approach not only enables us to examine current rules but also to analyse whether foreign rules and potential new policies are worthwhile. Furthermore, this transaction cost-theory is also embedded in several corporate governance theories (such as contractarianism, the agency theory etc..). Furthermore, economic theories aim to lay bare opportunism and opportunistic conflicts/risks (which might arise) between corporate actors. Furthermore, it is these economic theories upon which the economic visions for insolvency law

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54 Cf. *supra* paragraph 1.2. in relation to opportunism.
(such as e.g., the creditors’ bargain theory) are based and examining them allows us to get a better understanding of the foundations of the current insolvency framework, especially as the protection of unsecureds varies depending on which of the visions underpinning the insolvency law are adopted. Consequently, this knowledge provides this research with several angles and viewpoints to critically examine and analyse the position and protection of creditors and more in particular, whether (and if so, how) controlling creditors may be acting opportunistically and in what way one could/should respond to this.

V. National and International significance

Flowing from the theoretical background, one can argue that analysing the protection of (factions of) unsecureds would be significant from several points of view. The knowledge that insolvencies (can) occur every moment creates the need to critically examine to what extent the current safeguards for unsecureds can be improved and/or guaranteed in the best possible way. In this regard, unsecureds are very often still only being examined as “one group” although different types of unsecureds might require different types of protection.

Therefore, contrary to the great deal of previous research, this research aims to seek which groups/factions of unsecureds may be more vulnerable than others in order to provide appropriate solutions as to how one may provide these more vulnerable groups of unsecured creditors with better protection. By doing so, this research will fill a currently still existing gap by ascertaining how these weaker factions of unsecureds can be better protected. By doing this, it will also have to focus on how to improve the ways in which the insolvent company is governed (insolvency governance), an area which is also still quite under-researched (despite the large attention given to corporate governance before financial difficulties kick in).

Subsequently, by taking this new angle of “insolvency governance” as a means to critically examine and improve the protection of more vulnerable factions/classes of unsecured creditors, this research is expected to move the current debate (with regard to the protection of unsecured creditors) forward. Scientifically, using the perspective of “insolvency governance” also grants the possibility of comparing the position of non-controlling unsecureds with the protection granted to non-controlling shareholders. Moreover, it enables us to examine to what extent insolvency law can be made fairer for non-controlling unsecureds in terms of initiating and controlling an insolvency procedure and holding (former) managers/directors and/or the office-holder to account.

Practically, such research is important as a fair, well-balanced and efficient insolvency law for non-controlling unsecureds may have positive consequences for the economy and markets, as
has also been highlighted by the Juncker policy agenda of the EU Commission.\(^{55}\) First, creating a strong and good regulatory framework may reduce the amount of insolvencies which is expected to lead to an increase of investments\(^{56}\) and credit being granted to companies before and during the financially distressed phase which may prevent these companies from entering into financial difficulties or becoming liquidated (preferably) enabling unsecured creditors (or more vulnerable unsecured creditors) to get a higher or perhaps even their full share repaid. Subsequently, this may enhance national and international market trust which is expected to encourage entrepreneurship. Consequently, such an increased market trust sustained by encouraged entrepreneurship may attract national and international businesses and may, therefore, not only lead to workers being able to keep their jobs\(^{57}\) but it may also create even more jobs. Furthermore, fewer insolvencies will also lead to fewer losses borne by creditors and other stakeholders which, in turn, can be expected to stimulate them in assisting in the economic growth process\(^{58}\). Similarly, ensuring that weaker or more vulnerable factions of creditors (such as consumers) can recover from over-indebtedness should also stimulate them to keep contributing to the economy, hereby also assisting in the economic growth process. Finally, providing a sound protection for all classes of unsecured creditors whilst improving the insolvency governance-system might also provide guidelines for weaker unsecured creditors in other (common law and/or civil law) jurisdictions.

**VI. Conclusion**

After briefly describing the literature/background against which this research will be undertaken, this chapter merely intends to provide the skeleton of this future research project. Therefore, after a brief introduction into the literature, the research questions have been set out followed by the required aims which need to be satisfied in order to facilitate finding an appropriate response to the research questions. How the research will be conducted has subsequently been explained in the methodology-part after which the national and international significance of this research and the thesis structure has been dealt with.

Structure-wise, the second chapter will elaborate on the general principles and theories underpinning insolvency law. The third chapter will build further on this by showing some differential treatment between factions of unsecureds before chapter 4 and 5 will respectively point out the contemporary pitfalls and drawbacks which vulnerable factions of unsecureds are


\(^{58}\) Ibid 3.
confronted with both as member of the general group of unsecureds and as a vulnerable faction itself. In doing so, chapter 5 will provide tools to assess an unsecured’s vulnerability. After having examined the regulatory issues that currently still exist as regards vulnerable unsecureds, chapter 6 and 7 will set elaborate on the necessary values that ought to underpin the insolvency framework and against which regulatory adjustments ought to be measured. These values lay the foundation for the assessment of the regulatory adjustments that will be discussed in chapter 8. Chapter 9 will conclude this research.
Chapter II

Insolvency Law: meaning, principles and underpinning insolvency theories

I. Introduction

Maladministration, market losses, fraud and loss of long term finance are some of the primary causes of corporate insolvencies in the United Kingdom, according to an R3 report.\(^{59}\) Insolvency may have an impact on a variety of other businesses, companies, shareholders, creditors, employees, consumers and other stakeholders who may have dealt with the failing company. However, before being able to discuss “insolvency”, it is important to define what “insolvency” entails, especially as not every company facing financial problems or having difficulties paying their creditors in time is or will become insolvent. Furthermore, insolvency also happens to be a measure for courts to decide whether companies should be wound up or not.\(^{60}\) The rationale for this is twofold. On the one hand with the removal of insolvent companies, it is expected to be able to reduce the risk of companies building up large debts which could affect other companies and persons dealing with the failing company, thereby reducing the risk of ripple-effects (preventing other entrepreneurs from becoming insolvent). Troubled companies can be given the opportunity to rescue once it has been determined that the company is in financial difficulties/insolvent.\(^{61}\) Finally, once a company becomes insolvent and becomes subject to an insolvency procedure, specific liability procedures also come into existence (as part of the measures to swell the asset pool in favour of the unsecured creditors). Once it becomes clear ‘what’ one can understand under the term ‘insolvency’, this research can move on to general principles characterising insolvency law. As these general principles are subject to so many exceptions, it can be seen that this may create legally differential treatments (and therefore perhaps economic conflicts) between the different insolvency players. The latter observation will lead us to the insolvency theories underpinning insolvency law as all these different economic approaches will lead to different solutions for the same recurring problem, namely the protection of unsecured creditors, and particularly the weaker classes of unsecured creditors. So, this chapter intends to provide the legal, economic and social foundations of insolvency by critically examining the goals and fundamental principles of insolvency after which the economic and social theories underpinning insolvency law and their impact on insolvency players will be analysed. These foundations will provide the necessary background and will therefore be pivotal.

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for the upcoming analysis in the next chapter where the thesis will critically examine how different classes/factions of unsecured creditors are currently protected.

II. Meaning of insolvency
   2.1. Corporate failure: tests for insolvency

As mentioned, the fact that companies may end up in financial difficulties during which they can be in arrears in paying their debts in time, does not necessarily mean that the company would (or should) be (considered) insolvent. To be able to determine whether a company is ‘insolvent’, the law has set two primary tests which ought to be employed to examine whether a company is ‘insolvent’ or not. The first test is a "cash flow"-test under which a company is regarded as insolvent once it cannot pay its creditors anymore due to a lack of or insufficient financial resources. At that point, the company has become ‘unable to pay its debts as they become due’62. The second test is the “balance sheet”-test63. Under this test, the company is determined to be insolvent once its liabilities outweigh its assets64. Under this test, it should be borne in mind that “liability” is a broader term65 than “debt” whereby “liability” is being defined for the purposes of a winding-up or an administration as “a liability to pay money or money’s worth, including any liability under an enactment, a liability for breach of trust, any liability in contract, tort or bailment, and any liability arising out of an obligation to make restitution.”66

As these insolvency tests are alternative (instead of cumulative) tests, a company may thus be "cash flow"-insolvent despite having a great deal of assets67 or be balance sheet insolvent despite being able to pay its debts as they fall due68. The first example would be the case if a company would have sufficient assets although suffering from an insufficient amount of cash leading to an inability to pay debts which are due. The second case would appear in the opposite scenario when a company would currently have sufficient cash flow to pay debts which are due despite having more liabilities (e.g. deferred payments, prospective liabilities etc.) than assets. However, in practice one can see a close link or interconnectedness between both the cash flow and balance sheet insolvencies. This is because a company being able to pay its creditors, and thus operating on a going-concern basis, can also be expected to satisfy the balance-sheet test as assets are usually worth more as long as a company can continue with its business. Instead, when companies enter into financial difficulties, they often become subject to threats of secured creditors being able to sell company’s assets using their security interest. This is the

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62 Insolvency Act 1986, section 123.
64 Insolvency Act 1986, section 123(2).
65 Ibid (n 58) 20.
67 Ibid (n 58) 16.
reason why companies feel often financially obliged to sell (some of) their assets at a lower/discounted price in order to quickly increase their cash flow at “fire sales”. The discounted prices at which the assets are sold can be explained as a means to attract investors more easily as they could be expected to wait until they could buy these assets at a liquidation price if the company would not sell them at a discounted value. However, selling company’s assets may have a negative impact on the going-concern value of the company. The rationale behind this is that the aggregate value of all assets enabling the company to continue with its business is worth more than the (piecemeal) value of all the same assets being dismantled\textsuperscript{69} (or sold separately without the business) which would be the case if a secured creditor would sell an asset encumbered by a security interest or if a company would sell its assets at fire sales prices for instance. In the latter event, the value added by the “business” will have evaporated which will lead to a “break-up”- or “liquidation”-valuation of the remaining assets which can thus be expected to be lower as the combination of these assets does not allow the company to continue its business. Obviously, this situation only happens if at least one creditor has not been paid and has already started with (or planning) an attack on the assets of the company which clearly indicates that the company was likely to be “cash flow” insolvent. In addition to this, the fear or suspicion that a company may need to engage in fire sales to increase its cash flow or to avoid a dissipation of its assets may destroy the going-concern value of the company as creditors, acting in their economic interests and provided they are aware of the looming fire sales, will try to get their claims repaid as soon as possible, and before others.

\textbf{2.2. Difficulties with these tests}

Although these insolvency tests seem to be quite straightforward and easily applicable at first sight, in practice it may not always be very clear as to when the conditions to fulfil the insolvency tests have been satisfactorily met.

First, in relation to the cash flow insolvency, it is not always easy to determine the moment at which the company ceases to be able to repay its creditors. Although courts will study the whole financial position of a company (considering the current revenue of the company along with any income the company may receive from realising or borrowing against its assets within a relatively short period of time)\textsuperscript{70}, some recent cases clearly illustrate the difficulty to establish whether a company ought to be considered as “cash flow insolvent”.


In this regard, both the High Court and the Court of Appeal upheld in *Bucci v Carman*\textsuperscript{71} that the company could not simply be regarded as “cash flow-solvent” just because it could repay its creditors as it had to rely on further deposits received from other creditors which would increase its prospective liabilities and which should be taken into consideration.\textsuperscript{72}

Unfortunately, the courts neither decided whether this meant that under these circumstances in *Bucci v Carman* the company had to be regarded as “cash flow insolvent” nor did they give further guidance regarding the indicia when a company must be seen as “cash flow insolvent”. Although regrettable, it is also questionable to what extent a clear legal definition would be able to catch all occasions when “cash flow insolvency” might occur as the question from what moment the company cannot repay its debts anymore remains principally very factual anyway. Surely, this can be illustrated by the great variety of different ways to establish that a company has become cash flow insolvent. For example, the delay in discharge of obligations, the large number of unpaid debts which have become due or an increased pressure of creditors may all be indicators that a company has become cash flow insolvent. However, as already indicated above, the fact that a company continues to be able to repay its creditors does not necessarily mean that a company ought to be treated as cash flow solvent as courts will also need to study ‘if’, ‘why’ and ‘how’ the company continues to remain able to repay its current and future creditors. Surely, the outcome whether a company is cash flow insolvent or not will always depend on all the particular features of the company whose solvency is being questioned.

Secondly, the balance sheet test may create some unwanted difficulties if a company ought to be deemed balance sheet insolvent every time the assets of the company are outweighed by its liabilities.\textsuperscript{73} In this regard, in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc*\textsuperscript{74}, a case which came before the UK Supreme Court, Lord Walker (with whom all other Lords agreed) stated that, whilst examining whether a company is insolvent, a court should “on the balance of probabilities”, consider whether, “[...] a company had insufficient assets to be able to meet all its liabilities, including prospective and contingent liabilities.”\textsuperscript{75} The usage of this test had already been contended in *re Cheyne Finance plc (No 2)* where Briggs J\textsuperscript{76} stated that “the effect of the alterations to the insolvency test made in 1985 and now found in section 123 of the 1986 Act was to replace in the commercial solvency test now in section 123(1)(e), one futurity

\textsuperscript{71} *Bucci v Carman* [2014] EWCA Civ 383.
\textsuperscript{72} Ibid.
\textsuperscript{74} *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2013] UKSC 28.
\textsuperscript{75} Ibid at [48].
\textsuperscript{76} *In re Cheyne Finance plc (No 2)* [2008] Bus LR 1562 at [56].
requirement, namely to include contingent and prospective liabilities, with another more flexible and fact sensitive requirement encapsulated in the new phrase ‘as they fall due.’

One of the problems with this test, however, is that contingent and prospective liabilities should be taken into account whereas only current but no future assets may be taken into consideration which – from a rigid viewpoint – may create the risk of making the company ‘balance sheet insolvent’ every time it buys new assets for the company before having received these newly bought assets or every time it makes a great investment before having received any returns on it. Surely, the risk of ending up in an insolvency procedure every time a snapshot of a company’s balance sheet shows that the company’s liabilities exceed its assets would prove to be unworkable. Fortunately, as with the cash flow-test the courts also take a more commercial approach vis-à-vis the balance sheet-test granting them some more discretion. As has already been stated above, rather than determining that a company is insolvent, after the decision in BNY Corporate Trustee Services Ltd, the courts will, on a discretionary basis, determine, that a company should be considered balance sheet insolvent if the aggregate amount of its prospective and contingent liabilities exceed the company’s aggregate amount of assets. This net-liability will, however, not be conclusive evidence of a company’s balance-sheet insolvency. In the aftermath of the Eurosail-case, recent cases have shown that courts will consider the facts of each case and consider each company from a commercial viewpoint. Consequently, “taking into account” contingent and prospective liabilities does not mean simply adding up the value of each liability in order to assess whether the liabilities outweigh the total amount of assets. Instead, it should merely be seen as a consideration of the court to determine whether, in practical terms, the liabilities are so high that the company would no longer be able to meet these liabilities if it would continue doing business.

Furthermore, and in light of the aforementioned difficulties (or vagueness) in assessing whether the court is balance-sheet insolvent, it has been contended that the court in Eurosail failed to make it clearer to creditors how they should determine whether their debtor is balance-sheet insolvent and, more in particular, how they should quantify whether conditions of balance-sheet insolvency have been met.

77 BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc [2013] UKSC 28 at [48].
Having considered both insolvency tests, one can conclude that, despite remaining issues, both with the cash flow and the balance sheet test, courts seem to have adopted a more discretionary and commercial approach whereby the interests of creditors are aimed to be reconciled with the interests of the company allowing the latter one to continue functioning unless it has reached the stage of clear insolvency.\(^\text{82}\)

### III. Goals and fundamental insolvency principles

#### 3.1. Goals

Having examined what the meaning of “insolvency” entails, this research can now turn to studying what the goals and theories are which underpin insolvency law prior to examining how these goals are to be achieved.

Although the goals of insolvency law can somewhat be distilled from case-law, these purposes are very diverse and have never been fully or systematically stipulated which is quite logical as the law continuously evolves due to *inter alia* societal changes and new legal, financial, social developments but perhaps also ethical insights which have an impact on the destination of the journey insolvency law undertakes.\(^\text{83}\) Furthermore, the goals are also intertwined with the insolvency theory underpinning the regulatory insolvency framework and they will differ and be somewhat dependent on what theory will be supported whereby this theory itself also becomes subject to changing corporate and commercial cultures. Bearing this in mind, it is neither the aim nor intention to provide a fully comprehensive structure of all the goals of insolvency law. The intention of this research is rather to provide a general background regarding the goals important for the (research) needs in approaching the research questions as being set out in the previous chapter.\(^\text{84}\) In this regard, the highly influential work undertaken by Sir Kenneth Cork in 1982 resulted in some very useful insolvency objectives related to the needs of this research such as the prevention of conflicts between creditors, the fair distribution of the assets of the insolvent estate, the integrity of the insolvency procedure and the protection of arguably more vulnerable parties that are part of the insolvency procedure.\(^\text{85}\)

In general, the objectives of insolvency law can be summarised to aim to devise an efficient, fair and commercially pragmatic regulatory framework whereby the interests of all parties

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\(^{84}\) Cf. Chapter 1.

concerned are properly taken into account during the insolvency procedure and whereby actors (such as directors) who breach the law can be held to account.

Although these primary goals ought to be broadly the same in each insolvency procedure, the Cork Report made a clear distinction between two different ‘types’ of insolvency procedures, namely corporate rescue procedures on the one hand and liquidation/winding-up procedures on the other hand illustrating that despite shared primary goals (such as fairness and equality) the ‘destination of the (insolvency) journey’ may be completely different for both the company and all people whom the company has dealt with and who are affected by the financial difficulties suffered by the company (such as creditors and employees for example). Nonetheless, despite the laudable attempt to set out, in general, what the objectives of an insolvency framework ought to be, such objectives are always contestable for every insolvency procedure (i.e. restructuring/rescue or liquidation) is different and relates to different stakeholders, directors, creditors. As a result, every insolvency procedure is, thus arguably, very fact-sensitive. In other words, what may work for one indebted debtor-company may not work for another and as will be discussed in chapters 2, 6 and 7 the underlying insolvency theories (cf. chapter 2) and values (cf. chapter 6 and 7) are subject to a considerable amount of debate too.

Nonetheless, generally, corporate rescue procedures aim to put a financially distressed company back on track by preserving either the separate legal entity of the company (company rescue) or only the core business of the financially distressed company with the old company terminating (business rescue). On the other hand, liquidation, will start preparing the company for its dissolution which will lead to the termination of the company’s life. Liquidation will involve an office-holder trying to collect and realise the assets of the company in order to discharge the company’s debts and liabilities after which any remaining surplus will be distributed amongst the shareholders of the company. Although not recognised as a rescue procedure, a liquidation procedure may have the effect of preserving a company’s business if during the winding-up the entire business gets sold in which case a liquidation may in fact have exactly the same outcome as the ‘business rescue’ described above. However, this occurs rarely.

Despite the principal differences in outcome between insolvency procedures and particularly between corporate rescue and liquidation procedures, a common feature shared by all liquidation procedures is the collectivisation to which principally all parties involved in the insolvency procedure become subject (cf. part 3.2). This is, however, different in corporate

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88 Ibid (n. 78).
rescue procedures (such as part 26A Restructuring Plans, CVAs/IVAs, schemes of arrangements etc.) whereby it might be necessary to refrain from a ‘collective’ approach for differentiating creditors may be the only to ensure that business continuity can be achieved.\textsuperscript{89}

3.2. Collectivisation

3.2.1. Fundamental principles

Collectivisation emphasises the fact that once a debtor enters into a liquidation procedure, the law aims to avoid a “race to collect” by all creditors which would inevitably lead to a “first come, first served-approach” whereby the first creditor will receive the most with the last ones probably receiving nothing at all.\textsuperscript{90} Therefore, Jackson underlined that insolvency law is designed to mandate a co-operative solution for a common pool problem whereby the law should prohibit creditors from trying to recover the most as early as possible at the expense of creditors who might be late in collecting their claim and would - as a consequence - risk losing out.

This economic rationale resulted in some core insolvency principles such as the \textit{pari passu} and anti-deprivation rule which are both related to each other.

\textit{Pari passu} means that the (proceeds of the) assets of the insolvent company ought to be distributed equally and rateably amongst all unsecureds so that all the unsecured claimants benefit to the same extent from these company’s assets whilst in the meantime sharing to the same extent in the losses of the company. This equal and rateable distribution of assets among creditors without a security interest in the company’s assets aims to avoid the aforementioned common pool problem which would arise in the absence of this \textit{pari passu}-rule. In such a (common pool) scenario, unsecured creditors would all want to enforce their rights as quickly as possible in order to obtain either all or as many dividends as possible. Subsequently, the creditor who is able to enforce his rights first would end up in a much better position that the creditors coming after him. As stated above, this would lead to a Darwinian race to collect the dividends, although this would be at the expense of the other creditors. A \textit{pari passu}-rule avoids such a Darwinian race and requires that all the liabilities of the insolvent estate will be rateably and equally (i.e. in accordance with the debts owed to the unsecured creditors) discharged from all the assets the office-holder could collect after the company has become insolvent\textsuperscript{91}. For example, if an insolvent company has got £300 assets and only two unsecured creditors who both lent £200 to the insolvent debtor, they will both get £150 or 50\% of the total amount of assets upon a distribution by the office-holder. However, if one unsecured creditor would have

\textsuperscript{89} \textit{Discovery (Northampton) Ltd v Debenhams Retail Ltd} [2019] EWHC 2441 (Ch); G. McCormack, A. Keay and S. Brown, \textit{European Insolvency Law} (Edward Elgar 2017) 246-247.


lent £300 whilst the other would only have lent £100, the first unsecured creditor would receive £225 or 75% of the full amount of assets whilst the second unsecured creditor would only get £75 or 25% of the assets available in the insolvent estate. But both would get 75% of what they are owed. The rationale behind this rule is to offer an orderly and fair distribution amongst the unsecured creditors whereby every unsecured creditor receives a dividend pro rata in accordance with the size of their claim.\footnote{Ibid 92.}

The general aim behind this is to ensure that the distribution of company’s assets happens fairly and orderly. To be able to have such a proper distribution, and more in particular to ensure that all the creditors get the right amount of dividends, the law prohibits the company from being deprived of assets that should have formed part of the insolvent estate for the benefit of all creditors of the insolvent estate. This is what is called the ‘anti-deprivation rule’. Without the anti-deprivation rule, agreements could be made that assets of companies would be distributed at the time when insolvency procedures are triggered allowing to privately benefit some creditors at the expense of other creditors which would make the ‘pari passu’-principle rather worthless and would undermine the co-operative aim of insolvency law as described above. Although the anti-deprivation rule will be important for the analysis about the size of the insolvency estate that is to be distributed to creditors, the research will be more concerned with the \textit{pari passu}-principle, which determines who gets what.

\subsection*{3.2.2. Real and false exceptions}

However, despite these fundamental principles and despite the fact that the pari passu principle is still seen as one of the cornerstones of insolvency law\footnote{Re Nortel GmbH [2011] EWCA Civ 1124.}, throughout the years so many exceptions have been built into the law allowing several types of creditors to jump the queue ahead of other creditors, thereby drastically weakening these cardinal principles to the point of being mere default rules\footnote{A.R. Keay and P. Walton, \textit{Insolvency Law Corporate and Personal} (Jordan Publishing Limited 2012) 25.}. As a result of this wide variety of exceptions, several authors have already criticised the “equality-principle” which is claimed to underpin insolvency procedures in accordance with the \textit{pari passu} rule. In this regard, Mokal indicated that the “differing priorities of claims seem to represent the rule”, instead of the \textit{pari passu} principle.\footnote{R.J. Mokal, \textit{Corporate Insolvency Law: Theory and Application} (1st edition Oxford University Press 2005) 162-171.} Furthermore, also Keay and Walton indicated that \textit{pari passu} can be seen as no more than a mere “default rule”.\footnote{A. Keay and P. Walton, “The Preferential Debts’ Regime in Liquidation Law: In the Public Interest?” [1999] Company, Financial and Insolvency Law Review 84, 94.}
Turning back to the exceptions, one can divide all of them into two groups, on the one hand the “real” and on the other hand the “false” exceptions. First, the real insolvency exceptions encapsulate all the situations in which insolvency law has granted (some) creditors a right to get paid before other creditors increasing the chances that these creditors receive either their full claim or at least a higher percentage of their claim compared to the other remaining creditors ("post insolvency entitlements"). These exceptions in fact disregard the rateable and equal distribution that the pari passu principle (as an exemplification of the collective approach) mandates. Without going into too much detail about all the different creditors’ rights and relationships, the following situations should illustrate some common and widespread examples of these real insolvency exceptions:

For instance, the liquidation expenses (such as payments for employees who continue working for the insolvent company during the insolvency procedure) benefit from a privileged position. The rationale behind this can be found in the incentive this position creates for people are more likely to continue working if the chances of getting repaid are higher. The same rationale counts mutatis mutandis for accountants or lawyers who may get instructed to act for the insolvent estate in order to undertake certain actions during the winding-up process.

However, in some occasions the law not only grants a preferential position to certain post-insolvency claims but also to certain pre-insolvency debts. This is inter alia the case for an insolvency set-off granting the opportunity for a claimant and a debtor-company to discharge mutual claims they have got against each other between them. This allows the claimant to discharge its own debt payable to the financially distressed company with the claim owed by the debtor-company to the claimant. Thanks to such set-off, the claimant is legally avoided from becoming under an obligation to pay its debt owed to the debtor-company without any prospect of getting his claim owed by the debtor-company fully repaid. In fact, without a set-off a debtor would risk coming under an obligation to pay his debt owed to the insolvent company whereas the debt owed by the insolvent company to the same debtor may not be paid at all if the (proceeds of the) assets of the insolvent estate are insufficient to pay off the unsecured creditors.

Another real insolvency exception (as already mentioned above) for a pre-insolvency debt is the preferential position granted to certain unsecured creditors for their pre-insolvency claims,

99 Insolvency Rules 2016, rule 14.24 (administration) and rule 14.25 (liquidations).
such as for employees. Although their claims for work pursued once an insolvency procedure has been instigated will be preferentially treated as “expenses of the insolvent estate”, their claims for work undertaken prior to the commencement of an insolvency procedure will also receive a preferential status allowing to get certain dividends ahead of other unsecured creditors\(^\text{101}\). Since 1 December 2020, after being entirely abolished by the Enterprise Act 2002, the Crown also regained a preferential status in the UK for the collection of “VAT, PAYE (including student loan repayment), National Insurance contributions and Construction Industry Scheme deductions”\(^\text{102}\). In addition, there is also a separate statutory scheme entitling the employee to be paid by the Secretary of State out of the National Insurance Fund when his/her employer is not able (or willing) to pay the wages to the employee\(^\text{103}\). In such occasion, the Secretary of State will be subrogated into the employees’ preferential rights provided that the payments which have been made to the employee (in respect of the liabilities of the employer vis-à-vis the employee) are preferential pursuant to the Insolvency Act 1986\(^\text{104}\).

Secondly, next to the aforementioned “real” exceptions, there are also some “false” exceptions. These exceptions refer to the group of creditors with a security interest (such as e.g., a charge, mortgage or a lien) and are, therefore, known as “false” because the assets which are encumbered by such a security interest are claimed to have already (legally) left the insolvent company rendering it impossible to consider them as being part the distributable insolvent estate\(^\text{105}\). In fact, these security interests grant the secured creditor a proprietary (rather than a contractual) right in the assets of the (insolvent) debtor\(^\text{106}\). Although the debtor retains the legal ownership, the creditors receive an equitable interest allowing them to sell the debtor’s assets upon default. By doing so, they are able to trump the general pari passu distribution amongst unsecured creditors\(^\text{107}\).

In addition to this, next to the security interests, also the quasi-securities fall within this category of “false exceptions”. These quasi-securities (such as a retention of title clauses) only allow the transfer of legal ownership to the buyer-debtor once the debt has been fully paid to the creditor.

\(^{101}\) Insolvency Proceedings (Monetary Limits) Order 1986 (SI 198/1996), article 4.
\(^{104}\) Ibid.
\(^{106}\) Nonetheless, there is one exception for the chattel mortgage which has got a legal – not an equitable interest. This type of security interest, is however, rarely used.
Again, these exceptions look as if they were “real” exceptions but in reality, they are not. These goods will also be presumed not to have been part of the insolvent estate due to the fact that these quasi-securities also grant a proprietary right to the quasi-secured creditors upon default of the debtor. However, on insolvency a retention of title creditor is usually permitted to repossess the goods sold or the proceeds thereof.

Leaving the justifications for these exceptions to the pari passu-rule – flawed or not – aside for now, this differential treatment either between unsecureds themselves or between quasi-secured/secured and unsecureds already illustrates the lack of uniformity between creditors. However, understanding the vulnerability of unsecureds can only be achieved through consideration of some of the main insolvency theories which underpin insolvency law.

IV. Insolvency theories
In this regard, a great variety of theories underpinning insolvency law have been articulated, particularly by US scholars. Although these theories are important to understand the current insolvency regime and to improve the regulatory framework (which is the reason why this research will come back to the insolvency models later in chapters 6 and 7), it would be beyond the scope of this chapter to examine all the details and differences of all approaches in too much detail. Therefore, the focus will only be on the main theories and in what way they address the question which creditors are involved and whose interests ought to be protected or not.

In this regard, a broad distinction can be made between more economic, market-based theories that focus on maximising creditors’ (financial) interests and the more social theories that aim to also protect the interests of other stakeholders without primarily confining themselves to enhancing creditors’ gains.

At the forefront of such economic theories is the creditors’ wealth maximisation or bargain theory. This theory has its roots in contractarianism which has been very influential in Corporate Law. Contractarian scholars take a market-based approach and many see the company as a nexus of contracts in which all contract parties strive to maximise their own benefit.

In the creditors’ bargain theory, advocated by Jackson and, later, by Baird, insolvency law is expected to reflect the bargain creditors should have made with the insolvent company prior to

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108 Cf. chapter 3.
110 Ibid, 27.
the advent of insolvency if they would have had the chance to bargain with the insolvent company. The outcome of this hypothetical bargain, Jackson argues, would have been the outcome all unsecureds would have preferred if these unsecured creditors would have faced a common debtor unable to fully pay them both. Jackson illustrates this with an example. If for example two unsecureds share a common debtor which owes both unsecureds £10,000 separately whilst only having assets worth £15,000, it is expected, according to Jackson, that both would agree to share the £15,000 equally between them. The rationale behind this is the risk-aversion of unsecureds. If they would not agree to share the assets fifty-fifty, they have only got a 50% chance to receive the (full) £10.000 which would incentivise creditors to try to grab their money as quickly as possible. In this uncertainty, this might lead to creditors trying to grab the debtor’s assets once the debtor enters into financial difficulties which could leave other creditors behind with little more than what has been left by the first creditor (if there would remain something...). Moreover, an attack on the company’s assets could destroy the added value of the business exploited by the company. For example, if one secured creditor would sell one of the company’s assets, the company might be forced to stop its business as it would lack the appropriate assets to keep the business going. Absent a business, there would be no business value (known as the going-concern value) anymore of the company. What will be left behind, is nothing more than a conglomeration of the remainder of assets which the company cannot use for trade/business-purposes.\textsuperscript{112} At that point the value of the company will be reduced from the going-concern value to the liquidation value.

Consequently, given the need to avoid these “grab-practices” by unsecureds, Jackson argues that these creditors would agree to act (and thus bargain) collectively by sharing the remaining amount of assets rateably and equally once the company ought to be liquidated. As insolvency regimes ought to reflect this “hypothetical bargain”, insolvency law, he argues, can never get involved in distributional objectives. Based on this theory, insolvency law is thus seen as the law as a debt collection mechanism whereby an insolvent company is regarded as a common pool of assets which ought to be distributed with the only aim of maximising the returns to creditors based on their pre-insolvency entitlements.\textsuperscript{113}

Following the aforementioned conclusion, it is submitted that there should, in principle, be no exceptions to the \textit{pari passu} distribution.

However, Jackson does argue that some creditors may have received some different rights prior to the advent of insolvency.\textsuperscript{114} Contrary to unsecureds who would have agreed to share

\begin{footnotes}
\item[112] T.H. Jackson \textit{The Logic and the Limits of Bankruptcy Law} (Beardbooks Washington D.C. 2001) 14
\item[113] Ibid 20-26.
\item[114] Ibid 153.
\end{footnotes}
the proceeds rateably and equally amongst them, some creditors will have voluntarily agreed to have the residual claims (i.e., shareholders) whereas others will have a legal entitlement to come first (i.e., secured creditors). As the primary goal of insolvency law is only to organise an orderly debt collection, Jackson argues that insolvency law should respect these pre-insolvency entitlements without any interference. This is justified, according to him, as imposing new distributional rules upon insolvency would incentivise some creditors (or “holders of rights in assets”) to trigger an insolvency procedure which might be at the expense of the other creditors. For example, this would be the case if upon insolvency one party (such as a lender or a bank) would be contractually allowed to withdraw from his/her contractual obligations (to grant credit to the company). Such a situation could reduce the going concern value of the company’s business (as the company’s business may be in need for these funds) although this creditor who would have triggered the insolvency process would a priori know that he would receive his full claim thanks to a prioritised (or preferential) insolvency treatment. In a scenario where other creditors are being granted a preferential position at the expense of other secured creditors (cf. infra chapter 3), they would be incentivised to start an insolvency procedure as quickly as possible in order to avoid his security interest no longer enabling him to get his full credit/loan repaid whilst in the meanwhile refusing to grant any further credits to the company.

Nonetheless, the creditors’ bargain theory has already become subject to various criticisms.

First, this theory has been described as “bankruptcy darwinism” as only the most intelligent, wealthiest and experienced creditors would be able to benefit from this approach arguably leaving the other more vulnerable creditors behind. For example, Finch points out that in a business context there may be several other classes of unsecureds which are all different such as employees, managers, consumers, involuntary creditors and who may, therefore, be in need for better (insolvency) protection illustrating that one cannot only take regard of voluntary creditors and that creditors are all different.

Secondly, Jackson’s theory presupposes a perfect (i.e. totally efficient) market where transaction costs are reduced to a minimum increasing the value of the insolvent estate. This, however, is utopian as in practice even several so-called voluntary creditors (such as

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115 Ibid 153-155; For a general overview of the ranking of claims during a winding-up procedure see: Re Nortel GmBH [2014] AC 209 at [39].
116 Ibid (n. 101) 32-33.
landlords\(^{119}\) might, for a variety of reasons\(^{120}\), end up in a vulnerable (non-controlling) position and several non-creditors’ interests may also need to be addressed during the insolvency procedures.\(^{121}\)

Thirdly, as this theory only appears to equate insolvency law with a debt collection regime, it also seems to ignore any attempt to restructure or rescue failing companies.\(^{122}\) In this regard, it should be emphasised that creditors, and in particular unsecureds, are expected to recover more through such a rescue procedure.\(^{123}\)

Finally, and related to the aforementioned criticism, Jackson’s theory also ignores the existence (and importance of the) governance-part of insolvency law, although improving insolvency governance (e.g., by enhancing accountability of the directors/office-holders) could positively impact the final distribution to creditors.

Nonetheless, the critics of the creditors’ bargain theory mainly focused on the ostensible lack of concern for the interests of other stakeholders. As a consequence, other theories started to nuance the rather market-based approach of the creditors’ bargain theory by putting forward theories that focus more on other stakeholders.

Although not eschewing considerations of economic arguments, the most social theory in this regard is, arguably, the communitarian theory.\(^{124}\) This approach is fiercely represented by Karen Gross.\(^{125}\) Contrary to proponents of the creditors’ bargain theory, communitarians claim that not only creditors’ interests should be considered but also a wide variety of non-creditors such as the interests of employees, consumers, suppliers, the environment, the government. When a company is on the brink of insolvency, they argue that one should also think about these wider community interests as, according to them, individuals are all highly interconnected and

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\(^{120}\) This research will elaborate on this in chapter 3.

\(^{121}\) V. Finch, Corporate Insolvency Law (Cambridge University Press 2009) 35.


\(^{123}\) M. Brouwer, Governance and Innovation (Routledge Taylor & Francis Group 2008) 92.


therefore interdependent rather than mere private, rational decision-makers independent from each other, the view of contractarians.

Contrary to Jackson, insolvency law should thus not only be concerned with debt collection, but it should also care about the prospects of survival of businesses and companies. In contrast to the creditors' bargain theory, communitarian scholars neither put their emphasis on the private rights creditors have got against the debtor nor on the wealth maximisation interests. Rather than seeing redistribution as a failure or an inefficient outcome (such as Jackson, in principle, does), communitarians argue that redistributing wealth is an important factor in order to be able to protect the rights of certain creditors and others if a distribution appears to be necessary. If distribution can be avoided by keeping the business or company alive, one should give preference to the latter option.

Critics of this communitarian approach, however, argue that taking so many different views into consideration would be inefficient, increase economic costs and would therefore reduce the value of the insolvent estate. For instance, this might be a possible outcome if the management of the financially distressed company ought to take a balanced approach between all these different community interests at a crucial moment when it might already be very difficult to satisfy the interests of competing creditors. In fact, if managers lose crucial time in weighing all the different community interests against each other, this could incentivise impatient creditors to execute their security interests which would drastically reduce the value of the insolvent estate and which, as contractarians would argue, could have been avoided if only creditors' interests would have been taken into account (something which may prove to be already difficult enough for the incumbent management of the insolvent company).

Furthermore, if so many community interests are to be considered, critics argue that it becomes easier for the company’s incumbent management to escape accountability as directors/managers may more easily find someone whose interests could be argued to be

128 This could be the case because, according to critics of the communitarian theory, it is very difficult to determine whose interests should have been regard to by the company’s directors which, so goes the argument, may lead to indeterminacy. Cf. V. Finch, “The Measures of Insolvency Law” [1997] 17 Oxford Journal of Legal Studies 227 at 237; B.S. Schermer, “Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy—A Modern-Day Tale of Belling the Cat” [1994] 72 Washington University Law Review 1049 at 1050-1051.
129 T.H. Jackson, The Logic and the Limits of Bankruptcy Law (Beardbooks Washington D.C. 2001) 160-162 using an example whereby a supplier acts in a similar way akin to a secured creditor having the ability to destroy the going-concern value.

Finally, the communitarian theory also fails to determine how vulnerability of unsecureds ought to be ascertained.\footnote{V. Finch and D. Milman, *Corporate Insolvency Law* (Cambridge University Press 2017) 37; V. Finch, “The Measures of Insolvency Law” [1997] 17 Oxford Journal of Legal Studies 227 at 237; B.S. Schermer, “Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy—A Modern-Day Tale of Belling the Cat” [1994] 72 Washington University Law Review 1049 at 1050-1051.} Critically, for communitarian scholars, vulnerability is merely seen as a consequence of the type of (unsecured) debt (e.g., a consumer debt or an employment debt) without properly appreciating all the practical facts of the situation (e.g., voting power of entire group of consumers, directorial ability to act in the interests of different factions of stakeholders etc.). In this regard, this theory also leaves the question unanswered as to how an insolvency regime that is not only concerned with fairness but also efficiency and accountability can be designed.\footnote{E. Warren, “Bankruptcy Policy” [1987] University of Chicago Law Review 775.}

In response to the aforementioned rather ‘radical’ theories, a more centrist theory, finding itself more in between the aforementioned theories, arose which is the ‘multiples value-theory’. This theory is represented by Elizabeth Warren and was originally developed by Finch in earlier editions of her handbook titled *Corporate Insolvency Law: Perspectives and Principles*. It claims to find an appropriate answer to the various competing interests during an insolvency, thereby also defending the fact that interests other than the creditors’ interest should be taken into account\footnote{E. Warren, “Bankruptcy Policymaking in an Imperfect World” [1993] 92 Michigan Law Review 336.} which, as said above, is contrary to the creditors’ bargain theory. The multiples value-theory seeks to find a balance between efficiency and fairness whilst aiming to protect various stakeholders’ and the debtors’ interests.\footnote{A.R. Keay and P. Walton, *Insolvency Law Corporate and Personal* (Jordan Publishing Limited 2012) 31.}

However, in trying to do so, this theory tends to become rather vague. Although this multiples-value-approach states that it holds fairness, justice and efficiency at its heart\footnote{A.R. Keay and P. Walton, *Insolvency Law Corporate and Personal* (Jordan Publishing Limited 2012) 31.}, it does not clearly define which interests ought to be considered and when. Consequently, critics would doubt that this theory would be better than the communitarian theory as it may still be very hard
to strike a balance between all different interests which need to be taken regard of making it
(again and similar to communitarianism) very hard to offer proper managerial guidance.136

Due to its open-texted character, it is also unclear how these different interests all interact with
each other and, it may again become harder to hold directors to account in the absence of clear
principles. This might in the end be disadvantageous for weaker creditors just as the
communitarian theory is claimed to be by critics for similar reasons related to inefficiency
negatively affecting the value of the insolvent estate.

Finally, as with the communitarian theory, the multiples value theory fails to appropriately
determine vulnerability of unsecureds and merely continues to see vulnerability as a
consequence of the type of (unsecured) debt again without properly appreciating all the practical
facts of the situation.

V. Conclusion

To conclude, insolvency law tends to organise an orderly and fair process so that creditors might
get repaid whilst the insolvent company gets either rescued or liquidated if rescue is not possible
anymore. Whether a debtor is insolvent is determined through the two alternative (non-
cumulative) tests, namely the balance sheet and cash-flow test. The former test entails that a
debtor is insolvent if the liabilities outweigh the assets whilst the latter test determines that a
debtor must be unable to pay its debts when they become due to be held insolvent.

Once a company is held insolvent, two key principles – the anti-deprivation rule and the pari
passu principle – aim to ensure that the insolvency process happens in a fair and orderly
manner. Whilst the anti-deprivation principle intends to safeguard the debtor’s assets, the pari
passu principle maintains that these assets will be distributed amongst unsecureds in an equal
and rateable manner. Nonetheless, several exceptions already apply to this ‘equality’-principle
with certain creditors that are deemed ‘weaker’ (e.g. employees) having received a preferential
status.

In order to determine whether certain creditors (such as e.g. consumers) are in need for further
protection, various insolvency theories have been set out which, according to the relevant
scholars and academics, should or should not underpin the regulatory insolvency framework.
Contractarian theories can be defined as “creditor primacy models” whereas other more
stakeholder-focused and communitarian theories tend to shift the focus to a greater variety of
interested parties.

31.
As there is surely not only one theory underpinning English insolvency law, one can see aspects of several theories through our current rules. In this regard, the *pari passu* could be argued to be a clear proliferation of the creditors’ bargain theory of Jackson as it avoids an insolvency Darwinism where a certain survival of the fittest between the creditors could occur (although distinctions are made between a more Orthodox and multi-layered definition of it). The way it aims to guarantee this is by making sure that all creditors without a security interest (within their rank) are treated equally receiving a rateable share of the debt owed to them whilst creditors who do have a security interest are being protected so that they can execute their pre-insolvency entitlement whereby these fundamental principles are being upheld through the usage of the anti-deprivation rule preventing creditors from grabbing assets/proceeds just before an insolvency procedure has started as this would bring the *pari passu* principle into jeopardy.

However, as a pure and only use of Jackson’s theory would disregard the ability of the company to get rescued and the possibility of insolvency law actually protecting more vulnerable creditors whilst also ignoring other interests than creditors’ interests (such as the willingness of an employee to keep working for the insolvent firm or the small trade creditor/supplier to keep trading with or supplying to the company), the law has built in several additional protections whereby certain unsecureds do receive additional protection during insolvency procedures and where more and more emphasis is granted to corporate rescue procedures.

 Nonetheless, as will be shown in the next chapter, there are still many drawbacks with the current regulatory insolvency framework, more in particular, when it comes to ascertaining different classes of creditors which is the reason why the third chapter will critically investigate how vulnerability of unsecureds is currently being determined.
Chapter III

Different factions of unsecured creditors

I. Introduction
After having discussed the main insolvency principles and theories in chapter 2, this chapter will build on these foundations by elaborating on the vulnerability of unsecured creditors.

In doing so, some general characteristics which can influence the position of an unsecured prior to and during an insolvency procedure will be examined first. In spite of the general premise that all unsecureds are to be treated equally, this chapter will refer to a variety of case-examples. This will indicate that, in practice, various factions of unsecureds may have considerably different interests which might not only impact the outcome of the insolvency procedure but could also affect the dividends they can(not) be expected to receive. The latter issue ties into the question of how control is being exercised over the management of the debtor’s affairs and, if the debtor is subject to an insolvency procedure, how certain unsecureds can or cannot (try to) influence or impact the outcome of said procedure.

The latter issue is the question of ‘control’ and, more in particular, ‘private benefits of control’ certain (strong) unsecureds could extract from weaker unsecureds, and this will be discussed later in chapter 5. Before being able to elaborate on this, this chapter will, however, first set out how classes of creditors are currently being determined based on the current regulatory and judicial principles in place.

II. Vulnerability of unsecureds
As referred to above, before examining the rights of the unsecureds, and particularly vulnerable classes amongst them, it is deemed important to explain first who these vulnerable groups of unsecureds are or could be. In this regard, this research will examine several possible ways of determining how and why a specific faction of unsecureds may have to be regarded as more vulnerable. However, before doing so, this chapter will first illustrate the existence of different classes of unsecureds through some case-examples.

2.1. Practical illustrations of subclasses within group of unsecureds
These cases aim to illustrate situations where one can see a clear difference between factions of unsecureds and, more in particular, the implications this may have on unsecureds. They are, in fact, an illustration of the existence of several groups of unsecureds within the general group of unsecureds.
Firstly, in *Mourant & Co Trustees Ltd v Sixty UK Ltd (in admin.)*\(^{137}\) the court revoked the approval of a company voluntary arrangement (CVA) by the creditors’ meeting due to the fact that the landlords, one subclass of the unsecureds, were, successfully, argued to have been treated in an unfairly prejudicial way as the CVA of the debtor-company (which had leased two properties from the landlord) stated that the debtor’s parent company would get released from its liability (stipulated in the guarantee that it had given for the debt owed under the leases) to repay all the debts to the landlords if the debtor-company would not be able to do so.\(^{138}\) This had created a distinction between all the other unsecureds and the landlords. The reason for this is that all unsecureds under the CVA would get paid in full whereas the landlords would lose their recourse to claim against the parent company although their leases had still more than seven years to run. This CVA left the landlords at risk of not getting paid in full (compared to all the other unsecureds who would be paid in full in accordance with the CVA).\(^{139}\)

Although below in part 2.2 this research will determine how a class of creditors can be determined, this example already shows that despite being legally together in one seemingly undivided group of unsecureds, different (economic) interests strengthened by the creditor’s voting power might lead to clashes within the group of unsecureds itself. Furthermore, such clashes might develop during the insolvency procedure (which was the case in *Mourant & Co*) but might also just come on the surface despite the fact that they have already been there before the insolvency procedure started.\(^{140}\)

When such conflicts arise, it becomes evident that not all unsecureds are equal. For example, a big unsecured creditor with a lot of prior knowledge, information and strategic power are the tax authorities (HMRC). HMRC, acting in their own (or the public’s) interests, has already been accused of trying to neglect the interests of other unsecureds during an insolvency procedure. In *HMRC v Portsmouth City Football Club Limited*\(^{141}\), the HMRC sought to block the CVA of the Portsmouth football club although the CVA would be more profitable for the unsecureds, including, the HMRC in the short-term.\(^{142}\) However, the HMRC appears to stick to a policy of


\(^{138}\) Ibid.

\(^{139}\) Ibid (n. 119).


\(^{141}\) *HMRC v Portsmouth City Football Club Limited* [2010] EWHC 2013 (Ch).

challenging what is known as the “football creditors rule” in a bid to overturn it given the fact that it often loses out in similar procedures.

The ‘Football Creditors Rule’ entails that football creditors of clubs that are part of the Football or Premier League are entitled to be paid or have their debts secured in full. Logically, this often results in football creditors (such as e.g., footballers who have not been paid yet) to get paid in full at the expense of other unsecureds who receive nothing or only a little. One of such unsecureds is the HMRC.

Turning back to the case, blocking the CVA would not only have been more disadvantageous for the HMRC (in the short-run) but also for the footballers who might have lost their job. This illustrates the specific position of the HMRC with often larger claims, more information and experience than the majority of other (small) unsecureds and, hence, the HMRC’s ability to advance their specific strategic goals in their relations with debtors. Surely, one can hardly blame the HMRC to act in its own interests especially since they had lost lost their preferential position after the reforms enacted by the Enterprise Act 2002 and as their interests are arguably the ‘public’s’ interests. Nonetheless, the HMRC has now partially regained its preferential position, in particular as regards VAT and PAYE Tax taken from employees’ wages and unremitted to HMRC. Nonetheless, without elaborating too much on the preferential position of the HMRC (which will be discussed further in chapter 8), the aforementioned Portsmouth case clearly shows that the HMRC is, arguably, in a much stronger position than most other unsecureds.

Undoubtedly, this more powerful position of the HMRC contrasts with other unsecureds (such as e.g., consumers) who are not in a similar position to the government or, for example, a bank.

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144 HMRC v Portsmouth City Football Club Limited [2010] EWHC 2013 (Ch) at [42] and [43].
149 This is, inter alia, because they attend more creditors’ meetings, possess more information about the debtor, have more experience and legal/financial knowledge as well as more financial means to initiate and pursue legal proceedings.
This can be illustrated by the Farepak-case. Farepak was a Christmas Savings Club and approximately 100,000 consumers had saved money with Farepak for Christmas by placing orders with it either directly or through agents who were paid by these consumers. The average amount saved was £400 per person, but some had already saved more than £2,000. In total, Farepak owed £37 million to all these consumers but it collapsed just before Christmas in 2006. Its biggest asset was a £33 million debt which had to be repaid by Farepak’s parent company, European Home Retail, to Farepak and which could not repay the debt. The result was that a great number of customers who had saved money for Christmas ended up, just before Christmas, with almost nothing from what they had saved. The huge losses suffered by consumers caused by a lack of information and understanding and hence the inability to protect themselves better led to the Law Commission advising changes to improve consumer protection, particularly in relation to trust saving schemes and prepaid consumer debts while remaining cautious to avoid defending too radical (and arguably costly) new measures. However, also other unsecureds (that are not consumers but equally vulnerable) can lose out.

A very recent case in this regard, is the House of Fraser-case where the company started shutting down several of its stores in the UK and in Ireland. Although the CVA passed after getting support of more than 75% of the creditors, the landlords believed that there were irregularities and that, as a result, their interests were unfairly prejudiced. Although the landlords started challenging the CVA, they ultimately withdrew their challenge and agreed to settle. Nonetheless, the reason why they had started this challenge was because landlords would see their rents cut and believed that other solutions needed to be worked out in order to ensure that the interests of the landlords would have been better protected without House of Fraser (the debtor) losing out on the possibility of rescuing its company.

2.2. Determining “classes” of (vulnerable) unsecureds

Having shown the existence of different factions of unsecureds within the general group of unsecureds, the question arises how such factions (or ‘classes’) of unsecureds could be determined. Examining how the courts in England and Wales approach the determination of

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152 The Law Commission, Consumer Prepayments on Retailer Insolvency: summary (Law Com No 368 2016) 15.
classes of unsecureds is useful in order to be able to critically assess the determination of creditors’ vulnerability which will be extensively examined in chapter 5. When are creditors part of a smaller sub-class? And what are the benefits/drawbacks of this? As will be shown below, such a sub-class might be important to strengthen the position of certain factions of unsecureds who are in a considerably different position than their fellow unsecureds.

For the determination of a specific class the cases Re Hawk Insurance Co Ltd154, following Dodd155 have set out some criteria. However, different from administration/liquidation cases where all creditors are grouped together, these are scheme of arrangement cases where, pursuant to Part 26 of the Companies Act 2006, specific principles have been designed to differentiate amongst classes of unsecureds. This is because what class one is put into is really critical for schemes, but this has no real application to liquidations or administrations.156 Nonetheless, although schemes of arrangement are often used for different purposes than insolvency such as restructuring, one could argue that these principles may still provide useful guidance regarding class determination given their abstract description and the fact that schemes of arrangement can also be used for insolvency purposes.

These principles state that classes are determined first by the similarity or the dissimilarity of the legal rights they have got. However, they do not, in principle, distinguish between commercially different interests although (as stated below) the economic/commercial interests of the unsecureds may seriously differ. Nonetheless, differences in commercial interests are analysed by the court at the sanctioning of a scheme of arrangement.157 This is important because this is where the court, using its wide discretionary power to sanction a scheme or not158, can consider whether differences of interests between non-controlling and controlling unsecureds might mean that a sanction should be withheld. Secondly, although having different legal rights, the principles do not make any requirement to have separate classes provided that the creditors share a common interest making it possible for them to consult together.

Nonetheless, the determination of the class is quite important as a class which is too broad might give the controlling creditors the ability to oppress the non-controlling unsecureds.159

155 Sovereign Life Assurance Co v Dodd [1892] 2 QB 573, 583.
156 That is because all unsecureds form part of one general group of unsecureds during administrations and liquidations whilst the approval of at least 50%+1 of the number of creditors constituting 75% in value of each class of creditors is required for a scheme of arrangement to be sanctioned by the court. Cf. Companies Act 2006, s.899(1). Unlike the cross cramdown provisions in relation to a Part 26A Restructuring Plan pursuant to the Companies Act 2006, section 901G, schemes of arrangement do not have a similar cross cramdown provision. Cf. infra part 2.3.
159 Re Opes Prime Stockbroking Ltd [2009] FCA 813, 66.
However, fragmenting all the unsecureds into too many subclasses might also make it more difficult for an arrangement to succeed as every subclass of unsecureds would have the ability to veto the deal unless their interests are more/fully taken into account which thus increase the risk of a hold-up problem\(^{160}\) which could delay\(^{161}\), reduce the value of the restructuring or perhaps even scupper the whole intent of rescuing the company or its business.

However, the fact that the *Dodd and Hawk Insurance* cases set out that only legal rights (instead of commercial interests) are important in determining whether subclasses of unsecureds could be created, significantly limits the amount of subclasses one can form as differentiating business interests do not *ipsa facto* justify the creation of subclasses unless creditors’ legal rights would be too dissimilar from one another. This was for example the case in *First Pacific Advisors LLC v Boart Longyear* where the court stated that some unsecureds being also shareholders and directors of the company does not necessitate them to be put in a separate subclass.\(^{162}\) Also, the fact that some creditors participated in a lock-up agreement\(^{163}\) obliging them to vote in favour of the scheme did not require these creditors to be put in a separate subclass according to the High Court in *Primacom Holding GmbH v Credit Agricole*\(^{164}\). Repayments to different creditors which ought to be made in different currencies is also not a sufficient reason to split the whole group of unsecureds meaning that repayments can be done in one single currency to all of them following *Re Telewest Communications Plc.*\(^{165}\) All these cases have in common differing commercial interests but, according to the courts, legal rights which are not too dissimilar from each other.

As a result, courts in England and Wales tend to find commercial interests irrelevant to the class issue, using legal rights instead of commercial interests in determining whether subclasses have to be created. However, this might increase creditors’ apathy as the interests these creditors truly care about might seem to be neglected/ignored as long as their “legal rights” are not too dissimilar from the legal rights of the other unsecureds who might – legally – be in the same boat whilst – commercially – being in a different one. In this regard, showing that the commercial interests have been taken into account might facilitate the negotiations\(^{166}\) as the commercial interests some creditors could have, might be related to the profitability, potential financial difficulties, or perhaps even the survival of the creditors’ businesses or the financial solvency of

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161 Ibid, 89.
162 *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116.
163 A lock-up agreement is an agreement obliging underwriters that are party to the deal to refrain from selling their (share in the) equity for a certain amount of time.
164 *Primacom Holding GmbH v Credit Agricole* [2011] EWHC 3746 (Ch).
165 *Re Telewest Communications Plc* [2004] EWHC 924.
the individual. A situation where this could exist is if extending the final payment date means that the creditor becomes unable to repay his/her debts in which case the particular creditor might prefer an immediate liquidation of the company rather than waiting for his/her money. This becomes the more likely the higher the creditor is in the distribution chain.

The apparent irrelevance of commercial interests in determining classes of creditors can arguably also be discerned in an insolvency context. As shown in chapter 2 the main distinction between classes of creditors is the distinction between secured and unsecured creditors whereby the possession of a security interest will determine which group creditors will be allocated to. In spite of the many *inter alia* commercial differences between unsecureds (e.g. small trade creditors/consumers/suppliers) most of them will still be subject to the same insolvency principles (such as e.g., *pari passu*). Nonetheless, whether further differentiation could be advisable and how this ought to be determined will be assessed in the following chapters (cf. chapter 5-8).

### 2.3. Cram-down provisions

However, depending on the quora and some requirements to have consent by the majority of the creditors within all classes, the fragmentation through different classes risk creating the situation whereby one faction of creditors might engage in a hold out if they think it fits their interests. Given the fact that this could be harmful for all the other creditors as a successful corporate rescue could so be jeopardised by one class, cross cram-down rules\(^\text{167}\) have been created to ensure that dissenting classes of unsecureds can be overridden by the majority (or other consenting classes) of the creditors.

Cross cram-down rules differ from ordinary cram-down rules in the sense that cram-down rules only apply to one class where (a majority overrides the minority) whereas cross cram-down rules apply to all classes ensuring that a minority of objecting classes can be overridden by the majority of the consenting classes.\(^\text{168}\) In this regard, following the example of the US Chapter II reorganisation provisions\(^\text{169}\), the 2019 EU directive aiming to harmonise substantive insolvency


\(^{168}\) This, for example, applies to a Part 26A Restructuring Plan pursuant to the Companies Act 2006, s.901G as introduced by the Corporate Insolvency and Governance Act 2020. See also: *Re Virgin Active Holdings Ltd [2021] EWHC 1246 (Ch)* at [104]; *Re Deepocean 1 UK Ltd [2020] EWHC 3549 (Ch)*.

\(^{169}\) 11 USC §129(b).
law pertaining to restructuring across EEA countries\textsuperscript{170} also introduced some cross cram-down provisions.\textsuperscript{171} Although cross cram-down-rules have the benefit of getting reorganisation plans approved without dissenting classes of creditors being able to (unduly) veto it\textsuperscript{172}, it may also lead to an alleged oppression of minorities\textsuperscript{173} by giving one class the power to overrule other unsecureds.\textsuperscript{174} However, absent any cross cram-down rules and thus the ability to bind certain creditors who only have a minority of the voting rights\textsuperscript{175} one would always face the risk of a hold-up problem which is when one or some of these creditors holding a minority of the votes would be able to block a restructuring by trying to force all other creditors to accept their demands.

These cram-down rules are often implemented in the regulatory framework in order to facilitate decisions amongst creditors during a procedure which is intended to be fully (or largely) out of court. However, the EHYA already pointed out that there may be a need for more court supervision as they fear that insolvency procedures are becoming more and more complex due to changing capital structures alongside the disbursement of payments in relation to debts and the significant number of different parties involved all having their own economic reasons to agree or reject a deal.\textsuperscript{176} Two more contentious issues in this regard are (i) the question whether suppliers and consumers remain able to enforce their contracts which enables them to pull out of an agreement in the event of an insolvency of their debtor\textsuperscript{177} and (ii) whether the “out of money” parties, being the parties who have not got any economic interest in the outcome of the insolvency procedure anymore due to a lack of funds in the insolvency pool, will be given a vote on the deal being sought.\textsuperscript{178}


\textsuperscript{178} V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 347.
The *Re Bluebrook* case\(^{179}\) illustrates the latter situation very well. As part of a restructuring attempt, three schemes of arrangement had been concluded by the indebted companies (which formed part of a group of companies). Only the senior creditors of these group companies were able to participate, vote and agree on the terms and conditions of these schemes of arrangement, according to the court, because the value of the group of companies was claimed to be lower than the value of all the senior debts making it impossible to pay any other creditors which were in this case contractually subordinated to the senior lenders. Here the junior creditors were “out of the money”. Although the latter junior creditors disagreed and wanted to take part in the restructuring process, the court stated that their rights were not affected, and this was the reason why they could not and did not have to participate in this process. The value of the senior claims could not even be paid, let alone the claims of these junior creditors whose debts were subordinated to these senior creditors. This reasoning may give some classes of unsecureds an unpleasant feeling but the rationale behind this is that creditors need to have an economic interest in the process. It is not enough to only have a technical legal interest but no economic one\(^{180}\) whereby ‘technical’ has to be understood as basically only having theoretical rights given the fact that there is not enough money to repay their debts making it – according to these cases – pointless to give these creditors a say over the insolvency procedure if they do not have anything to gain from the outcome of the insolvency procedure.

A similar situation also occurred in the *MyTravel Group* case whereby, in a nutshell, a scheme of arrangement was ‘twinned’ with a pre-packaged administration transfer (or sale) of the business of the insolvent MyTravel holding company to a newly incorporated NewCo. The bondholders who ranked below unsecureds and shareholders\(^{181}\) disagreed with the scheme of arrangement because, in contrast to the other creditors, the debts owed to them would not be transferred to NewCo and, instead, they would only receive 2% of the shares (equity) in NewCo. However, the bondholders were neither consulted nor offered to take part in the scheme of arrangement because they were deemed to be ‘out of the money’ according to MyTravel. Although this construction left the dissenting bondholders stranded in a shell company (i.e. the MyTravel holding company which after the transfer had become empty / worthless)\(^{182}\), the court agreed (in an *obiter dicta*) with the argument set out by MyTravel to exclude the bondholders

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\(^{180}\) *Re Tea Corp Ltd* [1904] 1 Ch. 12.

\(^{181}\) Due to a subordination clause; *Re MyTravel Group* [2004] EWHC 2741 (Ch); M. Crystal QC and R.J. Mokal, ‘The Valuation of Distressed Companies: A Conceptual Framework – Part II’ [2006] 3(3) International Corporate Rescue 123.

from the scheme of arrangements.  

Although this might seem reasonable at first instance (looking at it from an efficiency perspective), this restructuring technique whereby schemes are combined with pre-packs could appear a handy technique to ‘get rid of’ dissenting voices amongst unsecureds if they are deemed ‘out of the money’ at the moment when the restructuring takes place which undoubtedly raises questions about fairness.

III. Conclusion

During the previous chapter some pivotal insolvency theories and principles had been analysed whereby it became clear that “the pari passu” principle was one of the cornerstones of modern insolvency law. According to this principle, as discussed above, all unsecureds are, in principle, to be treated rateably and equally.

Although the exceptions to this rule were elaborated on in chapter 2 by referring to the preferential position of some unsecureds, the analysis in this chapter aimed to provide further evidence that, although unsecureds are supposed to be part of one (to some extent) homogenous group, many differences continue to exist between several factions of unsecureds.

To some extent, some of these differences between unsecureds and, perhaps, the need for a more differentiated approach have been reflected in the current, regulatory framework. Therefore, this chapter critically continued with the determination of what ‘classes’ of unsecureds are. Although this legal term (i.e. ‘classes of creditors’) has its roots in the relatively recent ‘schemes of arrangements’, the parameters designed to distinguish unsecureds as part of a scheme of arrangements, are, nonetheless, useful to understanding how ‘classes’ or factions of unsecureds might well be approached when they are part of a different procedure (such as a corporate rescue or liquidation procedure).

Having shown how ‘classes’ are being determined and how this could have implications for creditors’ vulnerability, this chapter paves the way for the next chapter in which a more extensive and critical analysis of the current regulatory framework will take place primarily from the perspective of the more vulnerable (factions of) unsecureds.

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184 Fairness and efficiency as insolvency values will be critically examined in much greater detail in chapter 6 and 7.
Chapter IV

Contemporary Insolvency Rights and its drawbacks for unsecured creditors

I. Introduction

Once a company enters into insolvency, creditors can start claiming (the process is known as ‘proving’) to get their debts repaid. However, as has been shown in chapter 2, security interests, quasi-securities and statutory preferences might make it quite difficult for unsecureds to get repaid as they become the ones who bear the residual risk contrary to the aforementioned creditors who – due to their security interest or preferential position – come before them in the insolvency queue for repayment (cf. infra part II).

However, various mechanisms have been built into the law with the aim of protecting unsecureds better trying to ensure that they can recover as much as possible (cf. infra paragraph 3). In this regard, office-holders have got several insolvency procedures at their disposal which should ensure that the unsecureds are not deprived of their fair share of the debtor’s assets. One can divide these procedures into procedures empowering the office-holder with on the one hand the ability to claw-back assets which the asset pool has been deprived of and on the other hand liability procedures to hold the former directors or the managers of the company accountable for what they did. As these procedures, in principle, affect all unsecureds as one indivisible group, they also affect the weaker factions of unsecureds. It appears therefore necessary to draw attention to some of the current drawbacks with these procedures without going into too much detail.

Equally important, however, is the ex ante control which unsecureds may be able to exercise as regards the incumbent management or the office-holder and which could potentially avoid the need to litigate against former directors (or the office-holder) afterwards during an insolvency procedure. To the extent that monitoring the debtor may enhance the debtor’s financial position, it would undoubtedly benefit the entire group of unsecureds, part of which are the more vulnerable groups. As will be shown below (part IV), empirical research already undertaken in this area has shown that greater control by creditors could improve the dividends which are returned to creditors. This issue begs questions in relation to the performance of the office-holder such as his/her alignment with the interests of the debtor.

By critically examining these issues, this chapter will aim to clearly illustrate the current multifarious legal and practical problems the unsecureds (incl. vulnerable factions) continue to face. These difficulties which all unsecureds tend to face have an impact on the likelihood of getting (at least partially) repaid. After having shown the existence of several factions of unsecureds in chapter 3, this chapter along with the previous one will pave the way for a critical
determination of how vulnerability of unsecureds can be determined and which (potential) additional risks such a vulnerable faction could be exposed to which is what the next chapter will elaborate on.

II. Unsecureds’ rates of return

In spite of the existence of several weaker factions of unsecureds (which will be elaborated on more extensively in chapter 5), generally, unsecureds as a group are already in a rather unenviable position. Several figures indicate that after a debtor has entered into liquidation unsecureds are considerably losing out, especially if the majority of the company’s assets are subject to a security interest. For example, Brouwer states that unsecureds receive almost nothing in the UK during liquidations. Franks and Sussman’s empirical data are quite similar. They claim that the recovery of unsecureds is ‘close to zero’. In the US, unsecureds end up receiving nothing in 97.2% of the chapter 7 liquidation cases according to a study by LoPucki.

However, Finch gives a slightly more optimistic view by referring to the R3’s 12th Survey on Corporate Insolvency drafted in 2002-2003. The survey states that unsecureds in the UK already received up to 10% of their claim and preferential creditors even up to 50.2%. It should be borne in mind hereby that these figures even date from before 2002 when several reforms were enacted which should arguably have improved the position of unsecureds. These were contained in the Enterprise Act 2002 which adopted a carve-out of floating charges for the benefit of unsecureds whilst also abolishing the Crown’s preferential position (which has now partially been reinstated). It was designed to enhance greater corporate rescue.

Nonetheless, more recent figures provided by Crawford based on empirical research conducted by Walters and Frisby in 2011 show that in a compulsory liquidation the rate of return for unsecureds never exceeds 19 per cent of the debt owed to them indicating that rates of return for them vary between 1 per cent and 19 per cent (with a proportion of only 17 per cent of these unsecured creditors eventually receiving the aforementioned (highly reduced) dividends). This is different for CVAs. Crawford shows that in 3.19 per cent of the CVA-cases

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188 V. Finch, Corporate Insolvency Law (Cambridge University Press 2009) 95.
unsecured creditors even get their debt fully repaid. The conclusion reached by the Walton report is quite consistent with this as they found that returns – if any – varied between 0.0054 percent in the pound to 79.81 percent in the pound.\textsuperscript{191}

Nonetheless, in 52 per cent of the CVAs unsecureds receive nothing. However, unsecured creditors are still worse off in a liquidation. Empirical findings by Frisby and Walters show that in 74\% of the cases where a company was dissolved through compulsory liquidation after having been subject to a CVA, unsecureds did not receive anything and in the 26\% of the situations where unsecureds did receive something, the average dividend was only 1\% of their claim.\textsuperscript{192}

To conclude this part and whilst different outcomes depending on the type of insolvency procedure are possible, the rates of return remain pretty low for unsecureds. Although a variety of legitimate reasons can explain this (such as the priority position of secured creditors and the reasonably expected low amount of remaining assets in the company’s asset pool), this still stresses the need to ensure that assets which can be brought back into asset pool for the benefit of unsecureds should be brought back. As the following paragraphs will show, procedural and substantive drawbacks may not only create legal but also practical challenges to what can be achieved, and which inevitably weakens the position of the whole group of unsecured creditors which the weaker factions are part of.

III. Remedies ex post: swelling the asset pool

Both during corporate rescue and liquidation procedures, the office-holder has generally got two ways to add assets to the existing assets of the company, with the intent of augmenting the dividends the whole group of unsecured creditors is going to receive. This is either through claw-back procedures and/or liability procedures holding the former directors and management (and sometimes shareholders) to account.

3.1. Claw-back procedures

The usage of claw-back procedures aims to challenge certain actions undertaken by the company in the twilight zone that could thwart the pari passu principle.\textsuperscript{193} These procedures,


\textsuperscript{193} With ‘twilight zone’, this research intends to refer to the moment at which a debtor is approaching insolvency and when directors of the debtor know or must have known that the debtor was or was likely
which are only available when a company has entered into administration or liquidation, comprise transactions at undervalue, preferences, transactions defrauding creditors, invalidation of floating charges and the setting aside of extortionate credit transactions. The aims of these actions are manifold. For example, claw-back procedures have been argued to prevent a Darwinian race to the (insolvent) debtor’s assets. Furthermore, it is contended that they might reduce value-destroying transactions such as ‘over-investment’. Over-investment may occur when a debtor in the run-up to insolvency tries to invest in new projects in order to ‘gamble’ the firm. In this situation, the debtor might seek to borrow new money from a pre-existing lender who is out-of-the-money and who may bargain for a security interest that would not only cover the new loan agreement but also the pre-existing debt. In such occasion, the pre-existing lender would be granted a better position compared to fellow creditors and claw-back procedures are, so goes the argument, designed to halt such value-destroying transactions. Additionally, claw-back procedures (such as preferences) are also contended to encourage creditors to monitor their debtor’s behaviour. And finally, claw-back procedures are designed to ensure that the pari passu principle will be upheld during the insolvency procedure. Several drawbacks, however, limit the functioning of these procedures. Although it is beyond the scope of this research to elaborate too much on these procedures, it is still worthwhile highlighting some of the important difficulties. This is because they have an important impact on the recoverability of the office-holder for all the unsecureds.

Firstly, transactions at undervalue under s.238 of the Insolvency Act 1986 will generally not be set aside if a third party which has received a benefit emanating from a transaction at undervalue has acted in good faith which means that (s)he was not aware of the “surrounding circumstances” which had led to the impugned transaction (likely) worsening the position of several other creditors. Furthermore, managers of the debtor-company could also argue that they acted in good faith and believed that the transaction would be beneficial to interests of the company which would, for example, be the case if the company would be able to receive

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195 At that point, the debtor has, almost, nothing to lose any more for the business is already insolvent or almost insolvent and investing in risky project could, so goes the argument, potentially get the company back on track. This, however, is effectively gambling with the few existing assets of the company/business and thus gambling with unsecured creditors’ money (who are now the residual risk-bearers). Cf. A. Gurrea-Martinez, ‘The avoidance of pre-bankruptcy transactions: An economic and comparative approach’ (2018) Chicago Kent Law Review 711, 726.
197 Ibid.
198 Ibid.
additional credit in exchange for the transaction at undervalue. For commercial reasons and the willingness to survive, the company’s managers may find it appropriate to engage in some transaction(s) at undervalue. However, this issue indicates the difficult onus of proof in establishing the undervalue which must be proved by establishing the discrepancy between the respective values of the “consideration” given by the parties to the transaction (i.e. debtor and third party). If the consideration is higher than the value being received by the insolvent debtor, there is likely to be an undervalue. Such a difficult onus of proof may, however, make it hard to win a case and might reduce the likelihood of unsecureds benefiting from a swollen asset pool.

Secondly, regarding preferences under s.239, a similar “commercial reasons”-defence could be used to defend the granting of additional benefits by the debtor to certain creditors who would otherwise (during an insolvency procedure) not have received these benefits. For example, the debtor may again argue to have granted the additional benefits in order to receive (more) credit from lenders to keep the business going. Although case-law suggests that this defence is not particularly successful with regard to defending transactions at undervalue, entering into a preference for the sole reason of commercial purposes will make an office-holder’s attack likely to fail. Despite the lack of a definition of “commercial reasons”, case-law indicates that a genuine threat exercised by creditors at a financially difficult moment for the debtor (e.g. ending credit-line) is seen as a valid commercial reason to grant a non-voidable preference. The fact that a “preference” has been granted absent the free will of the debtor validates the transaction. In order to set preferences aside, one has to prove in England, although not in most other common law jurisdictions, evidence that the indebted company does anything or suffers anything to be done which has the effect of putting that person [e.g. a creditor] into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done. Besides the fact that it is

200 This is the Cf. Re Brabon [2001] 1 BCLC 11; Philips v Brewin Dolphin Bell Lawrie Ltd [1999] 2 ALL ER 844 at [853].
not very clear what is actually meant by this “desire” to ameliorate the position of one (faction of) creditor(s), such a subjective intention is also often very hard to prove. Furthermore, allowing a preference in case of commercial pressure will likely incentivise the more equipped/stronger creditors to put pressure on the debtor which could be disadvantageous for the weaker classes of unsecureds who, perhaps as a result of this preference, might receive less or even nothing.

Thirdly, in relation to transactions defrauding creditors under section 423, similar problems (such as the difficult burden of proof) arise when the claimant needs to establish that the transaction (i) was entered into at an undervalue by the debtor with another person (ii) by having made a gift to the other person or by entering into a transaction with the other person on terms that provide the debtor to receive no consideration or by entering into a transaction with the other person for a consideration of which the value, in money’s worth, is significantly less than the consideration provided by the debtor herself. Courts will only set aside contested transactions pursuant to section 423 of the Insolvency Act 1986 if they are satisfied that the debtor entered into this transaction for the purpose of “putting assets beyond the reach of the person who is or may make a claim against [the debtor]”.

Finally, there are also some procedural drawbacks limiting the extent to which certain managerial actions can be challenged. In this regard, courts have not only got a large discretionary power, they are also trying to avoid hindsight bias along with the short timescale before insolvency occurs during which these objectionable transactions should have passed.

However, the Small Business Enterprise and Employment Act of 2015 made some changes which can be seen as beneficial for the general group of unsecureds as it states now that the proceeds of procedures such as avoidance and adjustment actions like preferences, transactions at undervalue and extortionate credit transactions will no longer be part of the net property of the financially distressed company which means that the proceeds can no longer fall under the scope of a security interest (such as a fixed or floating charge) which results in the proceeds going straight to the unsecureds. Although this looks like a silver lining for

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210 Insolvency Act 1986, section 423 (1)(a).
211 Insolvency Act 1986, section 423 (1)(c); See also: Insolvency Act 1986, s.424-425.
212 Insolvency Act 1986, section 423 (3)(a).
215 Insolvency Act 1986, section 240(1)(b) and section 245.
unsecureds, in section 3.2, this research will show that this seemingly positive change may not be that beneficial after all for certain classes of creditors.\textsuperscript{217} In addition, in the empirical R3 study of 2014, Walton found that there were not so many solicitors specialised in insolvency litigation.\textsuperscript{218} According to the findings, many insolvency practitioners tried to avoid insolvency litigation because if they did not have to start insolvency procedures (such as accountability procedures), they would not have to bear the costs in case they lose the case. This is a clear sign of risk-aversion by some IPs who prefer not to engage in insolvency litigation in order to avoid the costs of a lack of funding. Subsequently, the amount of litigation being pursued is relatively low. In 2010 there happened to be only 444 CFA-backed sanctions requests of which only 98 company cases with regard to all insolvency procedures.\textsuperscript{219} However, in 2014, the updated R3-study undertaken by Walton finds an increase of 39% of CFA-backed litigation cases in relation to compulsory liquidations being undertaken with 133 sanctions requests granted out of a total number of 3,738 compulsory liquidations compared to the amount of 4,792 compulsory liquidations in 2010 while in 2010 only 96 applications were granted in relation to compulsory liquidations.\textsuperscript{220} However, these figures only relate to CFA-backed cases. Nevertheless, there is still a variety of other litigation funding options available for the office-holder and, in certain occasions, the unsecured creditors during an insolvency procedure such as, for example, the ability to assign a claim\textsuperscript{221} (as will be discussed in chapter 5 part 3.1.3. and chapter 8 part 2.2.1.5.).\textsuperscript{222} Nonetheless, despite the slight increase, the amount of insolvency litigation being pursued still remains rather limited/poor, although these procedures, intended to swell the asset pool for the benefit of these unsecureds, are often highly important to get their claims repaid.

Given these difficulties, office-holders may be reluctant to initiate claims, even though such procedures would be beneficial for the group of unsecureds which increases the chances that the unsecureds (and especially the vulnerable factions) lose out. This is why (alongside other drawbacks regarding private enforcement), chapter 8 will assess whether a public trust and/or public enforcement could or should be utilised to enhance the protection of more vulnerable unsecureds.

\textsuperscript{217} Cf. section 3.2.


\textsuperscript{219} Ibid 20.

\textsuperscript{220} Ibid 11.

\textsuperscript{221} Small Business Enterprise and Employment Act 2015, section 118.

Turning back to claw-back procedures, on balance and despite the apparent attractiveness of such procedures, it is clear that several pitfalls still make it possible for the corporate debtor to neglect the unsecureds’ interests which consequently puts the claims of the more vulnerable factions of unsecureds (more) at risk.

Nonetheless, an office-holder could always try to bypass the difficulties regarding claw-back procedures by starting a liability procedure against the directors who have granted a priority to (a) certain creditor(s) arguing they have not acted in the best interests of the creditors prior to the onset of insolvency but this will definitely not be a guarantee that these directors will effectively be held accountable, especially given the wide range of drawbacks related to such accountability procedures as well.

3.2. Recovery procedures against directors

These accountability/liability procedures all seek to swell the asset pool by trying to get the losses suffered by the entire group of unsecureds repaid. In principle, one can make a distinction between four different types of procedures: (i) procedures for breach of directors’ duties, (ii) wrongful trading-procedures, (iii) fraudulent trading-procedures and (iv) compensation orders existing alongside disqualification procedures. Instead of clawing back assets, the asset pool is hoped to be swollen via these procedures due to the payments payable into the asset pool of the debtor by those liable.

However, there are many drawbacks with the aforementioned actions. To begin with, although the wrongful trading provision seemed to be promising at the moment when it became law, practitioners indicate that it has actually never been used very often. One of the main reasons is the fact that courts want to avoid hindsight bias trying not to interfere in the business and by claiming what should have been done in the past after knowing all the facts while managers had to make a decision before knowing what could happen. If managers show that they know their business/company and they can justify the decision they took, courts are unlikely to hold directors/managers accountable for “wrongful trading” or continuing trading despite being in financial difficulties. This is even more the case if the managers/directors sought professional advice. As with many other cases in the corporate field, this could also be considered to be an application of the business judgment rule whereby courts do not look behind the decisions made by the directors. If decisions are examined, they are examined in terms of the ability of a

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226 Ibid 665.
director to make a decision\textsuperscript{227}, using a “reasonably prudent businessman” as a standard.\textsuperscript{228} In this regard, the court reiterated in \textit{Re Continental Assurance Plc}\textsuperscript{229} (a wrongful trading case) the wide discretion courts have got in assessing directorial liability.

Furthermore, even if there is the possibility to start an action for breach of directors’ duties instead of/or alongside an action for wrongful trading, courts can also grant relief to directors\textsuperscript{230} in this situation if they believe that they acted “honestly and reasonably” which immediately waters down the chances of success. Nonetheless, it has been held that directors cannot be excused for wrongful trading under section 1157 of the Companies Act 2006 as this defence is incompatible with the objective nature of the test found in section 214 of the Insolvency Act 1986.\textsuperscript{231} Also, as the company will likely be lacking funds and the office-holder will be pursuing this case on behalf of the company, the directors are likely to apply for “security of costs” ensuring that the insolvent company will be able to repay the litigation costs if the defendant wins the court case.\textsuperscript{232}

Turning to the proceeds, the Small Business Enterprise and Employment Act of 2015 made some changes regarding the proceeds of fraudulent and wrongful trading cases stating that the proceeds of these procedures (just as with the claw-back procedures mentioned above) can no longer be perceived to be part of the net property of the financially distressed company,\textsuperscript{233} and would be taken by the secured creditors. Although this is perceived beneficial for the general group of unsecureds\textsuperscript{234}, the downside of this will be a relatively weaker position of floating chargeholders due to the fact that preferential creditors who are ranked ahead of floating chargeholders might benefit the most from this rule. This is because preferential creditors are paid from funds going to creditors holding a floating charge if there are insufficient funds to pay them from the funds available to the general body of unsecureds.\textsuperscript{235} Nonetheless, this will only be the case if there are insufficient assets in the general funds to pay the preferentials. Despite the relatively weaker position of the floating chargeholders\textsuperscript{236} and without digging into all the implications of this (as this would be outside the scope of this chapter), it is, nonetheless,

\begin{thebibliography}{1}
\bibitem{228} \textit{Re Brian D Pierson (Contractors) Ltd} [2001] 1 BCLC 275 at 306; \textit{Re Continental Assurance Plc} [2007] 2 BCLC 287 at [135].
\bibitem{229} \textit{Re Continental Assurance Plc} [2007] 2 BCLC 287.
\bibitem{230} Companies Act 2006, section 1157.
\bibitem{231} \textit{Re Produce Marketing Consortium Ltd} [1989] 1 WLR 745; \textit{Re Brian D Pierson (Contractors) Ltd} [2001] BCLC 275.
\bibitem{233} Small Business Enterprise and Employment Act 2015, section 119 (2).
\bibitem{234} \textit{Ibid}, section 119 (2).
\bibitem{235} Insolvency Act 1986, s.175(2).
\end{thebibliography}
important to stipulate that the floating charge still provides a highly valuable security interest for creditors, which is arguably the reason why almost every businessman/company continues using floating charges, albeit often in combination with other real and personal securities (such as fixed charges and third party guarantees).\(^{237}\) As proceeds generated by a successful action for breach of directors’ duties are still part of the net property of the company, the secured creditors will still come first\(^{238}\) leaving scarce chances for unsecured creditors of recovering anything of it (except for the funds they may get from their prescribed part of floating charges\(^{239}\)).

Allied to the proceeds and turning to drawbacks related to all liability procedures mentioned above, another major issue is the fact that if the wrongdoer is personally bankrupt himself, he will be unable to pay.\(^{240}\) The debtor’s office-holder would have to prove in the wrongdoer’s bankruptcy then and is likely only to get a portion of what is owed by the director.

Furthermore, prior to the commencement of an insolvency procedure, unsecureds have no basis on which to start an accountability procedure against the company’s management leaving them rather powerless to undertake any steps against managerial misbehaviour. This is because it is the shareholders who need to hold the management to account before the start of an insolvency procedure as up until then they are perceived to be the residual owners of the company (instead of the creditors). If shareholders do not take the decision to (derivatively) start proceedings themselves, managers are generally ‘off the hook’ (as long as the company does not become subject to an insolvency procedure). This issue is definitely important for small and medium-sized companies (e.g. family businesses) with a more concentrated ownership where directors are often the (majority) shareholders themselves or at least affiliated or connected to them as it is highly unlikely that someone as a (majority) shareholder will start a lawsuit against him-/herself or one of its connected persons. This is definitely an important issue in continental Europe where companies, even large ones, are often characterised by a concentrated ownership.

Different, however, in some European jurisdictions on the continent like the Netherlands\(^{241}\) is the fact that, if certain conditions have been met\(^{242}\), a creditor can start liability proceedings

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\(^{239}\) Insolvency Act 1986, s.176A.


\(^{241}\) Dutch Civil Code, article 2:138 and 2.248.

\(^{242}\) This is, if the directors have clearly behaved improperly and if this behaviour most likely appeared to be one of the triggers of the company’s insolvency, they will be jointly and severally liable for the amount of debts exceeding the amount of recoverable assets.
himself on the basis of tort if he can establish that the behaviour of managers could have led to the insolvency. Although creditors in Belgium used to be able to commence liability procedures on the same ground (as in the aforementioned Dutch situation) before the liquidator had made a decision about the issue whether she was going to commence a procedure on this ground or not (i.e. if the creditor can establish that the behaviour of managers could have led to the insolvency), recent legislative changes (that came into effect on 1 May 2018) require the creditor now to wait for one month after having urged the liquidator to commence a procedure before starting a liability procedure herself, that is, until she discovers that the liquidator is inert and will not start a procedure herself and after the creditor has urged the liquidator to start a procedure herself.243 In contrast to the UK and as will be discussed in chapter 8, some jurisdictions such as Canada and Singapore have also given creditors the right to start a derivative claim on behalf of the insolvent estate.244 Nonetheless, in the course of the winding-up of a company, creditors are entitled to file an application against an officer, liquidator, administrative receiver or director/manager of the company for the misapplication or retention of any money or property of the company or a breach of their fiduciary duty or any other duty in relation to the company.245 Section 212 of the Insolvency Act 1986 does not create a new cause of action or its own wrongful act but it grants the applicants a summary remedy to enforce rights that already existed and could have been enforced prior the company’s liquidation.246 This summary remedy is described as a ‘misfeasance claim’. Usually, liquidators will initiate such a claim, however, creditors can do so too when the liquidator fails to do so.247 If creditors are successful in pursuing the misfeasance claim, the court can only make an order to the benefit of the company and not to the benefit of the applicant-creditor248 and the applicant must prove that the company (not the applicant itself) has suffered a loss249 which is both very similar to the functioning of a derivative claim. Consequently, the existence of misfeasance claims which are open to creditors reduces the need for a derivative claim in the UK. Nonetheless, the misfeasance claim has also got its limits. Next to the difficult burden of proof, potential difficulties in obtaining sufficient information, the ability for directors and officers250 to be get relief under s. 1157 of the Companies, one can only make use of the misfeasance claim of s. 212 of the Insolvency Act 1986 if the company is subject to a winding-up procedure. Consequently, a contributory who

243 Belgian Code of Economic Law, article XX.225 §3.
244 Cf. infra Chapter 7 and 8.
245 Insolvency Act 1986, section 212(1).
250 See for example: Re Powertrain Ltd (in liq.) [2015] EWHC 3998 (Ch.). There remains, however, discussion as to whether an administrator or liquidator can be seen as an officer of the company for the purposes of s. 1157 Companies Act 2006. Cf. A.R. Keay and P. Walton, Insolvency Law: Corporate and Personal (LexisNexis 2020) 759-760.
initiated a misfeasance claim after a winding-up petition had been lodged failed because no winding-up order in relation to the debtor-company had been made yet.\textsuperscript{251} In other words, the misfeasance claim would not be open to creditors during a CVA, IVA, scheme of arrangement or Part 26A Restructuring Plan, even though the creditors are that point, economically, the residual risk-bearers (given the company’s financial position) and may want to hold directors (or the office-holder such as the supervisor in a CVA or the pre-pack administrator) to account for alleged breaches of their duties. For the latter situations, a derivative claim as available to creditors in Singapore and Canada could be more optimal than solely relying on a misfeasance claim.

Turning back to procedures in the UK, there also remain funding issues (even despite several recent developments in this area)\textsuperscript{252} in order to try to encourage the office-holder to bring proceedings to hold the previous management to account for the benefit of the unsecured creditors if necessary. Based on Australian Law\textsuperscript{253}, Finch, therefore, argues that it would be good to grant a creditor the option to start a procedure himself for which he could be granted a priority/preferential position in relation to any proceeds obtained.\textsuperscript{254} This comes along with a wide range of other general and specific procedure-related pitfalls or obstacles to bringing proceedings, such as specific time-limits, a lack of a clear definition (such as ‘what fraud actually entails’), lack of proof and the inability to obtain the necessary evidence alongside the risk-aversion of office-holders and courts tending to try to avoid hindsight bias (as discussed above).

To conclude, in light of all the pitfalls set out above, weaker factions of unsecured creditors without a preferential position could, consequently, lose out as all these liability procedures but also the aforementioned claw-back procedures do not make any distinction within the group of unsecured creditors and might put weaker unsecured creditors at risk of either stronger unsecured creditors that are passive (or exploiting their strong position) and/or managers/office-holders who may not act sufficiently diligently or who struggle to overcome the various regulatory, practical and judicial obstacles set out before. As shown above, a legal principle for the benefit of the whole group of unsecured creditors does therefore not mean necessarily that all unsecured creditors will \textit{ipso facto} be better off. Given these difficulties that exist as regards private enforcement, it will, as said before, be examined in detail in chapter 8 whether public trusts and/or public enforcement might be helpful to complement private enforcement measures and, in doing so, to ‘fill the gaps’ or to mitigate the risks that continue to exist at the level of private enforcement.


\textsuperscript{252} V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 473.

\textsuperscript{253} Re Glenisla Investments Ltd (1996) 18 ACSR 84.

\textsuperscript{254} V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 480.
One example of public enforcement in this regard is the ability of the state to pursue compensation for disqualification and to determine which creditors should receive the proceeds. This will be discussed here as this procedure would also allow the company and/or creditors to get compensated albeit not through private but public enforcement. The benefit of this procedure is that, as said, it can be initiated by the Secretary of State which would allow individual creditors to have a chance at getting compensation for the losses they may have suffered as a result of wrongdoings by the directors for which they would be disqualified. This is important for there may be situations where the office-holder remains reluctant to initiate a procedure against directors and where it may be difficult for unsecureds to get financial redress themselves. Nonetheless, despite the merits of the compensation order, the advantages should not be overstated. At the time of writing only one case has been reported, namely, the *Re Noble Vintners Ltd* case. This shows that the procedure ex section 15A of the Company Directors Disqualification Act 1986 is only rarely used. This should not surprise given the stringent conditions that need to be met in order to be successful in an application for a compensation order. Namely, the Secretary of State can only initiate such a procedure if the director has been disqualified but it cannot act in cases where the director has not been subject to a disqualification order. Furthermore, it goes without saying that seeking a compensation order can only be done *ex post*, i.e. after the harmful act has occurred but the Secretary of State (unlike the Australian Securities and Investments Commission ("ASIC") in Australia) does not have any ability to monitor/control the directors' behaviour prior to wrongdoing taking place. Additionally, concerns have been raised that the ability to pursue a compensation order could lead to the office-holder being bypassed by the Secretary of State or directors facing double recovery for the same wrong because of double recovery regimes (i.e. the compensation order pursuant to the Company Directors Disqualification Act 1986 and the aforementioned liability procedures that the office-holder can pursue to swell the asset pool). Nonetheless, the latter concerns can significantly be nuanced as it does not only seem unlikely that office-holders will

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255 The private enforcement measures have been elaborated on above.
256 Company Directors Disqualification Act 1986, section 15A and 15B.
257 Company Directors Disqualification Act 1986, section 15A(3).
258 C. Buckley, “Re Noble Vintners Ltd - compensation orders following disqualification: why, what and where next?” [2020] 33(4) Insolvency Intelligence 124; This could, for example, be if unsecureds are financially unable or unaware of the legal possibilities (e.g. a misfeasance claim pursuant s. 212 Insolvency Act 1986) they may have at their disposal to file a claim themselves or to pursue the office-holder to press for the instigation of a procedure against the (former) directors of the company.
259 *Re Noble Vintners Ltd* [2019] EWHC 2806 (Ch).
260 Company Directors Disqualification Act 1986, section 15A(3).
262 *Re Noble Vintners Ltd* [2019] EWHC 2806 (Ch).
be bypassed by the Secretary of State\textsuperscript{263} (especially given the stringent conditions that need to be fulfilled to obtain a compensation order), they also ignore the involvement of the courts who can oversee (i) whether a compensation order should be granted and if so, (ii) what the amount of compensation should be.\textsuperscript{264} Nonetheless, a more critical concern seems to be the uncertainty as regards the relation between the \textit{pari passu} principle and the ability for \textit{individual} creditors to recover a loss pursuant to a compensation order instigated by the State. In the \textit{Re Noble Vintners Ltd} case, the court determined that the individual creditor should only receive compensation it had individually suffered as a result of the wrongdoing by the directors. The judge gave an example of discriminatory treatment towards the tax authorities (HMRC) whereby the HMRC would only be entitled to be compensated for the losses suffered as a direct result of this discriminatory treatment without being able to claim the \textit{entire} tax debt.\textsuperscript{265} It would only be entitled to claim the difference between what was paid by the debtor and what the debtor, absent this discriminatory treatment, should have paid, even though this may not cover the entire tax debt HMRC would be entitled to claim.\textsuperscript{266} Although this principle seems clear in abstract terms, it needs to be seen how this will be applied in practice. Namely, how can one distinguish between the individual loss one has suffered as a creditor if that conduct \textit{also} caused losses to the company? Which parameters/factors must be taken into account to determine the compensation that the \textit{individual creditor} is entitled to receive and which compensation should go to the company? Neither the \textit{Re Noble Vintners Ltd} case nor the Company Directors Disqualification Act 1986 makes this clear.

Nonetheless, despite the considerable drawbacks, compensation orders are, on balance, considered a useful instrument to the extent that they may increase unsecureds’ chances of getting compensation which might enhance fairness and accountability (cf. \textit{infra} chapter 6 and 7 for the discussion as regards the insolvency values), however, as will be discussed in chapter 8, this research argues that more emphasis should be put on public enforcement due to the various concerns that continue to exist regarding private enforcement.

In conclusion, after having discussed measures \textit{ex post} (litigation) it becomes important to shift the focus now to measures one can take \textit{ex ante}. More in particular, to the ability to monitor the director (and office-holder) is critical here for it could potentially reduce the need to initiate insolvency litigation if such monitoring may align the interests of the management with the company for the benefit of the unsecureds when the company is (almost) insolvent. This will be discussed below in part IV.

\textsuperscript{263} C. Buckley, “Re Noble Vintners Ltd - compensation orders following disqualification: why, what and where next?” [2020] 33(4) Insolvency Intelligence 124, 126.
\textsuperscript{264} \textit{Re Noble Vintners Ltd} [2019] EWHC 2806 (Ch) at [46].
\textsuperscript{265} \textit{Re Noble Vintners Ltd} [2019] EWHC 2806 (Ch) at [36].
\textsuperscript{266} Ibid.
IV. Monitoring and control rights of unsecured creditors

Whilst the previous part (i.e. part III) critically focused on the remedies that could be applied by the office-holder to hold directors to account in order to swell the asset pool for the benefit of the entire group of unsecureds in case these directors would have violated the law (such as e.g. their directors’ duties), unsecureds might also be able to contribute to good insolvency governance themselves whereby such good governance may have a positive impact on the debtor’s financial position (and, thus, the amount of money which may be distributed amongst them). However very difficult, unsecureds can do this by attempting to monitor the debtor’s management (to the extent possible) which could reduce the necessity of the office-holder having to file proceedings against the management for alleged wrongdoings.\(^{267}\) In addition, unsecureds may also want to monitor and control the office-holders in order to ensure that these ‘new managers’ manage the debtor in a way which is conducive to getting a dividend as high as possible.

Surely, this issue relates to the performance of the managers/office-holders and their alignment with the insolvent debtor-company in whose interests the managers/office-holders ought to act. In practice, however, this means that the managerial duty to act in the interests of the members of the company\(^{268}\), becomes a managerial duty to act in the interests of the unsecureds (incl. several factions within this group of unsecured creditors). This is why we examine below to what extent the current regulatory framework stimulates an alignment between the interests of the management/office-holder and the company’s unsecureds. Although several rules only consider the interests of the whole group of unsecured creditors, it is therefore also quite important to discuss their impact as weaker classes of unsecured creditors might still benefit from these protections. This, however, is not always the case due the still-existing regulatory drawbacks which will be elaborated on more extensively below.\(^{269}\)

4.1. Unsecured creditors’ monitoring power

4.1.1. Meaning

First, one of the ways to enable control over the management as unsecureds is through controlling the performance of the management/office-holder. This relates to the usage of voting rights in insolvency procedures, the attendance at creditors’ meetings and/or committees and

\(^{267}\) Given the scope of this chapter which focuses on the contemporary rights creditors have got, the fact that directors do not owe a direct nor an indirect duty to creditors and the significant amount of economic and practical difficulties for unsecureds to appropriately monitor the debtors’ management prior to the onset of insolvency, this research will focus in this chapter on the monitoring rights given to (unsecured) creditors which are rights that are applicable during an insolvency procedure vis-à-vis the office-holder.

\(^{268}\) Companies Act 2006, s172.

\(^{269}\) If unsecureds don’t control (even not the ones with a majority of the voting rights, then the actual controller might be the office-holder and in such case the whole group of unsecureds might be considered "non-controlling".
the voting strategy of these unsecureds which will be elaborated on below. This research will, hereby, illustrate that the current regulatory framework contains several drawbacks vis-à-vis the ability of classes of unsecured creditors to control or influence the corporate restructuring, corporate rescue or liquidation procedure which may also result in their voice being crammed down and perhaps even being fully ignored in some cases.

However, before going into the details of such monitoring rights, it is, however, necessary to define first what is meant by “controlling or monitoring managers/office-holders”. In legal literature, this is often equated with accountability despite both terms (i.e. monitoring/exercising control on the one hand and accountability on the other hand) being two different notions which are only ‘linked’ to each other as control or monitoring power does not necessarily mean having the ability to determine the direction or action which, according to the controller, ought to be taken. However, although chapter 6 and 7 will examine the principle of accountability in much greater detail, for the ease of understanding this chapter, it already ought to be set out that the impact of control is quite an important aspect to be able to hold the managers/directors (who were governing the company prior to the onset of insolvency) or the office-holder (who takes over once a company enters into an insolvency procedure) to account.

In this regard, it is important to stress that “control” ought to be divided into two parts.

On the one hand the ability of the controller to influence a decision taken by the debtor-company (which would be the case for example if a shareholder or a group of shareholders holds a majority of the voting rights in a shareholders’ meeting enabling them to remove managers with whom they do not agree or, although shareholders are not able to instruct boards what to do in English law, to advise the decisions they prefer the board of directors to take (by holding their ability to remove as a means to put pressure on them).

On the other hand, even without having a majority in voting rights, controlling also means the ability to “monitor” and being able to “review” the actions the management has undertaken or is willing to get engaged in and in case of directorial shirking the “controller” (this time being in a minority position (from a voting perspective)) should still be able to act upon the wrongdoings of the directors/managers. In the first case, the “controllers” control through the ability of being able to determine what actions will be taken by the (managers of the) company. In the latter situation, the “controllers” review actions which have or will be undertaken by the (managers of the) company and in case of a breach of law or any harm caused to them, they should still be

270 A.R. Keay, Board Accountability in Corporate Governance (Routledge, 2015) 59.
271 Companies Act 2006, s.168.
able to get their voice heard (through a variety of legal procedures despite the shortcomings of which some of them have already been addressed above).

The same counts *mutatis mutandis* for insolvent companies. However, once a company becomes insolvent, the role undertaken by shareholders will now be undertaken by the unsecureds (cf. chapter I) where they can use their voting power in a creditors’ meeting or other decision procedures which is comparable with the shareholder’s meeting. Furthermore, once an office-holder will be appointed it will no longer be the managers of the company who will be taking the decisions but it will be the office-holder instead who will perhaps find it tactical to obtain the backing of the (unsecured) creditors and possibly a liquidation or creditors’ committee (cf. below).

**4.1.2. Importance of monitoring power**

Moving forward to the necessity of controlling, it is quite remarkable that despite a great deal of attention given to this issue in corporate governance literature, insolvency literature still remains rather silent about the monitoring and controlling impact unsecureds could (or should) have on either the incumbent management of the company and/or the office-holder. Given the existing comparison between solvent companies (regulated by corporate law) and insolvent companies (regulated by corporate insolvency law) as shown in the first chapter, throughout this and the following chapters, we will sometimes take corporate governance literature into consideration with regard to the examination which governance may or may not be applied in an insolvent company (where the key players are different but the roles largely the same).

From that perspective, in corporate governance literature, there is still a debate ongoing to what extent, if any, effective and improved corporate governance rules (such as e.g, monitoring powers of shareholders) could improve managerial performance.\(^\text{272}\)

On the one hand, it is argued that better corporate governance, and particularly active monitoring, reduces agency costs which will improve managerial performance. The rationale behind this is the assumption that managers, without being controlled, want to shirk and act opportunistically against the interests of the company and its shareholders.\(^\text{273}\) According to this theory’s proponents, active monitoring will make shirking either impossible or at least much tougher to do. By having at least reduced the level of opportunistic behaviour, the performance is expected to be better.

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On the other hand, an empirical study undertaken by some scholars indicate that improving the company’s corporate governance structure does not directly lead to better firm performance.\textsuperscript{274} Based on the data they examined, they find that companies who improve their corporate governance have in 50% of the cases a worse performance afterwards.\textsuperscript{275} Nonetheless, specifically with regards to monitoring, they find indications that more active monitoring (which is seen as an improvement in corporate governance) leads to better performance of the company.\textsuperscript{276} Although the latter observation may not come as a big surprise, it still remains an issue in practice. The parliamentary committee report\textsuperscript{277} covering the recent demise of the Carillion group which was involved in several construction services for the UK government, shows why monitoring of the management may be an appropriate tool to avoid inappropriate managerial behaviour. In this particular case, the House of Commons Briefing Paper (despite a still ongoing investigation) stated that the management of the Carillion group engaged in aggressive bidding and accounting, invested in worthless projects and paid high dividends to the shareholders despite a declining revenue. All of these factors are detrimental for a company/group and could easily lead to the liquidation of a company or a group of companies. As a result of these alleged wrongdoings and (expected) mistakes at corporate governance-level, the government launched a consultation paper in order to assess whether improvements should happen at the level of corporate governance in order to avoid or mitigate the risk of an insolvency.\textsuperscript{278}

The importance of monitoring during an insolvency procedure (and not only prior to the onset of it) also became clear in an empirical study undertaken by Kempson who examined the impact of creditor monitoring on the performance of liquidators during an insolvency procedure. In line with previous findings, also Kempson concluded that a close(r) monitoring of the office-holders (who have taken over the management of the insolvent company) by creditors could lead to a lower and stricter oversight of the remuneration of the office-holder which would leave more

assets in the asset pool to be able to distribute amongst the creditors\textsuperscript{279} (and which would thus
be positive for the creditors). Nonetheless, the creditors on which he was focused, were secured
creditors while – again – no attention had been paid to the fact that also unsecureds could have
the possibility to monitor the office-holder closer. This is particularly important as Kempson’s
research indicates that a lower level of control might lead to inefficiencies such as a
lower/reduced engagement of the insolvency practitioner and his members of staff which could
lead to a longer and more costly insolvency procedure for the unsecured creditors for no good
reason.\textsuperscript{280}

### 4.1.3. Contemporary monitoring rights of unsecured creditors

Whilst company’s directors are expected to be monitored more closely by the
shareholders/investors during the company’s solvency, that may change when a company-
debtor becomes subject to an insolvency procedure and the management gets replaced by an
office-holder (unless the debtor would opt for the commencement of a CVA in which the
management continues to play a very crucial role).\textsuperscript{281}

As set out in the first two chapters, upon insolvency, different interests of different players might
clash whereby we draw a comparison between the key players in corporate and insolvency
governance. Of particular importance from the perspective of unsecureds is the relationship
they (and factions within their group) have got with the office-holder who is, once a company
becomes subject to an insolvency procedure, the one who will be “managing” the (insolvent)
company for the benefit of the new residual claimants, i.e. the unsecureds, although in both
CVAs and administrations the directors might still play some roles. A similar reasoning, as
contractarians and agency theorists make for companies while they are still solvent, would lead
to the argument that the office-holder would have to act as an agent of the unsecureds once
the company becomes insolvent. Although, this would legally not hold water (as the office-holder
is not the ‘agent’ of the unsecureds), several commentators still argue that there are several
benefits in practice of controlling/monitoring the managerial performance.\textsuperscript{282}

\begin{itemize}
  \item \textsuperscript{279} E. Kempson, “Review of Insolvency Practitioner Fees: Report to the Insolvency Service” [2013] 13-15
  accessible through the following link: https://www.gov.uk/government/publications/insolvency-practitioner-fees-a-review.
  \item \textsuperscript{280} Ibid 35.
  \item \textsuperscript{281} Insolvency Act 1986, section 1(1) setting out that the directors of the insolvent company make a
  proposal to the company and the company’s creditors with the aim of composing an arrangement in
  satisfaction of its debts. S. Paterson and A. Walters, ‘Selective Corporate Restructuring Strategy’ [2021]
  19 available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3924225 (last checked: the 5\textsuperscript{th}
of December 2021) in which the authors state that the CVA is largely an out-of-court procedure with the
  nominee (i.e. insolvency practitioner) merely being an adviser to the company instead of a monitor for the
  (insolvent) company’s creditors.
  \item \textsuperscript{282} A. Klein and E. Zur, ‘Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors’
\end{itemize}
Therefore, in order to get a good understanding of the contemporary framework, it seems appropriate to critically examine the current controlling and monitoring rights unsecureds have got at their disposal at the moment. This will also allow this research to show the current pitfalls/challenges which will enable to provide some regulatory suggestions that would improve the insolvency framework (cf. infra chapter 8).

Subsequently, as the specific voting rights and quorums (which are both important factors to be able to control the management) have already been set out at the beginning of the chapter, the important question we will address now is how unsecured creditors use these rights in practice to exercise control over the insolvency procedure by (i) appointing the management of the insolvent company, (ii) monitoring and scrutinising the performance of the managers/office-holders and (iii) holding the management/office-holder accountable in case of managerial underperformance or improprieties.

i) Nominating the office-holder

Unsecured creditors (along with contributories) have the right to nominate the office-holder of the insolvent company.\textsuperscript{283} However, in reality, the qualifying floating chargeholder is likely to control the appointment in many cases. The office-holder is a repeat player and is, in practice, likely to be influenced by the wishes of the bank (holding a floating charge) meaning that the qualifying floating chargeholder is more likely going to be able to dictate the identity of the appointee (i.e. office-holder).\textsuperscript{284} Furthermore, if no insolvency procedure has been commenced, unsecured creditors have got no influence over the management of the company as, until then, the appointment/removal of managers remains a power of the general meeting of shareholders. It is only when a formal insolvency procedure commences that unsecured creditors get – legally – bestowed with the voting powers of residual owners although – economically – they may have been longer in the position as “residual owners” due to the decreased amount of distributable corporate assets. Nonetheless, the ability to nominate a director is in corporate governance regarded as an important feature to grant shareholders control over the management.\textsuperscript{285}

Consequently, for some companies (such as listed ones) the rules specifically try to limit the risks of abuse of this power by limiting the amount of control they can exercise.\textsuperscript{286} However, although directors owe their duty (primarily) to the company, the controlling/majority shareholder has de facto still got the possibility to appoint directors who will be acting predominantly (or

\begin{itemize}
\item \textsuperscript{283} Insolvency Act 1986, s.139(3).
\item \textsuperscript{284} S. Paterson, ‘Debt Restructuring and Notions of Fairness’ [2017] 80(4) The Modern Law Review 600, 609-610.
\item \textsuperscript{285} A.M. Pacces, Rethinking Corporate Governance: the law and economics of control powers (Routledge 2012) 175.
\item \textsuperscript{286} Ibid 192.
\end{itemize}
perhaps solely) in the interests of the controlling shareholders due to the fact that a majority shareholder contains the majority of the voting rights in a shareholders’ meeting\textsuperscript{287} and has thus got the ability to approve of the directors he/she wants.

Although shareholders stay in the position to appoint a new manager (i.e. the office holder) once entering into an insolvency procedure, creditors can also get involved in the appointing procedure from then (as they can also appoint an office-holder, for example in a voluntary liquidation). In case the contributories (members of the company) on the one hand and the creditors on the other hand appoint a different office-holder in a creditors’ voluntary liquidation (s.100) any creditor or contributory may seek recourse in court in order to have these appointed office-holders acting jointly or alone. In the latter option, the office-holder will either be the one appointed earlier by the contributories or a new one replacing the former appointed by the creditors\textsuperscript{288}. Whether the court decides to add an office-holder to the office-holder who is already appointed, depends on the question whether “due cause is shewn”\textsuperscript{289} whereby “due cause” must be interpreted as requiring a certain necessity to have an additional office-holder acting on behalf of the insolvent company. For example, in the aforementioned case, the court decided to appoint an additional office-holder to pursue some misfeasance cases (where the commencement of which was opposed by the other liquidators). Nonetheless, the ability to have a say over the person who will be acting on behalf of the insolvent company does grant some significant rights to the creditors (in whose interests the company needs to be managed from the moment it enters into insolvency).

\begin{itemize}
  \item[ii)] Scrutising behaviour of the office-holder
    \begin{itemize}
      \item[a)] Overview
    \end{itemize}
\end{itemize}

Controlling the actions undertaken by the manager/office-holder can be argued to be quite important in order to reduce the existing “agency costs” between the unsecured creditors and the office-holder as, in economic terms, the “contract” between them is incomplete or imperfect given the fact that the office-holder has not only got more knowledge about the insolvency rules and insolvency practice but also about the particular company (which is subject to an insolvency procedure). Legally, this means that the manager/office-holder who should act in the interests of the insolvent company for the benefit of the creditors may engage in shirking or self-dealing by acting opportunistically and exploiting creditors and/or acting in an inefficient way which may also cause harm to the same creditors.\textsuperscript{290} Controlling the behaviour of insolvency practitioners

\begin{footnotes}
\item[287] Ibid 175.
\item[288] Insolvency Act 1986, s.139(4).
\item[289] Re Sunlight Incandescent Ltd [1900] 2 Ch 728.
\end{footnotes}
(as a characteristic of good insolvency governance practices in general) should, as it is supposed to do in corporate governance where it concerns shareholders and managers, reduce the risk of exploitative or inefficient behaviour improving the performance of the incumbent management/office-holder of the insolvent debtor-company.  

Therefore, insolvency law has set out a variety of governance rights enabling the unsecured creditors to monitor the office holder’s performance. As already mentioned above, unsecureds receive voting rights measured in accordance with the value of their claims. These voting rights can be used during creditors’ meetings during which unsecured creditors (or someone entitled to represent them, a proxy) *inter alia* can request further information from the office-holder, agree or disagree with the proposed remuneration of him/her and approve or disapprove of the planned or already undertaken actions of the office-holder. A creditors’ meeting between the office-holder and the unsecured creditors is designed to reduce this information-asymmetry between them by informing the unsecured creditors and granting them the ability to question the office-holder. Furthermore, if at least 10 per cent of the creditors in value, 10 percent of the number of creditors or ten creditors want a decision to be taken through a physical creditors’ meeting, they can requisition the office-holder (e.g. an administrator or a liquidator) to hold a physical meeting, even though physical meetings are, in principle, prohibited. This is because under the new Insolvency Rules 2016 which have been in place since April 2017, physical meetings are intended to become the exception due to the arrival of the “decision procedures”. In these decision procedures, decisions are made via either deemed consent procedures or qualifying decision procedures. A deemed consent procedure is a procedure where the creditors are given notice by the office-holder of the intended decision which will be adopted unless, pursuant to the Insolvency Act 1986 or the Insolvency Rules 2016, a decision is required to be made by a qualifying decision procedure (such as e.g. for the remuneration of the office-holder or for CVAs or for any other decisions that are required to be taken by a qualifying decision procedure pursuant to the Insolvency Act 1986 or the Insolvency Rules).

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291 B. Tricker, *Corporate Governance: Principles, Policies, and Practices* (Oxford University Press 2019) 66-68 referring to several studies that point out that good corporate governance has already had a positive impact on firm performance.

292 Insolvency Rules 2016, r.15.31(1).


294 Insolvency Act 1986, section 246ZE(7).

295 Insolvency Rules 2016, r.15.6.

296 Insolvency Rules 2016, r.15.2 and r. 15.3.

297 Insolvency Act 1986, section 246ZF(2).

298 Insolvency Act 1986, section 3(3).

299 See e.g. Insolvency Act 1986, s.171(2)(b) regarding the decision by the creditors in a creditors voluntary winding-up to remove the liquidator as also referred to by A.R. Keay and P. Walton, *Insolvency Law: Corporate and Personal* (LexisNexis 2020) 41.
if the court orders that a decision must be made by a qualifying decision procedure or if at least 10% of the creditors (by value) object to the proposed decision. If the appropriate number of creditors object to the proposed decision, the deemed consent procedure will terminate and no decision will have been made. In that situation, a qualifying decision procedure must be used in order to seek a decision on the matter that needs to be decided upon. This can be organised through a variety of prescribed options (such as electronic voting, a physical meeting, correspondence voting etc.) and, as said, subject to the requirement that at least 10 percent of the creditors by value object to the intended actions the office-holder wanted to undertake. In case this 10 percent threshold (to object) is not met, the office-holder is allowed to presume that the creditors consented to the decision he/she intended to go for (e.g. starting a liability procedure against the former directors), hence the term “deemed consent procedure”. Nonetheless, creditors can get a meeting if they want one.

However, in principle, office-holders do not need to seek approval of the unsecureds for most actions they wish to take. This is understandable given the fact that unsecureds appear to be quite apathetic and either the rescue or the liquidation of the company cannot be jeopardised by a lack of participation of unsecureds. However, it seems prudent for the office-holder to inform the unsecured creditors and still seek for approval anyway (certainly in relation to the exercise of controversial powers) in order to avoid potential problems with unsecureds afterwards. In order to assist the office-holder, unsecured creditors may decide to set up a creditors’ committee or (in case of a liquidation) a liquidation committee. Although the amount of members who can participate in these committees is quite small (minimum three, maximum five), the information and, thus, broader insight one gets on the powers the office-holder intends (not?) to exercise and the ability to get in closer contact with the office-holder, are great advantages of being part of such a committee. However, even without being part of a committee

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300 W. Trower, A. Goodison, M. Abraham, A. Shaw, Corporate Administrations and Rescue Procedures (Bloomsbury Professional Ltd 2017) 73.
301 Insolvency Act 1986, section 246ZF(3), (4) and (6).
302 Insolvency Act 1986, section 246ZF(5)(a); W. Trower, A. Goodison, M. Abraham and A. Shaw, Corporate Administrations and Rescue Procedures (Bloomsbury 2017) 71.
303 Insolvency Act 1986, section 246ZF(5)(b).
304 Ibid (n 240) 71.
306 Insolvency Rules 2016, r.15.7; W. Trower, A. Goodson, M. Abraham and A. Shaw, Corporate Administrations and Rescue Procedures (Bloomsbury 2017) 71.
and provided one has got the threshold of 10 per cent in value other unsecured creditors can still request and obtain the same information, although the committee represents these creditors so that they do not need to request additional information which should helpfully reduce the search and monitoring costs of those creditors who are not part of the committee whilst those part of the committee can spread their monitoring costs between them.

Next to these monitoring rights and the supervision of the court, the unsecured creditors also have got the right to hold the office-holder to account by trying to remove him (under certain conditions) and/or to institute proceedings against him or her for misfeasance and/or to lodge a complaint against him/her if he/she is underperforming.\(^{309}\)

b. Critique

However, despite all these insolvency rules seemingly providing a framework for good insolvency governance granting unsecureds a variety of supervisory, monitoring and accountability rights, in practice it is not as rosy in the garden as one might think.

First, there is a great lack of creditor participation. Liquidation committees are rarely formed and given the lack of interests of (unsecured) creditors in participating in the insolvency procedure one could quite correctly state that there is a certain “creditor apathy”.\(^{310}\) Although the legislator tried to improve the situation by making it possible for unsecured creditors to vote by proxy which is argued to make the procedure “more democratic”\(^{311}\) while also ensuring creditors’ meetings can be held electronically, virtually, via correspondence or through whatever form of meeting they agreed upon instead of only in person modernises the insolvency system and broadly opens up the possibilities for having a meeting.\(^{312}\)

However, office-holders are no longer required to hold a creditors’ meeting\(^{313}\) which leads to my second criticism. Pursuant to section 122 of the Small Business Enterprise and Employment Act 2015 and the Insolvency Rules 2016, the decision procedures follow the principle that a decision is made without a meeting being held, even if a decision of the creditors for certain actions of the office-holder is required. This is because creditors are “deemed” to have agreed

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\(^{313}\) Small Business Enterprise and Employment Act 2015, section 122.
with the decision the office-holder intends to take. Creditors will be notified by the office-holder of the actions he/she intends to pursue in the course of rescuing/liquidating the company and unless 10 per cent of the creditors by value, 10 percent of the creditors by number or ten creditors protest against the proposed decision the office-holder is, by law, allowed to infer that all the creditors have agreed. This is the “deemed consent procedure”.

However, given the apathy of unsecureds, abolishing the necessity of having a physical meeting does not seem to be able to encourage/incentivise unsecureds to start participating in the process. One can draw a comparison here with the annual general meetings of shareholders in a company before it becomes insolvent. Although private companies might not be required to hold AGMs, section 336 of the UK Companies Act 2006 does require that an AGM is held annually in a public company. The reason why the legislator has made the AGMs mandatory is because they are seen as a mechanism of “good corporate governance” as it gives the shareholders the opportunity to question the (actions of the) board of directors while directors have to provide an annual and directors’ report before the meeting and are somehow expected to interact during the meeting. Although some commentators have already described the AGM as mere symbolic just giving a rubber-stamp to the actions already undertaken (or in the process of being undertaken) by the directors, several authors have already emphasised the benefits and/or the importance of a face-to-face meeting. It is argued that only such a meeting will be able to function best as the accountees (the shareholders in this regard) will be able to see the body language, face expressions of the accountors (the directors of the company) while potentially having to have unpredictable questions. Based on this, one argues that the accountees can be more or less be reassured to the extent how the directors react and/or interact during such a face-to-face meeting. Consequently, even with (or perhaps because of) new/modern technologies, research continues to favour a face-to-face meeting in order to improve the quality of scrutinising directors’ behaviour. Turning back to the creditors’ meetings, one could easily argue that they would benefit as well from having face-to-face meetings.

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314 Insolvency Act 1986, section 246ZE(7).
320 Ibid.
meetings instead of these new “deemed consent procedures” which may arguably only lead to more apathy among unsecureds and which may, therefore, reduce their monitoring power and influence. Previously, a director had to turn up to meetings to give an account of the managing of the company which also gave an opportunity for creditors to ask him/her questions, however, at least creditors’ meetings could now be virtual. However, the opposite argument has been raised by both the Insolvency Service as well doctrinal scholars. The argument goes that holding a physical meeting may be costly and would not be worth it given the lack of engagement by creditors.\textsuperscript{321} Furthermore, the ability to use modern technologies to hold meetings is contended to increase the potential for unsecured creditor engagement as creditors would no longer have to give up time to travel to a creditors’ meeting which might be faraway for the unsecured.\textsuperscript{322} Nonetheless, other scholars, such as Fletcher are more cautious and argue that “it remains to be seen whether active participation by creditors and contributories will significantly increase in consequence of these innovations”\textsuperscript{323} and fears, as does this research, that, despite good intentions, the intended goal of the reforms (i.e. more creditor engagement) may lead to the exact opposite (i.e. less engagement) due to the ‘invisibility’ of the decision-making procedure and thus the growing distance between the debtor, the creditors and other stakeholders.\textsuperscript{324}

Furthermore, although compliance with the “rule of 10” is needed for objecting might seem rather low at first instance, in practice this is quite high, especially for smaller creditors (such as consumers) who might individuually have only got a small claim of 1 per cent (or not even 1 per cent) in value of the total debt but collectively there could reach well above the required 10 per cent.\textsuperscript{325} However, how do these unsecureds know that collectively they might have the possibility to object if there are no meetings held in the first place and office-holders only inform the creditors vis-à-vis their own individual claim? As set out below, one of the benefits a class of creditors provides for them is the ability to strengthen their monitoring capacities by diversifying the work and the costs of doing so. However, if they are not aware of the existence other creditors being in the same ‘boat’, it obviously becomes quite difficult to act and cooperate within the faction of unsecured creditors in which one might find him-/herself. Although it might

\begin{footnotesize}
\textsuperscript{322} S. Morgan, ‘Decision making in insolvency procedures: practical aspects of implementing the changes made by the Insolvency (England and Wales) Rules 2016’ \textit{[2017]} \textit{30(2) Insolvency Intelligence 17, 22}; F. De Leo, \textit{Schuldeiser en behoorlijk insolventiebestuur} (Inter sentia 2021) 637-638 (translated: F. De Leo, \textit{Creditor and good insolvency governance} (Inter sentia 2021) 637-638).
\textsuperscript{323} I. Fletcher, “Out of sight, out of mind”? The progressive dematerialisation of our insolvency procedures’ \textit{[2017]} \textit{30(5) Insolvency Intelligence 81, 84-85}.
\textsuperscript{324} Ibid 85.
\textsuperscript{325} The analogy with corporate governance is small shareholders in solvent companies being able to requisition meetings – cf. Companies Act 2006, s.303(2)(a).
\end{footnotesize}
accelerate the work of the office-holder (and might be seen as enhancing efficiency)\textsuperscript{326}, the abolition of creditors’ meetings seems to increase the already existing information-asymmetry between creditors whilst only deteriorating their interest in participating in the rescue or winding-up process. It might also make it rather unlikely that they will be able to build coalitions (if necessary).

Two other issues affecting (and arguably worsening) the position of unsecureds, and in particular negatively affecting their monitoring and controlling behaviour/capability are the fixed amount of the claims they have got alongside the lack of any (significant) market control which affects their claim and/or the performance of the insolvent company. This market-related governance-mechanism which exists at corporate governance and which may encourage positive managerial behaviour (in the interests of the company for the benefit of the shareholders) is of no importance once the company is insolvent.\textsuperscript{327} Compared with corporate governance, markets are argued to provide a significant tool for a better managerial performance as long as a company does not become financially distressed. Although the labour market and product market are quite relevant at that stage as well, from the perspective of the shareholders both the capital markets and the market for corporate control seem to be the most important. This is because the capital markets are perceived to be a good indicator how well a company performs and it is argued that the better the performance is, the higher the share prices will be. Furthermore, if a company performs well, one infers that it is unlikely that – following the logics of the market for corporate control\textsuperscript{328} – a company would get taken over by a competitor. This strengthened control as the (performance of the) board hinges on the idea that shareholders and investors have got sufficient information. However, contrary to unsecured creditors, shareholders/investors have got an incentive / a greater incentive to control the work undertaken by the managers. This is because shareholders do not have a fixed (but residual) claim on the company alongside the fact that the actions of the markets may lead to an increase or decrease in the value of their shares which should stimulate their monitoring behaviour\textsuperscript{329}. This is probably even so despite the fact that also shareholders are confronted with some drawbacks as one can also question to what extent shareholders or investors will have got sufficient information to determine whether managers perform appropriately\textsuperscript{330} and also markets

\textsuperscript{326} For a detailed discussion of efficiency and its meaning, see chapters 6 and 7.
\textsuperscript{327} Cf. infra pg. 71-72.
are argued to have shortcomings which impact their efficiency and to assist shareholders in their monitoring.\textsuperscript{331}

As a result, research undertaken by US scholars show that markets and the benefits shareholders/investors could gain from increased share prices have led to a more active engagement by shareholders.\textsuperscript{332} The rationale behind this is clear: self-interest of the shareholder/investor. This activism is shown through a variety of ways, such as voting in favour of resolutions of shareholders, asking more questions or articulating opinions to directors or seeking more involvement in continuous board control\textsuperscript{333}. Also, and particularly in the UK, there is a great number of examples showing that shareholders rebel quite a lot about the remuneration of directors in AGMs.\textsuperscript{334} However, and without addressing the potential pitfalls shareholder or investor involvement might have on directors\textsuperscript{335}, a similar situation does and cannot occur for unsecured creditors although they are arguably the “residual claimants” once a company becomes financially distressed. The reason behind this can be found in the fact that, even if they become the residual claimants as soon as the company becomes financially insolvent, the maximum amount each unsecured creditor could get is the full amount of their initial claim which immediately puts a cap on all their claims (which especially for consumers or small trade creditors might be a very low cap). Furthermore, the markets are not particularly interested anymore in a company which is insolvent (unless to the extent one could buy products or goods of the insolvent company for a decreased price). In some limited cases, raiders might, however, see a benefit in taking such a company (e.g. House of Fraser) or banks might be willing to provide restructuring capital if they see benefits. In addition, whilst managers might still be affected by the market for corporate control and capital markets, office-holders are not in the same position as directors. This is because office-holders (in contrast to directors/managers) are often hired with an eye on their repeat player status\textsuperscript{336} and with a predetermined and specific goal. For example, a liquidator will be appointed to liquidate the company whereas an administrator will try to achieve one of the three purposes set out in the

\textsuperscript{331} A.R. Keay, \textit{Board Accountability in Corporate Governance} (Routledge 2015) 235.


\textsuperscript{333} Ibid 9-10.


\textsuperscript{335} For example, short-termism, excessive risk-behaviour, lowering the performance to satisfy the demands of shareholders/investors…

\textsuperscript{336} This is often based upon pre-appointment discussions with significant (often secured) creditors such as banks. S. Paterson, ‘Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards’ (2014) 14(2) JCLS 333, 359-360.
Insolvency Act 1986. This leads to two conclusions with regard to unsecured creditors: on the one hand, it is clear that, due to the office-holders’ specifically described role and, often, an eye on their repeat status, they would not be subject to similar market mechanisms (such as the market for corporate control) in contrast to directors. Secondly, unsecureds may not have similar incentives (as shareholders) to control the performance of the incumbent management given their fixed claims. This is important for it limits, at least to some extent, the governance power that unsecureds possess themselves or that they can rely upon.

The latter issue of unsecureds potentially having fewer incentives to monitor the management of the company due to their fixed (instead of residual) claim is exacerbated by a potential free-ride problem which unsecureds may get confronted with. This free-rider problems occurs in terms of monitoring/controlling the management which, similar to problems at shareholder level prior to the onset of insolvency of a company, would both reduce the controlling capacity of the unsecured creditors and their willingness to monitor the directors’ behaviour. A free-rider problem can economically be described as a market failure where some players, known as rational actors, take advantage of the work of others. When a company becomes insolvent, such a free-rider problem occurs when unsecured creditors, especially those with a (relatively) small claim such as consumers or small trade creditors, rely on other unsecured creditors to do the monitoring and controlling due to the fact that the costs for an unsecured creditor individually would outweigh the gains he might get. For example, a consumer with a claim of £500 is unlikely to be willing to closely monitor the performance of the incumbent management as the costs this would involve (such as monitoring costs, contacts with professional advisors (lawyers, accountants etc.)) would quickly outweigh the (rather small) individual benefits he would gain from closely controlling the management of the company whereas other unsecured creditors would likely have a windfall (if the managerial performance would improve thanks to the monitoring of this creditor) without having to bear any costs at all. However, the more unsecured creditors that aim to rely on other creditors for the monitoring, the more likely that there would not be any monitoring of the management of the insolvent company at all by the unsecured creditors as everyone would believe that the monitoring would be done by someone else within the group although in reality no control might be exercised as a result of all unsecured creditors believing that someone else will do the monitoring. Furthermore, there might also be a risk that

337 For administration: see: Insolvency Act 1986, Schedule B1 paragraph 3(1); For a winding-up by court: see: Insolvency Act 1986, section 143(1).
338 By this I mean that, in contrast to shareholders who could be encouraged to be more engaged as a result of the mechanisms of the capital market or the market for corporate control, no such mechanisms apply to unsecureds and, hence, there is even less ‘encouragement’ for them due to a lack of markets stimulating creditors’ activism. For more on shareholders’ and unsecured creditors’ activism, see chapter 8.
some unsecured creditors monitor manager/action X and others might monitor manager/action Z. In the meantime, one might risk forgetting to control manager/action Y which is a the “falling through the cracks”-risk.

The only way when unsecureds would seem to be willing to engage in the controlling process would be when their claim would be high enough and/or when they have got sufficient financial resources themselves to pay these monitoring costs. One of the most likely unsecureds falling in this category would be the HMRC in the UK. However, taking into consideration some recent empirical research undertaken by the R3, the Association of Business Recovery Professionals, with regard to unsecured creditor engagement during CVAs, one only gets mixed answers as to whether HMRC does engage in monitoring.\textsuperscript{340} Despite the fact that HMRC has been reported to have declined to be interviewed for the purposes of the research, some insolvency practitioners considered HMRC to be more passive, late and/or merely using an ever-returning pattern of voting against CVAs unless the HMRC was to get a 100% dividend.\textsuperscript{341} However, others, making up 55 percent of the insolvency practitioners who participated in this empirical research responded that the HMRC was the most engaged creditor.\textsuperscript{342} Nonetheless, insolvency practitioners argued that, if HMRC engages, it merely uses “a formulaic template with standard amendments of the proposal” which was not considered to be very helpful especially in cases where the CVA was quite complicated.\textsuperscript{343} Next to the HMRC, trade creditors, secured creditors (who might be unsecured for the remainder of the debt which could not be paid off after the realisation of the secured assets), and landlords come next in terms of engagement in the CVA process according to the R3 report.\textsuperscript{344}

Although these conclusions could not necessarily be generalised throughout all the insolvency procedures (given the differences between them all), the empirical results seem to be in line with our expectations set out above, namely that the likelihood of control undertaken by unsecured creditors increases with the financial resources and information the creditor has got at her disposal which, as the examples above showed, is largely similar for all the unsecured creditors within the faction in which they could be categorised. It, however, does not provide an appropriate answer to the free-rider problem and the unwillingness of unsecured creditors, especially of certain factions within the group of unsecured creditors, to monitor the behaviour of either the incumbent management or the office-holder.

\textsuperscript{341} Ibid 64.
\textsuperscript{342} Ibid 53.
\textsuperscript{343} Ibid 64.
\textsuperscript{344} Ibid 53.
The latter point becomes even more pressing if one considers the fact that, as opposed to shareholders controlling the board, insolvency practitioners are highly skilled professionals with, it is logically assumed, a good knowledge of the insolvency rules which, next to all the financial information they have got about the insolvent company, will only increase the already existing information asymmetry between them and the unsecured creditors (who have had to face the consequences of the abolition of creditors' meetings\(^\text{345}\)). However, the issue of information asymmetry has to a certain extent been mitigated in several ways. Namely, through the ability granted to unsecured creditors to request, if certain requirements are met, more information or the convening of a meeting and, as will be described below, the guidelines stated in the ethics code to which insolvency practitioners need to adhere, the *ex post* control exercised by the courts and the accountability measures creditors can rely upon in respect of office-holders. Nonetheless, also these mitigating factors all contain their own pitfalls as set out below.\(^\text{346}\)

In conclusion, one can state that despite some voting rights given to unsecured creditors, the current drawbacks with regard to the monitoring power unsecured creditors can exercise, the pitfalls are likely to outweigh the benefits their voting rights could give them. Although, individually, unsecured creditors would be the first ones to financially benefit from good insolvency governance, collectively, the weaker factions of unsecured creditors are currently not sufficiently/adequately stimulated to monitor/control the behaviour of the person(s) who are managing the insolvent company as a group. As a result, each individual creditor is expected to only make his own individual cost-benefit analysis although from a collective point of view (which creates the possibility of diversifying the costs among all members of the particular class) the benefits might (or could) outweigh the costs they would have to bear individually.

iii) **Accountability of office-holders**

Next to the scrutinising/monitoring power of the unsecureds, the measures they have got at their disposal to hold the office-holder to account are quite important as they could give them some additional power to sanction the office-holder if she fails to act in the best interests of the

\(^{345}\) Nonetheless, as determined above, it already been contended that the introduction of new voting methods (i.e. through electronic voting etc..) may contribute to enhancing creditor engagement for creditors would no longer have to travel a physical meeting which could be very faraway. Also, holding a physical meeting was deemed worthless given the lack of engagement of creditors. See: The Insolvency Service, *Impact Assessment: Changes to the law governing insolvency proceedings* [26 February 2015] 15 at [52] available at [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/418432/IA_insolvency_processes_final.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/418432/IA_insolvency_processes_final.pdf) (last checked: 12\(^\text{th}\) of December 2021); S.Morgan, ‘Decision making in insolvency procedures: practical aspects of implementing the changes made by the Insolvency (England and Wales) Rules 2016’ [2017] 30(2) Insolvency Intelligence 17, 22. Other scholars, including this research, such as Fletcher remain, however, more cautious. Cf. I. Fletcher, “Out of sight, out of mind”? The progressive dematerialisation of our insolvency procedures’ [2017] 30(5) Insolvency Intelligence 81, 84-85.

\(^{346}\) We will elaborate on this particular issue of accountability in next paragraph and chapters 6 and 7.
insolvent company (where the unsecured creditors are at this point the residual owners (instead of the shareholders)).\textsuperscript{347}

One of the first mechanisms for the unsecured creditors is their right to remove or request to remove the liquidator. There are two legal ways unsecured creditors can use to get the office-holder removed which is either through a majority vote in a decision procedure if 25 percent of the unsecured creditors request such a procedure\textsuperscript{348} or through the filing of an application to the court\textsuperscript{349}. Although a decision procedure requested by 25 per cent might seem fairly achievable, in practice this might still be a difficult threshold to get, especially if one takes the arguments made above into account with regard to the creditors’ apathy and the free-rider problem. If no decision has been made, courts will have to decide where creditors make an application to the court.

However, similar to the business judgment rule alluded to above (cf. supra 3.2.), courts will not easily remove an office-holder just because a creditor (or perhaps the court as well) disagrees with the actions of the office-holder\textsuperscript{350}. Again, courts will examine whether the office-holder can be presumed to act objectively and impartially for the benefit of the whole group of unsecured creditors\textsuperscript{351}. However, although courts also take into account the interests of specific creditors who might be affected by certain decisions taken by the office-holder, one could argue that taking into consideration the interests of the whole group of unsecured creditors could alleviate the possibility of removing an office-holder, such as a liquidator, as an individual creditor does not have to prove or show any individual grievance against the office-holder\textsuperscript{352}. Nonetheless, one could also argue that this might increase the risk-aversion of the office-holders as they could get removed if creditors lose faith in him/her (even without having done anything wrong)\textsuperscript{353}, although the knowledge that the ability to get an office-holder removed (ex post) is not a mere theoretical but a serious weapon which can be used by the creditors could be considered to be an important means to improve his performance (ex ante). However, this issue could be exacerbated by certain unsecured creditors who might want that the office-holder takes (significant) risks believing that this could lead to or maximise their recovery, especially because they might not have anything\textsuperscript{354} (or much) to lose in certain insolvencies. This might also be a problem in the twilight zone where the management has to start acting in the interests of the

\textsuperscript{347} Cf. infra chapter 8 for a more elaborate discussion including suggested improvements.

\textsuperscript{348} Insolvency Rules 2017, rule 15.18(4).

\textsuperscript{349} Insolvency Act 1986, section 108.

\textsuperscript{350} Re Shruth Ltd [2005] EWHC 1293 (Ch).


\textsuperscript{352} Re Rubber and Produce Investment Trusts [1915] 1 Ch 382.

\textsuperscript{353} Re Edennote Ltd [1996] BCC 718; [2002] EWHC 1899 (Ch).

\textsuperscript{354} In a worst-case scenario where the company would not have any assets anymore.
company for the benefit of the unsecured creditors. Clearly, this would be a double-edged sword as the office-holder or the incumbent management might want to avoid taking risks whereas the unsecureds would perhaps only be satisfied if he would take risks in which case the position of the office-holder could be brought into jeopardy is unsecured creditors would be disgruntled by the office-holder failing to take the risks they would want him to take.

However, if no decision procedure can be held, filing an application to court as a creditor will be costly and, especially if one has got a small claim, the costs could easily outweigh the benefits of the claim. Furthermore, procedures are also uncertain and it is quite likely that courts will not overturn an office-holder’s decision.\(^{355}\) Removing the office-holder\(^{356}\) is even more difficult to achieve as case-law shows courts are very reluctant to do so.\(^{357}\) Moreover, given the apathy of the unsecured creditors and often their lack of sufficient information, interest and/or understanding of the insolvency procedure, one can still question to what extent especially the more vulnerable factions of unsecured creditors might actually use these procedures in an attempt to remove the office-holder. Nonetheless, following an application by a *secured* creditor\(^{358}\), the court, in *Clydesdale*\(^{359}\), the court did remove an administrator because, according to the court, the office-holder had fallen short by failing to act in the interests of the secured creditor. In this case, this was because the pre-pack administrator had been so closely involved with the debtor in concluding the pre-pack arrangement that it was held that the administrator could no longer independently review the strength/weakness of the pre-pack contract which justified his removal.

Next to the possibility of removing the office-holder, the unsecureds also have got misfeasance procedures at their disposal in order to hold the office-holder accountable for (alleged) wrongdoings during their “management” of the insolvent company. In the case *Re Centralcrest Engineering Ltd*\(^{360}\) the applicant-creditor was successful in proving that the liquidator/defendant should have terminated trading while also not having requested permission from the court to continue trading. Both issues led the court to the decision that the liquidator was liable for misfeasance. However, courts have got a discretionary power with regard to the amount of damages/compensation they award, and they might limit the compensation or apportion a certain amount of liability amongst one or more office-holders. If it does not harm the interests

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355 *Brake and others v Lowes and others* [2020] EWCA Civ 1491.
357 *Hobbs v Gibson* [2010] EWHC 3676 (Ch); *Re Shruth Ltd* [2005] EWHC 1293 (Ch); *Re Edennote Ltd* [1996] 2 BCLC 389 at 398.
358 Of course, a secured creditor, in contrast to unsecured creditors, would benefit from a higher ranking in the distribution chain, may have bigger claims and might be more financially able (and knowledgeable) to monitor the debtor (and office-holder) and, thus, more likely to initiate a (successful) claim.
359 *Clydesdale Financial Services Ltd v Smailes* [2009] EWHC 1745 (Ch).
360 *Re Centralcrest Engineering Ltd* [2000] BCC 727.
of creditors, it is submitted that courts might also grant relief to the office-holder pursuant to section 1157 of the UK Companies Act 2006. As already said above, an application for compensation from an office-holder might be quite difficult to prove, requires the applicant to have sufficient evidence which might cost some time and effort to gather (i.e. ‘controlling costs’) and does not guarantee that the courts will hold the office-holder liable. The corporate practice shows that courts are not readily inclined to either remove or hold an office-holder accountable. Neither do creditors seem interested in initiating a case against an office-holder given the quite low number of available cases in this regard.

In addition to these removal and misfeasance procedures, there is also some control/oversight by recognised professional bodies. For office-holders, this control is exercised by recognised professional bodies under ‘supervision’ of the Insolvency Service and the Secretary of State. Without going into too much detail (as this will be dealt with extensively in chapter 8), it should be emphasised that one initiative found that there was a great lack of confidence amongst creditors, particularly unsecureds, about the existing complaints processes which was shared by many insolvency practitioners. As a result, the UK government sought to improve the regulatory system through the creation of common penalties/sanctions for insolvency practitioners if a complaint against them was upheld.

361 Re Powertrain Ltd (in liq) [2015] EWHC 3998.
362 Brake and others v Lowes and others [2020] EWCA Civ 1491; Hobbs v Gibson [2010] EWHC 3676 (Ch); Re Shruth Ltd [2005] EWHC 1293 (Ch); Re Edennote Ltd [1996] 2 BCLC 389 at 398.
363 Insolvency Service, Consultation on strengthening the regulatory regime and fee structure for insolvency practitioners (2014) 12 at para. 49 available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/280880/Strengthening_the_regulatory_regime_and_fee_structure_for_insolvency_practitioners.pdf (last accessed the 13th of December 2021); The Office of Fair Trading, ‘The Market for Corporate Insolvency Practitioners: A Market Study’ (June 2010) at [1.13]-[1.15] available at https://webarchive.nationalarchives.gov.uk/20140402172033/http://oft.gov.uk/shared_ofi/reports/Insolvency/oft1245; See also: J. Wood, ‘Review of the regulatory system: how effective has the Complaints Gateway been?’ [2017] 30(7) Insolvency Intelligence 106 documenting how many complaints have been filed against insolvency practitioners for each insolvency procedure which indicates a relatively low number of complaints filed by creditors at the Complaints Gateway of the Insolvency Service. Anecdotally, the number of cases against office-holder has risen recently (albeit that the applicants are not only creditors but also shareholders or other office-holders). See for some recent cases in that regard: PJSC Uralkali v Rowley [2020] EWHC 3442 (Ch); Brake and others v Lowes and others [2020] EWCA Civ 1491; Fraser Turner Ltd v PricewaterhouseCoopers LLP [2019] EWCA Civ 1290; Davis v Money [2018] EWHC 766 (Ch); Brewer v Iqbal [2019] EWHC 182 (Ch); Re One Blackfriars Ltd [2021] EWHC 684 (Ch); Goel v Grant [2017] EWHC 2688 (Ch); Lehman Bros Australia Ltd (in liquidation) v MacNamara [2020] EWCA Civ 321.
Three years before, in 2011, some suggestions were made to set-up an independent complaints body in order to improve the oversight of the insolvency practitioners. However, such an independent body never became established. Instead, new powers were given to the Secretary of State and greater external control by the Insolvency Service was guaranteed. Whether much change has been achieved is debatable though as the complaints procedures and the control exercised by the Insolvency Service and Secretary of State are dependent on their view whether the insolvency practitioner/office-holder has acted in accordance with the professional standards as set out in the insolvency practitioners ethics code, SIP16 and the provisions in sections 391B-C of the Insolvency Act 1986. The problem with these provisions is their wide and open character lacking specificity. Furthermore, R3, the association of business recovery professionals, already warned that setting out objectives for insolvency practitioners might be at odds with current insolvency legislation which has to be applied by the insolvency practitioners while governing the insolvent company. Interestingly, R3 gave the example of specific objectives to protect specific vulnerable classes of unsecured creditors (as had been suggested) which would contravene the duty of the office-holder to act in the interests of the creditors as a whole (instead of focusing on individual creditors or specific vulnerable classes of unsecured creditors). As a result, neither in the objectives nor in the Insolvency Act 1986 has been made notice of specific protection for more vulnerable unsecured creditors or specific classes. Although it is understandable that objectives insolvency practitioners have to follow should not contravene the legislation, they have to apply in order to govern the insolvent company, it would still have been laudable if one would have at least suggested the need for an examination whether a better protection of vulnerable creditors might be necessary. The objectives might need to be in line with the insolvency legislation, the insolvency legislation can be reformed if deemed necessary.

Nonetheless, given the various pitfalls that exist as regards both the claw-back and liability procedures but also the many concerns as regards the unsecureds’ ability to monitor the managerial behaviour of the incumbent management of the (insolvent) company (such as, in

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368 Ibid 166.
369 R3, Response to the Consultation on Reforms to the Regulation of Insolvency Practitioners (R3 2011), 11 available at https://www.r3.org.uk/media/documents/policy/consultation_subs/R3_response_to_regulation_consultation_06.05.11.pdf.
particular, their apathy), the question arises whether relying on private enforcement measures would (or could) suffice. In this regard, it has been contended that public enforcement measures may be useful\(^{372}\) for a number of reasons (such as e.g. the ability to enhance accountability and creditor protection) which will be elaborated on extensively in chapter 8. Public enforcement would entail that a public regulator (such as e.g. the Australian Securities and Investments Commission (“ASIC”) in Australia\(^ {373}\)) would be entitled (i) to monitor the management of a company and, if deemed necessary and in the public’s interests, (ii) to take action against the director(s) of the company. Having a public enforcement regime operating in conjunction with private enforcement would, as this research will argue in chapter 8, allow to fill the gaps or pitfalls that continue to exist in relation to private enforcement measures. In this regard, public enforcement measures can be initiated against directors of both private and public companies in Australia\(^ {374}\) and have already been introduced in the UK too as regards office-holders (and to a rather limited extent against directors via disqualification procedures\(^ {375}\)).

V. Conclusion
To conclude, one can state that there is a great variety of procedures which have the aim to improve the position of unsecured creditors both during corporate rescue, restructuring or liquidation procedures.

Many procedures are designed to swell the asset pool (such as the claw-back and recovery procedures) where the office-holder can either try to get certain assets back which had been given away or sold by the company at a moment when it was in financial difficulties and/or it can try to hold the former management accountable through various liability procedures (such as wrongful trading, fraudulent trading).

Nonetheless, in spite of some improvements after the Small Business Enterprise and Employment Act 2015, significant drawbacks as regards the procedures continue to exist which reduce the chances of a successful outcome of such procedures. These difficulties are both on a procedural and substantive level and, without being exhaustive, relate to the often onerous onus of proof, time-limits, funding problems, courts utilising the business judgment rule (avoiding hindsight bias) etc…

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\(^{373}\) Australian Securities and Investments Commission Act 2001, part 3 (on the investigations and actions ASIC may take in case of non-compliance by e.g. the directors of a company).


\(^{375}\) Company Directors Disqualification Act 1986, section 7(1) (application for the making of a disqualification order) and 15A (compensation order).
In addition to these procedures, many procedures are designed to give unsecureds monitoring power so that they can control whether the office-holders have been governing the company in a way which is conducive to the interests of the creditors. Although creditors are rather powerless as regards monitoring the incumbent management of the debtor-company, several monitoring rights have been granted to creditors which they can employ to monitor the office-holders’ performance. The procedures creditors have got at their disposal include the ability to request more information from the office-holder, to requisition a creditors’ meeting, to remove the office-holder and hold her to account through a misfeasance procedure.

However, although these procedures are important for they intend to incentivise good insolvency governance by the office-holder which ought to maximise the unsecureds’ chances of getting repaid, many drawbacks have been elaborated on with regard to all these options currently available. Pitfalls include the lack of engagement by creditors, relatively high thresholds that ought to be met, recent changes to insolvency meetings making creditors probably even more apathetic, the courts’ significant reluctance to overturn an office-holder’s decision and/or to hold office-holders to account etc. As a result of these difficulties, the goal of these procedures (to improve the creditors’ interests) is considerably weakened which is something from which the whole group of unsecured creditors will suffer (including the weaker factions). And although several RPBs also monitor the office-holders’ performance under the supervision of the Insolvency Service and the Secretary of State, not many complaints have been made by creditors in the past, empirical results indicated a lack of confidence of creditors and the SIP16 guidelines tend to be incredibly vague making it difficult to hold office-holders to account (i.e. absent any specific rules/duties). Given the existing pitfalls in relation to private enforcement, chapter 8 will critically examine whether public enforcement may be useful to complement (and fill the gaps left by) private enforcement.

Nonetheless, one of the primary concerns is the fact that the majority of the insolvency rules and regulations are primarily designed for the whole group of either creditors or unsecureds (as one broad sub-faction within the group of creditors). This is, however, not necessarily in line with the variety of diverging and different interests between these creditors as also unsecureds might have conflicts of interest within their group which is something the next chapter will critically examine in a more detailed manner. This chapter which elaborated on the contemporary rights of unsecureds alongside the previous chapter which showed the existence of different factions of unsecureds therefore laid the regulatory foundation for the following chapter which will critically investigate the potentially existing conflicts of interest among unsecureds and, more in particular, the determination of unsecureds’ vulnerability.
Chapter V

Insolvency Governance Rights with regard to factions of unsecured creditors

I. Introduction

After having illustrated the existence of different factions of unsecureds in chapter 3 and having discussed the contemporary rights and their drawbacks for the entire group of unsecureds, this research showed that unsecureds and especially the vulnerable factions of unsecureds are certainly not in an enviable position. In examining this, chapters 3 and 4 paved the way to be able to focus on the contemporary rights of factions of non-controlling unsecureds and the implications for them now.

However, critically examining the specific position of non-controlling unsecureds will require me to start first with an analysis as to what can be understood as the (non-)controlling position. This research will examine the factors that could determine whether an unsecured is controlling or non-controlling.

This determination of the (non-)controlling position is critical for there might exist potential private benefits of control for those unsecured creditors that are in a controlling position. Clearly, this discussion which is given very scant attention in insolvency law emanates from similar discussions which have been extensively examined within corporate governance.

Knowing when an unsecured is in a (non-)controlling position and, thus, being able to ascertain whether the controlling unsecureds enjoy private benefits of control will lead to discussion as to whether or not there might be conflicts of interests between factions of unsecureds. This research will hereby critically examine situations that could either be exploitative and/or inefficient in respect of certain weaker factions of unsecureds. After having done so, this chapter will critically analyse which regulatory procedures disenfranchised factions of creditors currently already have at their disposal.

The analysis in this chapter is crucial to be able to appreciate the difficult position the weaker/non-controlling factions of unsecureds could find themselves in addition to the risks which they are already subject to by the mere fact of being part of the group of unsecureds (which chapter 4 examined). In doing so, this chapter will show the current challenges for these vulnerable factions of unsecureds and the drawbacks/pitfalls of the current regulatory framework. It will lay the foundations for the next chapters which will seek to propose improvements to the insolvency framework for vulnerable creditors.
II. Determination of the (non-)controlling character

2.1. Relevance of the question

Building further on this research’s analysis that various factions of unsecureds exist, it is crucial to critically assess whether certain factions may be more or less vulnerable. This is important to be able to envisage which unsecureds may be more at risk of e.g. bad governance practices (such as e.g. opportunism by directors/office-holders and/or exploitative behaviour by controlling unsecureds) and thus to determine which factions of unsecureds may need additional protection. In assessing this the (non-)controlling character of unsecureds becomes critical. As regards the determination of control, in corporate governance control has been defined by Pacces as the ability to “exercise real authority” in the decision-making of the financially insolvent company.\(^{376}\) This research will utilise the same definition for such a description of control goes beyond merely determining shareholders’ control based on the number of shares and voting power shareholders have got.\(^{377}\) This is important because shareholders who are in a minority position voting-wise\(^{378}\) may, nonetheless, still be able to influence the decision-making process of the company and they would thus be in a controlling position. On the other hand, shareholders benefitting from a majority position voting-wise may, on occasions still be ‘blocked’ by minority shareholders in which cases they would not be in a ‘controlling’ position. Hence the reason why this research believes that a concrete/practical (rather than a mere abstract) approach should be employed as regards the determination of control (see below part 2.2 and 2.3 of this chapter).

In insolvency governance, unsecureds are in a similar position to shareholders.\(^{379}\) Subsequently, although voting power remains a critical factor, solely determining unsecured creditors’ control based on their voting power or, in other words, the stake/percentage which the unsecured creditor’s claim would represent in the insolvent estate would, arguably, be misguided as well.\(^{380}\) This is why the literature has tried to envisage certain additional factors that could determine unsecureds’ vulnerability or, as this research states, ‘non-controlling’ position. These factors are *inter alia* the lack of financial resources, weak bargaining power and/or the lack of legal knowledge which negatively affects unsecureds. These factors which have already been considered in the literature are described as ‘traditional’ or ‘abstract’ factors.

\(^{376}\) A.M. Pacces, *Rethinking Corporate Governance: The Law and Economics of Control Powers* (Routledge 2012) 28; A similar definition has been provided in Competition Law whereby control is defined as “*rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking*”. Cf. Council Regulation (EC) 139/2004 of 20 January 2004 on the control of concentrations between undertakings, article 3 2.(b).


\(^{378}\) In principle, this is those shareholders who own less than 50% of the shares in the company.

\(^{379}\) Cf. *supra*, chapter 1.

\(^{380}\) This will be elaborated on below in part 2.2.1.
in this research as these arguments are the common arguments put forward to determine an unsecured’s vulnerable position. Nonetheless, although these factors provide good insight into which unsecureds could be more vulnerable, they do not sufficiently appreciate the practical circumstances and legal possibilities to which these vulnerable factions of unsecureds are subject. These traditional factors are therefore merely indicative of the unsecureds’ non-controlling position. Subsequently, additional more practical or concrete factors should be taken into account when determining whether the unsecured is actually non-controlling or not. These concrete factors will be described below.

2.2. Abstract/general factors

2.2.1. Voting power

As indicated above, voting power is an important factor when assessing creditors’ ‘control’. The amount of voting rights unsecureds have got in their debtor’s insolvent estate is determined in accordance with the value of their claim vis-à-vis the other unsecureds. The higher the stake of their claim in the insolvent estate, the more powerful the unsecured would be.

Having the majority of the voting rights as an unsecured, which is akin to what may occur in a ‘concentrated ‘ownership’ type company in corporate governance or obtaining the majority through the formation of a coalition of unsecureds in one strategic block, could be seen as gaining control.

However, as indicated above, control is not only a question of voting rights. Although having a majority of the voting power would certainly give benefits which might result in getting control over the insolvency procedure, what actually determines whether one has got control is the question to what extent one can “exercise real authority” in the decision-making of the financially insolvent company.

Consequently, even if an unsecured might be very large or if a group of unsecureds have been able to form a coalition block, they would only have control if they can determine or influence how the (insolvent) company is governed. To illustrate this further, the decision-making procedure must be analysed. The default rule regarding decisions in an insolvency procedure is that a “qualifying decision procedure” (IA 1986, s.246ZE) or “deemed consent procedure” (IA 1986, s.246ZF) must be employed. With the former, the office-holder should hold a meeting if at least 10 percent of the creditors in value requisition this meeting which ought to be held in accordance with Rule 15.3 of the Insolvency Rules setting out the prescribed procedures (e.g. correspondence, electronic voting) or if such a qualifying decision procedure is required by the

381 Insolvency Rules 2016, r.15.31(1).
Insolvency Act 1986 or the Insolvency Rules (such as e.g. for the remuneration of the office-holder\textsuperscript{383}, the extension of a standalone Moratorium\textsuperscript{384} or the voting on CVAs\textsuperscript{385}). With the latter deemed consent procedures, the office-holder is deemed to have the consent of all the creditors unless 10 percent of the creditors in value or 10 creditors or 10 percent by number of creditors\textsuperscript{386} want to convene a meeting (probably because they object to the proposals the office-holder has proposed). This “rule of 10” gives already some additional power to vulnerable factions of unsecureds but does not necessarily grant “control”. This is because, unsecureds with small claims might still need to form a coalition to reach the ‘10’ and, even, if one of the required thresholds has been reached, this only means that a “qualifying decision procedure”\textsuperscript{387} will be employed during which it will be questionable to what extent these “10 percenters” will be able to exercise “real authority”.

Conversely, a creditor with a very small claim (and expected to be non-controlling) could potentially still end up being in a position to influence the outcome of the insolvency procedure. For example, if the majority of the unsecureds are passive and disengaged (such as in the Farepak-case), an unsecured creditor with a minority of votes could influence the outcome of the insolvency procedure by, for example, hiding important information which could have benefited the other unsecureds or agreeing to management decisions of the office-holder deemed harmful to the other unsecureds but not to the creditor voting in favour of it.\textsuperscript{388} ‘Influence’ means that they could affect the decisions being made during the insolvency procedure (hereby potentially affecting the outcome of it). Equally and from a technical perspective, a person with a very small vote, say 0.2%, could also influence the outcome in certain situations, such as where a group has a 49.9% vote. This is because the vote of an unsecured creditor with just 0.2% could be decisive in determining whether a majority (of 50%+1) can or cannot be achieved.

2.2.2. Lack of information, knowledge, funds bargaining power, interest and nature of creditor’s claim

Other factors, next to voting power, which the current literature puts forward in order to determine the vulnerability of unsecureds are a (i) lack of information, (ii) lack of financial

\textsuperscript{383} Insolvency Act 1986, section 246ZF(2).
\textsuperscript{384} Insolvency Act 1986, section A12 (2). A qualifying decision procedure is also required to enable the pre-Moratorium creditors (of a debtor-company) to consent to an extension of a standalone Moratorium.
\textsuperscript{385} Insolvency Act 1986, section 3(3).
\textsuperscript{386} Insolvency Act 1986, section 246ZE(7).
\textsuperscript{387} W. Trower, A. Goodison, M. Abraham and A. Shaw, Corporate Administrations and Rescue Procedures (Bloomsbury 2017) 71.
\textsuperscript{388} This could for example be in cases where there is an hidden agreement between the debtor and one of the unsecureds such as in the Kapoor and Gertner case, although in these cases the ‘controlling’ unsecureds did have a majority of votes.
resources, (iii) lack of commercial/legal knowledge, (iv) lack of bargaining power and (v) lack of interest (because the claim is usually relatively small).\(^{389}\)

These factors are useful and give a good first impression of those who may be more vulnerable. In this regard, these factors are not seldom linked to the nature of the claim unsecureds have got (e.g. a consumer or employment claim) and are argued to justify further protection. The argument goes as follows: a consumer usually has not got much voting power whilst also often lacking the legal knowledge and financial means to be able to exercise control. Hence, the consumer is, arguably, more vulnerable and in need for further protection. A similar stance has been argued regarding tort creditors, small trade creditors, employees and other vulnerable unsecureds.\(^{390}\)

Although helpful, merely looking at these theoretical factors will not provide a totally accurate determination of unsecureds' vulnerability.

Some cases illustrate this. For example, in the *Mourant & Co Trustees Ltd* case\(^{391}\), it was the landlords who felt that they were placed in a disenfranchised position although almost no scholar would suggest that landlords ought to be considered to be part of the ‘more vulnerable’ group of unsecureds. Yet, although landlords may not be innately vulnerable, they were in a non-controlling position here and, arguably, more vulnerable vis-à-vis the other unsecureds because they were the only ones that would see their claim being reduced as part of the proposed CVA.\(^{392}\) Similarly, in the *Re A Debtor (No 101 of 1999)* case, it was the HMRC whose interests were harmed.\(^{393}\) Again, it seems unlikely (and perhaps even counterintuitive) that one would think of the government being in a (more) ‘vulnerable’ position. Yet again, it was the government (HMRC) whose position was put in jeopardy for it was in a non-controlling position. So, although one might not be seen as vulnerable per se, one can be non-controlling.

Therefore, focusing on the theoretical factors – lack of information, funds, knowledge, bargaining power and interest/power – could thus give an inaccurate view of those unsecureds who are more vulnerable. This is important from a regulatory perspective because inaccurately determining vulnerability risks creating a regulatory framework whereby certain unsecureds who are equally or more vulnerable than others risk not getting the appropriate protection.

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\(^{392}\) Ibid.

\(^{393}\) *Re A Debtor (No 101 of 1999)* [2001] 1 B.C.L.C. 54 Ch D.
Admittedly, although it would be impossible to *ex ante* determine every situation whereby an unsecured would be in a non-controlling position due to the different and fact-sensitive nature of every insolvency procedure and every insolvency estate, this research advocates that a more practical approach is necessary to be able to assess the unsecureds’ non-controlling position more accurately. There is a need to refrain from solely focusing on aforementioned theoretical factors and the nature of the unsecured creditor’s claim. This is because such general/abstract factors are merely indicative of the potential vulnerable/non-controlling position unsecureds can end up in but, as explained, they fail to appreciate the *actual* concrete circumstances and can thus not be conclusive as to the creditor’s *potential* vulnerability.

### 2.3. Practical factors.
As a result, there is, thus, a need for a second set of factors which look more into the practical/concrete circumstances of the case in which the unsecured is involved. These practical factors are as important as the more general/abstract factors and need to be assessed in combination with them in order to secure a better understanding of the unsecured’s controlling or non-controlling position.

As set out before, these more practical factors look at the *actual* situation and, more in particular, what the attitude/behaviour of unsecureds is during the insolvency procedure and will contribute to acquiring a more accurate assessment as to the potential vulnerability/non-controlling position of certain unsecureds.

Two important issues are particularly important when dealing with these practical factors. On the one hand, it should be established whether there is a disinterested majority which could make some unsecureds (although only having the minority of the votes) more powerful and on the other hand whether the unsecureds (although they may only have the minority of the votes) have joined forces and built a “coalition” to increase the power they have got (either building a majority or becoming a ‘controlling minority’).

For example: a consumer who might, based on the first set of general factors, be believed to be non-controlling could, when taking into account the practical/concrete circumstances of the case, actually be in a controlling position if she has joined forces with other consumers and built a coalition which could exercise more power/influence over the insolvency procedure. This could, for example, have happened in the *Farepak* case if all or most of the consumers would have formed a coalition. They could have used this controlling power to ask questions regarding the management of the previous directors to ascertain whether they had complied with their directors’ duties and, more in particular, whether insolvency claims should have been initiated against the former management. The pursuing of an insolvency claim (if there is a cause of
action) could swell the asset pool and would allow the unsecured to generate a higher divided.\textsuperscript{394} As set out in chapter 8, it should be required that directors inform the unsecured of their non-controlling position and the implications that that may have on them dependent on the insolvency procedure (if an insolvency procedure has commenced at all). For example, as part of CVAs/IVAs, non-controlling unsecureds who may be in a minority in terms of voting power could then still try to exercise their power to alter the CVA/IVA proposal suggested by the debtor. In doing so, unsecureds could ask the debtor to justify the decisions that were proposed by it (or its directors) to rescue the debtor-firm and, potentially, suggest alternative solutions that, according to the non-controlling unsecureds would be less harmful for their position without jeopardising the chances of rescue for the debtor. As explained in more detail in chapter 8, it is contended that it would be an act of good governance and that it would thus strengthen the position of non-controlling unsecureds if their non-controlling position and the options they have got at their disposal to make their voice heard would be disclosed to them, especially as this may contribute to enhancing their engagement with the insolvent debtor prior to or during the insolvency procedure. Furthermore, non-controlling unsecureds could exercise their power to question whether the office-holder’s remuneration is justified (and e.g. proportionate/in line with his/her performance).\textsuperscript{395} Considering this second set of practical factors (i.e. related to the unsecureds’ amount of votes, their coalition-building attitude and participation in the insolvency procedure) could, thus, help to determine more accurately who exactly is controlling and non-controlling (and, potentially, in need for further protection).

\textsuperscript{394} This also applies to administration procedures during which unsecureds could exercise their power to monitor the administrator and to press her to take action on behalf of the insolvent debtor against the former management if there appears to be a cause of action in the insolvent estate. This, of course, requires active engagement of the unsecured in order to obtain the relevant information in order to ascertain whether claw-back or recovery procedures can be commenced.

\textsuperscript{395} Insolvency Rules 2016, r.18.34(1), (2) setting out that in a compulsory or creditors’ voluntary winding-up, administration or bankruptcy procedure, the creditor – secured or not – has got the permission of the court or representing 10 percent in value of the creditors can object to the liquidator’s proposed remuneration if deemed excessive.
Both these more general and concrete factors will give guidance as to the expected and actual (non-)controlling position of the unsecured creditor and would be a useful guide for directors/office-holders to determine the non-controlling position of unsecureds but this guidance will also enable one to determine how one may improve the regulatory framework, especially given the somewhat difficult and fact-sensitive nature of the determination of the non-controlling position of unsecureds.396 This determination of the vulnerable character of unsecureds is critical for it aims to pave the way for the design of an insolvency framework which, to the extent possible, grants protection to those unsecureds who actually need it. Taking the approach of not merely being concerned with abstract/general factors, avoids creating a rule giving blanket protection to certain unsecureds whilst other equally vulnerable creditors may not receive similar protection.

The aforementioned analysis is significant and innovative as the current academic literature (and policy guidance) merely takes into account the more general factors (incl. the nature of a

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396 Cf. infra chapter 8 for the regulatory suggestions put forward to attempt to improve the regulatory position of the non-controlling unsecured and to attempt to get the non-controlling unsecureds more engaged/empowered so that they may be more able to have their voice heard and, in doing so, influence the decision-making process during (or perhaps even prior to) the insolvency procedure.
creditor’s claim) in order to determine vulnerability whilst this research argues that this only gives an indicative idea of the non-controlling (or vulnerable) position we can expect unsecureds to hold. However, in order to be clearer as to whether this vulnerability materialises in practice and in order to ascertain that unsecureds who initially might not have seemed (or expected) to be non-controlling can receive the required protection in case they are still non-controlling, the more concrete/practical circumstances determined above must also be taken into account. This is because these more concrete factors will be more conclusive (rather than merely indicative) in determining the actual (non-)controlling position of the unsecured rather than the potential position of creditors.

### 2.4. Private benefits of control?

#### 2.4.1. Notion

Being able to determine the non-controlling position is crucial because it illustrates the potentially difficult relationship these non-controlling unsecureds might have with controlling unsecureds, which law and economics scholars would describe as the ‘agency conflict’. Analogous to controlling shareholders who may get certain benefits for being in control of a solvent company, controlling unsecureds might also be able to gain certain benefits from their controlling position which might not be available to non-controlling unsecureds during the debtor’s insolvency.

Before looking into how such potential conflicts could materialise between controlling and non-controlling unsecureds, it is, however, deemed necessary to explain first what can be understood under the term “private benefits of control”. Since this has only been researched within corporate governance (and not yet in insolvency governance), this research will start from the definition given in corporate governance before tailoring this to the situation faced by unsecureds within insolvency governance. The analogies which can be drawn between corporate governance on the one hand and insolvency governance on the other hand is, as has been mentioned in the first chapter, part of my research contribution to the field.

In this regard, in corporate governance the notion of “private benefits of control” has been defined as “all kinds of benefits accruing exclusively to the corporate controller by means of his staying in charge of the company management”, which means that the controller stays in control of the management. Tailored to the insolvency context, it must be examined if controlling unsecureds (and perhaps others who might be in control of the insolvency procedure, such as the office-holders for example) are also recipients of certain benefits or “advantages” as a direct result of their controlling position while the non-controlling (factions of) unsecureds do not

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receive the same benefits which might put them at a disadvantage vis-à-vis the controlling unsecureds (or anyone who is in control of the insolvency procedure). The Kapoor-case below will be illustrative in this regard.

2.4.2. Kapoor-case

Having determined what can be understood by under "control" (or the lack of it) and when one is able to determine or influence the governance of the insolvent company, this research can move on to the next question: does this influence give private benefits of control? The *National Westminster Bank Plc v Kapoor*398 (which was still subject to the ‘old’ insolvency rules applicable, prior to the introduction of the new insolvency rules in 2017) will be examined first.

It is a good example to illustrate that some unsecureds might try to take control of the insolvency procedure, in this case at the expense of other unsecureds. The case deals with an individual voluntary agreement (IVA). The insolvent debtor, Kapoor, had got 4 creditors: the bank, Mr. Chouhen, the HMRC and Crosswoods (a company). This last creditor, Crosswoods, had a claim in excess of 50% in value of all the claims of the creditors but which would have been prevented from voting during the creditors’ meeting as it was an associate of Kapoor.399 However, in accordance with the instructions of Kapoor, Crosswoods assigned almost half of its debt (i.e. 4 million) to Chouhen in order to significantly reduce its share of voting power. Chouhen was guaranteed an amount of £43,840 in return for this assignment which was basically nothing more than an extra amount of money he would receive by making sure (via this assignment) that a majority could back the IVA (which seemed legally possible400). Both of them could now vote (given that Crosswoods did not have a majority anymore itself), and together, Crosswoods and Chouhen, held a majority in value. During the creditors’ meeting, both the bank and HMRC voted against the IVA while Chouhen and Crosswoods (who was allowed to vote by the chairman of the meeting) both voted in favour of the IVA. Consequently, the IVA got approved. Chouhen received more ‘dividends’ than he would have received without entering into this assignment with Crosswoods and Kapoor was able to use an enormous debt owed by an associate company to determine the outcome of the meeting which was designed to benefit Kapoor (the debtor). However, both the High Court and the Court of Appeal, on an appeal, ruled that the meeting was affected by a material irregularity as the assignment was only set up with the aim of circumventing the procedural rules which would have prevented Crosswoods from

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399 Insolvency Rules 2016, r.15.34 in conjunction with Insolvency Act 1986, section 435. At the time of the case it was Insolvency Rules 1986, r.5.23(4)(c). This rule can be found back now in Insolvency Rules 2016, r.15.34 in conjunction with Insolvency Act 1986, section 435. In this case, Crosswoods was considered an associate because the company Crosswoods was owned by a family trust, which could (and in fact did) lead to a conflict of interests between Crosswoods and the other unsecureds.
400 Without taking into account the existence of material irregularities as determined later.
Alternatively, the chairman should not have given the right to Chouhen to vote as an equitable assignee during the meeting. Absent the votes of Crosswoods and with Chouhen only being able to claim his own debts, there would not have been a majority for the IVA which is a completely different outcome than the one obtained now due to the structure set up by the debtor. In this case, the controlling block of unsecureds clearly exploited their controlling position to get a benefit at the expense of the other creditors who participated in the IVA. Interestingly, a majority only seemed to be obtainable by improper means.

### 2.4.3. Impact of control

However, there are not always negative consequences of an unsecured being in control for the other unsecureds who are not in control. On the contrary, control could potentially have a positive impact not only for the controlling (block of) unsecured creditor(s), but also for the wider group of unsecureds. The reasons for this are twofold. First, the controlling unsecureds might have more power to approve of plans and actions suggested by the office holder which could benefit the rescue of an insolvent company. Secondly, from a class-perspective these unsecureds are in a position to cooperate with each other which should enable them to diversify the tasks and costs within their group. For example, within a group of 100 consumers, some consumers could monitor the actions undertaken by the previous management, while others might want to monitor the actions of the office-holder. In the meantime, they could share all the costs amongst them which should ensure that the costs of control do not become too burdensome. The benefit of dealing with these issues within one group flows from the fact that the interests of the creditors within one group are assumed to be very similar so that by monitoring in their own self-interest, they might find information that could be useful for other members of their class who are technically ‘in the same boat’. Consequently, by being in control, the creditor could mitigate or perhaps even solve the coordination problems that exists among creditors during an insolvency procedure.

However, whether control would have an actual positive impact can be questioned for several reasons.

First, control undertaken by unsecureds, and in particular consumers, proves quite difficult to achieve in practice. To illustrate this, in the Farepak-case, there was an absolute majority of

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402 For the (potential) windfall obtained by unsecureds as a result of control exercised by secured creditors see: T.H. Jackson The Logic and the Limits of Bankruptcy Law (Beardbooks Washington D.C. 2001) 182; G. Triantis and R. Daniels, ‘The Role of Debt in Interactive Corporate Governance’ [1995] 83 California Law Review 1073, 1087. This, however, has been criticised by i.a. Finch and Milman: V. Finch and D. Milman, Corporate Insolvency Law (Cambridge University Press 2017) 81-87.
consumers which could have controlled the insolvency procedure but which did not control the procedure at all. The consumers had all prepaid a certain amount of money so that that they would be able to buy Christmas presents later on (with the money they had saved at Farepak). However, during the administration procedure of Farepak, the consumers were only able to recover 50 pence in the pound of their debt which was largely thanks to money provided by compensation funds (and not as a result of assets available from the debtor itself). Strikingly in this case was that consumers – despite being in the absolute majority – failed to control and monitor the previous management and office holder’s activities during the insolvency procedure which begs the question to what extent focusing on controlling rights would strengthen the hand of unsecureds held to be in a more vulnerable position. Nonetheless, it should be emphasised that if a major (controlling) unsecured creditor would act appropriately and, in fact, control the directors/office-holders, this would reduce the monitoring costs of the other creditors and provide them with a windfall (e.g. reduced monitoring costs and potentially a higher dividend).

Secondly, the fact that some unsecureds, although unlikely, might control the management of the debtor-company could result in free-rider behaviour by the other (unsecured) creditors. This issue has already been documented in the context of secured creditors who are assumed to be more sophisticated and, arguably, better placed than unsecureds to monitor the debtor’s behaviour. The latter unsecureds would then show free-rider behaviour by relying on the control exercised by others whilst, potentially, still benefitting from it (e.g. by receiving a higher dividend payment).

Thirdly, there is also the question to what extent this argument that by taking control of the insolvency procedure unsecureds might strengthen their position holds water during liquidation (instead of corporate rescue) procedures given the intention to wind-up (instead of rescue) the company and the (sometimes very) low recovery rates. In other words, the company which becomes subject to a liquidation procedure will cease to exist for all the unsecureds no matter which faction one would belong to and, contrary to the situation with rescue procedures, there is no hope for anyone that the company could continue doing business (something which inter alia small trade creditors and suppliers, unlike one-off consumers, often aim for during restructuring procedures). The fact that a company cannot be rescued (and may, sometimes, not have any assets at all anymore) might disincentivise the already vulnerable creditors, even

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404 The Law Commission, Consumer Prepayments on Retailer Insolvency: summary (Law Com No 368 2016) 15.
405 Ibid 44.
406 Ibid.
more as they might fear that the cost of control could (easily) outweigh the gains they would stand to win from controlling the insolvency procedure.\textsuperscript{408} In addition, given the low recovery rates for unsecureds\textsuperscript{409} one could also question whether it would not be too bureaucratic and cumbersome to start making (artificial?) distinctions within one group of unsecureds even if – despite some differences – they might all just receive a couple of pennies in the pound. Interestingly, in this regard, is the recent \textit{House of Fraser case}\textsuperscript{410} in which the court decided that it would not make distinctions within the group of unsecureds although some factions had the right to different interest rates on debts owed when compared with others. As has been set out above\textsuperscript{411}, the rationale behind this decision was the fact that the recovery rate for \textit{all} unsecureds, no matter what kind of interest rate they had, was very low so it did not seem worthwhile or efficient to start making artificial distinctions. Although this case was related to a scheme of arrangement the position taken by the court might be even more applicable in relation to liquidations given the even lower recovery rate there in general. This evidences a very pragmatic approach.

\subsection*{2.4.4. Class divisions}

Nonetheless, it is, arguably, questionable whether one should look at the final recovery rates to determine whether there should be class divisions, for these class divisions\textsuperscript{412} might actually stimulate a more controlling attitude and might, thus, in the end lead to higher dividends which arguably would/could not have been received if these class divisions would not have been made. However, this argument stems from the assumption that control would improve governance and would thus be able to lead to higher dividend returns.\textsuperscript{413}

Nonetheless, in light of the government inquiry with regard to corporate governance reforms, it became clear that many respondents felt that a cross cram-down was necessary in order to

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\textsuperscript{410} Re House of Fraser [2018] EWHC 1906 (Ch).

\textsuperscript{411} Cf. \textit{supra} part II.

\textsuperscript{412} For the definition of class and class divisions, see chapter 3 and 5.

\end{flushright}
avoid one class holding out the insolvency procedure.\(^\text{414}\) In this regard, both the UK\(^\text{415}\) and the EU\(^\text{416}\) have recently introduced cross cram-down provisions. The UK introduced these cross cram-down provisions in a newly introduced arrangement and restructuring process for companies likely becoming insolvent\(^\text{417}\) in light of the insolvency reforms taken, partly, in response to the COVID-19 pandemic.

\textbf{2.5. Conflicts of interests}

\textbf{2.5.1. General remarks}

As already touched upon in the previous section and elaborating further on the existence of conflicts within the same group of unsecureds, one has to deal with the important issue of “conflicts of interests”. Determining when this situation occurs, can be quite challenging given the fact that one might presume that all unsecureds will vote in their own self-interest from a distributional point of view.\(^\text{418}\) However, as every unsecured would probably like to receive a dividend as high as possible, the general assumption could well be that the interests of all these unsecureds will be more or less aligned. Nonetheless, the reality appears to be different with creditors voting for reasons which are not only different from the wellbeing of the group of unsecureds, but also different from their own dividend rights which they can exercise during the insolvency procedure.\(^\text{419}\)

This could for example arise when a creditor takes action with the intention to get rid of a competitor in financial difficulties\(^\text{420}\) or when connected parties of the debtor achieve a controlling position amongst the creditors with the aim of determining the outcome of the insolvency procedure. Furthermore, market changes might also induce concern for different interests of unsecureds which might be counter to the traditional view legislators and legal


\(^{417}\) Companies Act 2006, part 26A.


\(^{420}\) Ibid 157.
scholars might have about the unsecureds. A good example of such an evolution is the rise of distressed debt trading which will be discussed later.

However, despite the existence of these conflicts of interests, one should refrain from generalising by treating every conflict of interest as an obstacle/threat to the insolvency procedure or to a fair distribution of the company’s assets. On the contrary, assuming that many unsecureds will prefer an outcome that works best for themselves and taking into consideration that many of them might have conflicting commercial (therefore not necessarily legal) interests, it seems logical that different factions of unsecureds might have different preferences as to how the insolvency procedure should be pursued. Some might even say that these conflicts are ‘inherent’. This would be in line with the assumption put forward by law and economics scholars according to whom such unsecureds are ‘rational actors’ acting in their own interests (which inevitably leads to potential conflicts if their interests do not match).

Nonetheless, when there is a conflict of interests between unsecureds and they would act upon this conflict in their self-interest, such conflicts can arguably be categorised under two types of behaviour. One the one hand exploitative behaviour, and on the other hand inefficient behaviour. The distinction between ‘exploitative’ and ‘inefficient’ behaviour has already been used by Mokal in relation to the conflict between secured and unsecureds (with which we shall not deal in this research) and gives useful insight in understanding the conflicts that may arise between creditors and which would have a negative impact on the returns unsecureds would (be able to) receive at the end of the insolvency procedure.


2.5.2. Exploitative behaviour?

2.5.2.1. Notion

Turning to exploitative behaviour first, exploitative behaviour can be described as the behaviour whereby certain unsecureds would deliberately be put in a disadvantageous position compared to the other creditors with whom they have a conflict of interests (exploitation hypothesis).

A mere conflict of interest of differentiation between unsecureds would not necessarily be a result of exploitative behaviour. This is especially so as restructuring a debtor may only succeed if the dividend rights of certain groups of unsecureds are curtailed. Also, taking into account the additional statutory requirements enacted to protect certain specific vulnerable creditors (such as tort creditors)\textsuperscript{424}, the possibility of private insurance\textsuperscript{425} and the ability to protect oneself before the entrepreneur/company becomes insolvent via (quasi-) securities\textsuperscript{426}, it can be argued that, in addition to the mere conclusion that there is some divergence of interest, something else has to be proven before a conflicts of interests would become exploitative for certain unsecureds.

Case-law which will be described below provides a helpful tool in this regard by determining whether creditors acted in ‘good/bad faith’ whereby bad faith would occur if the interests of the other groups of unsecureds are jeopardised by one (faction of) unsecureds in order to gain a personal preferential/better position (for example by abusing their voting power during the creditors’ meeting).

2.5.2.2. Gertner I and Kapoor

Two good examples of exploitation are the cases, Gertner v CFL Finance Ltd\textsuperscript{427} (Gertner I) and Chamesh Kapoor v National Westminster Bank plc, Kian Seng Tan (Kapoor).

In Gertner, the biggest unsecured, Kaupthing bank, tried to abuse its controlling position at the expense of the other unsecureds of the insolvent debtor, Mr. Gertner during the first IVA.

\textsuperscript{424} The Third Parties (Rights against Insurers) Regulations 2016 (protecting tort creditors against any economic losses by granting a recovery right against the insurer); The Employers' Liability (Compulsory Insurance) Regulations 1998, section 3(1) (granting employees additional protection through mandatory insurance of the employers on behalf of the former creditors); Road Traffic Act 1988, section 151(5) (granting insured persons certain protection even if the insurance contract would have been cancelled by the insurer); R.J. Mokal, Corporate Insolvency Law: Theory and Application (1st edition Oxford University Press 2005) 151.
\textsuperscript{427} Gertner v CFL Finance Ltd [2018] EWCA Civ 1781.
Kaupthing, who possessed over 90% of the claims in value, had tried to abuse its controlling position in the IVA of Mr. Gertner by entering into a profit-sharing agreement that would grant the bank a significant share in the profits which Mr. Gertner would receive from an arbitration procedure in Israel. As a result of this agreement, Kaupthing would not only receive a certain dividend under the IVA of Mr. Gertner but it would also receive a payment equalling £4 million from the aforementioned arrangement. The latter payment was significantly higher than the dividends the other unsecureds would receive from the IVA. And rather than disclosing the existence of the profit-sharing agreement to the other creditors at the time of the creditors’ meeting, Kaupthing and Mr. Gertner decided to hide the terms of the profit-sharing agreement from the other creditors. In return, Kaupthing would vote in favour of the IVA and, thus, would not start a bankruptcy procedure.

Clearly, Kaupthing acted in its own self-interest aiming to circumvent the collectivist pari passu approach. The court, therefore, decided that Gertner’s IVA was invalid for it was affected by a material irregularity. This irregularity was Kaupthing’s vote in favour of the IVA which was solely based on its ulterior motive of receiving higher payments than and, importantly, at the expense of the other unsecureds which, according to Patten LJ, counted as ‘bad faith’.428

Nonetheless, one could question whether the terms “good” or “bad faith” ought to be used in this context as the mere reason why this IVA was held invalid was due to an unlawful conspiracy by some parties who intended to avoid the pari passu-principle. Given the fact that pari passu – as a general principle – applies to all insolvency procedures, one could question whether the terms “good/bad faith” are useful when examining the validity of the CVA- or IVAs. This is because, as a legal term, ‘good/bad faith’ does not add any value for one merely tries to ascertain whether parties deliberately attempted to bypass the pari passu-rules.

The outcome of this case seems very similar to the outcome of the Kapoor case429 which the judge referred to. Namely, also in the latter case430, it was held that the creditors’ meeting was affected by a material irregularity due to an agreement signed by two creditors at the instruction of the insolvent debtor which would have benefitted them at the expense of the other unsecureds who were also party to the same insolvency procedure. Due to the fact that the agreement made sure that one party which could otherwise not vote was now allowed to vote along with the other creditor with whom he had co-conspired431, the court ruled that such an agreement was set up with the aim of circumventing the procedural insolvency rules which – if

428 Ibid at par. [79].
430 Cf. supra for a more extensive explanation of the facts and the outcome of this particular case.
such a transaction would have been allowed – would have been beneficial only for those who signed up to the agreement.\textsuperscript{432} Some of these arrangements might even have been attacked on the basis of constituting the tort of conspiracy.

The key difference between Kapoor and Gertner, however, is that in Kapoor, one could indeed conclude that one had tried to circumvent the insolvency rules (on voting) whereas no such rules had been either circumvented or tried to be circumvented in the IVA proposal put forward by Gertner. Although there were some discussions during the procedure whether Kaupthing ought to be allowed to vote (and whether it could be seen as a creditor) both the judge at first instance and the Lord Justices on appeal agreed that there could be no question that – leaving the issue of the material irregularity aside for a moment – Kaupthing was allowed to vote in the IVA of Gertner for its full claim. Turning to the material irregularity, this was merely based upon the fact that the separate agreement Kaupthing had entered into could have given it a better position which – according to the Lord Justices – had to be perceived as “an inducement to Kaupthing to support an arrangement which would avoid Mr. Gertner’s bankruptcy”\textsuperscript{433} whereby the covert agreement Kaupthing had signed “was deliberately drafted in such a way as to enable Kaupthing to remain a creditor at the time of the meeting”.\textsuperscript{434} Through this undisclosed separate agreement, Kaupthing would have been entitled to share in the profits of an arbitration procedure Mr. Gertner was pursuing in Israel which would have constituted a benefit not available to the other creditors of Mr. Gertner. Secretly trying to obtain a benefit not available to other creditors was held to be a breach of the ‘good faith’-principle and Kaupthing should, thus, not have been allowed to vote during the creditors’ meeting where the IVA proposal had been put to a vote. Consequently, as Kaupthing was acting in bad faith and had nonetheless voted in favour of the first IVA proposal, the first IVA was revoked because of such material irregularity.

2.5.2.3. Gertner II

Following this, a bankruptcy procedure against Mr. Gertner was initiated by CFL Finance Ltd, a small unsecured creditor of Mr. Gertner. Meanwhile, Mr. Gertner proposed a second IVA and attempted to seek a stay of this bankruptcy procedure. His second IVA proposal looked very similar to the first one. The key difference to the first IVA was that another party creditor of Mr. Gertner, Laser Trust, had now taken over the position which Kaupthing had held in the first IVA. Kaupthing had assigned the rights it had against Gertner (guarantor) and Crosslet Vale (borrower)\textsuperscript{435} in exchange for 6 million US Dollar owed to Kaupthing by Laser Trust. As Laser


\textsuperscript{433} Gertner v CFL Finance Ltd [2018] EWCA Civ 1781 at par. [79].

\textsuperscript{434} Ibid.

\textsuperscript{435} Crosslet Vale was a party who had received loan facilities from Kaupthing and for which Mr. Gertner and his brother, Mendi Gertner had provided personal guarantees.
Trust had now taken over Kaupthing’s position the Insolvency and Companies Court initially stated that the second IVA proposal would also be subject to a material irregularity for the same reasons the first IVA proposal had been revoked.\(^{436}\) After all, also Laser Trust would now be in different position vis-à-vis the other unsecureds after having been assigned certain rights Kaupthing had against Mr. Gertner and Crosslet Vale. Consequently, Chief Insolvency and Companies Court Judge Briggs equated Kaupthing’s vote in favour of the first IVA proposal with an *intended* vote in favour of the second IVA by Laser Trust. It was, therefore, argued that Laser Trust’s vote would also be a vote in bad faith and thus invalid which would put the second IVA again subject to a material irregularity. Judge Briggs therefore saw no reason to allow a new creditors’ meeting to consider this second IVA proposal and refused to stay the bankruptcy procedure against Mr. Gertner.

Nonetheless, on appeal the High Court\(^{437}\) disagreed with Judge Briggs and allowed a stay of the bankruptcy procedure so that the Mr. Gertner’s creditors could consider his second IVA proposal. Although Laser Trust had now indeed taken over Kaupthing’s position, it was argued that there was a clear difference between Kaupthing’s and Laser Trust’s legal position. This was because, according to Mr. Justice Marcus Smith\(^{438}\), Kaupthing and Laser Trust were in an entirely different position. First of all, they stood on opposite sides with Kaupthing receiving £6 million from Laser Trust and Laser Trust receiving the assignment of Kaupthing’s rights against both Gertner and Crosslet Vale based on the Kaupthing Settlement Agreement for respectively the personal guarantees and the loan provided to Crosslet Vale by Kaupthing.\(^{439}\) Also, in contrast to Kaupthing, Laser Trust would not get any illicit benefit not available to other unsecureds. Furthermore, the rights which were assigned to Laser Trust by Kaupthing were rights that predated Mr. Gertner’s insolvency. Hence there did not seem to be any attempt to circumvent the *pari passu* rules and Laser Trust was thus not acting in bad faith. Consequently, the bankruptcy procedure against Mr. Gertner was stayed to allow the creditors’ meeting to consider and vote on the second IVA proposal.

Such a view is, however, difficult to accept for it paves the way for a differential treatment amongst unsecureds through third party agreements which could be negative for the equality of unsecureds.\(^{440}\) This is especially so in this case as the payment which Laser Trust would receive from Mr. Gertner and Crosslet Vale, after it would enforce the rights Kaupthing had

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\(^{436}\) *CFL Finance Ltd v Bass* [2019] EWHC 1839 (Ch).

\(^{437}\) *Gertner & Anor v CFL Finance Ltd* [2020] EWHC 1241 (Ch) at [7], [19].

\(^{438}\) Ibid at [91].

\(^{439}\) Ibid at [129].

\(^{440}\) If the non-disclosure of a third-party agreement is, however, immaterial and thus not having any impact on the amount of dividends unsecureds will receive, it would arguably not be justified to invalidate a CVA or IVA. See in this regard: *Lazari Properties 2 Ltd v New Look Retailers Ltd* [2021] EWHC 1209 (Ch).
assigned to it, would come from money Mr. Gertner and Crosslet Vale would obtain from the Israeli arbitration. This would be money not available to the other unsecureds which is similar to Kaupthing’s scenario as regards the first IVA. For this reason, this research favours the principle laid out by Lord Justice Patten (in relation to Mr. Gertner’s first IVA proposal) according to which third party agreements which by granting a ‘collateral advantage not available to other creditors’ [place a(n unsecured) creditor] ‘in a position of conflict with the interests of the other creditors’ would be a breach of the good faith principle. The requirement to ‘deliberately attempt to bypass the pari passu principle’ is, however, critical to fall under the scope of ‘exploitative’ behaviour according to this research. Absent such deliberate attempt to breach the equality principle, a case whereby wealth would be transferred from non-controlling to controlling unsecureds would fall under the scope of ‘inefficiency’.

In summary, both the Kapoor and Gertner cases were concerned with a material irregularity which would have unduly benefitted the controlling unsecured whilst disenfranchising the non-controlling one. By entering into an agreement that would have either breached procedural rules (as in Kapoor) or would have granted access to funds unavailable to some weaker creditors (as in Gertner), a deliberate but unjustified transfer of wealth from non-controlling unsecureds to controlling ones had (almost) occurred in both situations. The fact that the High Court granted the stay of Mr. Gertner’s bankruptcy proceedings so that creditors could vote on his second IVA proposal does not change the attempt that had been undertaken to ‘exploit’ the non-controlling position of the weaker unsecureds through the undisclosed separate agreement which had affected Mr. Gertner’s first IVA proposal.

In fact, the big similarity between Mr. Gertner’s first and second IVA proposal continues to raise eyebrows. The only difference between the two IVA proposals is that Laser Trust, as part of the second IVA and after the assignment of Kaupthing’s rights to Laser Trust, would be allowed to enforce rights previously belonging to Kaupting. The second IVA proposal thus still creates a differential treatment between unsecureds and would allow Laser Trust to obtain funds from the Israeli arbitration that would not be open to the other unsecureds of Mr. Gertner. Surely, this raises the question whether and when a third-party agreement that creates an inducement for only one faction of unsecureds leads to a material irregularity that would make the IVA/CVA proposal void. In addition, and as part of this issue is the question whether seeking to by-pass the pari passu-rule would be sufficient to be regarded as ‘bad faith’ hereby justifying the invalidity of a CVA/IVA proposal?

441 Gertner v CFL Finance Ltd [2018] EWCA Civ 1781 at par. [80].
443 Cf. infra part 2.5.3.
2.5.3. **Inefficient behaviour?**

2.5.3.1. **Notion**

Whilst the aforementioned examples in part 2.5.2. primarily dealt with cases in relation to 'exploitative' situations (seemingly) demanding certain evidence of 'bad faith' or a willingness to bypass the *pari passu* rule at the expense of the other unsecureds, this part will now also consider situations where mere *inefficiency* would occur without there being any need or deliberate attempt to bypass the *pari passu* rule. The type of situations falling under the scope of 'inefficiency' would be situations whereby non-controlling unsecureds would be worse off than the controlling unsecureds, even though there would be no deliberate attempt to bypass *pari passu*.

Although this research will discuss more in detail what ‘efficiency’ means from a regulatory perspective in chapter 6, ‘inefficiency’ here will be defined as the transfer or diverting of wealth from non-controlling unsecureds to controlling unsecureds as a result of the controlling unsecureds acting in a way which may be optimal for them but which it is not for the non-controlling unsecureds. This illustrates an agency problem whereby the controlling unsecureds are not using their ‘controlling’ power in a way that would also be conducive to the interests of the non-controlling unsecureds. The controlling unsecureds use their power to advance their own interests rather than also attempting to advance the interests of the non-controlling factions. This *agency problem* that exists in relation to the controlling and non-controlling unsecureds will lead to agency costs which will have to be borne by the non-controlling unsecureds whilst the controlling unsecureds are likely to benefit from their actions. The requirement of ‘bad faith’ (or deliberate attempt to bypass the *pari passu* principle) can be argued to be the distinguishing factor between exploitation and inefficiency. In both situations, there is said to be a certain wealth transfer from non-controlling vulnerable unsecureds to controlling unsecureds but in inefficiency-cases, there would not be any intent to act to the detriment of the other unsecureds or any effort to bypass the insolvency principles/rules.

In the inter-group relations between secured and unsecureds, it is argued that by granting a security the company’s business may be kept hostage to the secured creditor if the latter one tries to control or influence the company’s management too much which could make it harder for the company to do business and be rescued; it could arguably have the potential of externalising risks suffered by tort and uninformed unsecureds who might receive a lower dividend (or perhaps nothing) *due to* the security interest which gives a priority position to the

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444 This controlling power may for example be a result of their number of voting rights, their financial power, their legal skills and/or the financial insight into the debtor’s managerial performance.

secured creditors. The secured creditor may well have acted in good faith, but it is argued that such a situation would be ‘inefficient’ due to such ‘externalisation of risks’.  

2.5.3.2. Inefficiency scenario: distressed debt trading

A scenario where inefficiency might occur would be in case of distressed debt trading. Distressed debt trading can be described as the process whereby certain traders buy distressed debts at a discount to resell it immediately afterwards or benefit from a higher dividend as a result of an insolvency plan (such as an IVA or CVA) with the sole purpose of making a profit. Inefficiency would manifest because non-controlling unsecureds would not be able to benefit from the superior knowledge/financial strength of these debt traders, although these weaker unsecureds would have benefitted from the traders’ controlling position if these traders had monitored/controlled the debtor’s management.

Surely, it might be said that these distressed debt traders take the risk of buying distressed debts and therefore warrant a profit from selling these debts. Furthermore, these debt traders can only claim what the debt is but they might make a profit in that they bought the debt at a lower price. These traders have got a better knowledge and understanding about insolvency procedures than the average unsecured and are claimed to make use of their superior knowledge in order to ‘win’ from financial difficulties of the company/individual. In this regard, one could also argue that because of this superior knowledge, there might be the possibility to ensure better dividends for all unsecureds. This would require them to actively engage with and participate in the insolvency procedure which other non-controlling unsecureds could potentially benefit from.

Nonetheless, they may not necessarily do so, especially if they do not want to bear the monitoring/controlling costs and if they are only interested in selling their debt as soon as possible for an amount as high as possible in which case the remaining (non-controlling) unsecureds would not have had any windfall from the debt traders’ superior knowledge.

446 Ibid 160.
448 This is, however, something debt traders are unlikely to do because appropriately monitoring the debtor would incur economic costs and may, thus, result in lower profits for them (e.g. if controlling the debtor would mean selling the debt at a later moment).
449 Without going into too much detail, distressed debt trading is linked up with ‘factoring’.
However, even if a windfall would be created for the entire group of unsecureds, those unsecureds who had sold their distressed debt to these traders before could still lose out. This would be if they sold their claim to the traders with a discount higher than the benefit an individual unsecured would gain as a result of the superior knowledge used by these traders/controlling unsecureds to monitor and control the insolvency procedure.\textsuperscript{451} Having said this, one could counter-argue that it is perfectly legitimate for traders to buy these debts at a discount given the fact they will face the uncertainty of the insolvency procedures whereas the former seller-unsecureds will be certain to have their debt repaid (albeit at a discounted rate) and get their money sooner.

Nonetheless, this shows that not only the former but also the remaining unsecureds (those who either did not sell their debts or who were not made offers on their debt) might find that their interests conflict with the ‘new’ unsecureds as the latter can arguably be presumed to be only interested in making a profit in order to have a return on their ‘investment’.\textsuperscript{452} The ‘old’ unsecureds, on the other hand, might not only be interested in seeing a repayment of their debt but, contrary to these debt traders, they may also want the business to continue because they are employed by this company or because they supply goods and/or services on a regular basis to this company etc and they want repeat transactions. As these debt traders will also receive voting power and given their lack of interest in the (distressed) business/company, their votes could perhaps lead to an outcome which would jeopardise the interests of the other unsecureds who could not or did not sell their debts but, as indicated above, their presence might lead to greater dividends for all. And even if they would monitor/control the debtor’s management, there would, arguably, be no difference with the former unsecureds who sold their claim to these traders. Given the fact that they chose to sell their debts at the last minute does not offer much reassurance that they would have controlled/monitored the previous management and/or the office-holder’s performance if they would not have sold their debts.\textsuperscript{453}

Another strategy often employed as part of the restructuring of a distressed company is the ‘loan-to-own’ strategy. This strategy entails that the debts which are held by creditors (or acquired by debt traders) are swapped for equity in the company-debtor during the reorganisation process.\textsuperscript{454} The hope of those debt traders (and, thus, new equity holders) would

\textsuperscript{451} This is, of course, assuming that these debt traders would be able to create a windfall that would benefit every single unsecured which may not be the case.

\textsuperscript{452} Whereby the investment has to be seen as the purchase of the distressed debts.

\textsuperscript{453} By selling their claim to a debt trader, these unsecureds, in fact, relinquish the amount of control they would (or could) have over the insolvency procedure.

be that they can resell the shares of the company at a higher price (i.e. at a profit) once the reorganisation procedure has been completed.\textsuperscript{455}

In principle, a distinction is hereby made between senior and junior lenders with senior lenders ranking before junior lenders upon insolvency and, thus, being paid first if there would be a distribution of the company’s assets. Nonetheless, rather than focusing on the distribution of assets, during the restructuring process, it is usually designed that only the senior lenders will be entitled to swap their loans into equity with junior lenders only receiving a very small amount of what the company-debtor owes them or even nothing.\textsuperscript{456}

If this process is not tenable, for example, because of the objections raised by some other senior lenders, a scheme of arrangement could be utilised to facilitate the aforementioned loan-to-own strategy. This is because, under a scheme of arrangement, a simple majority in number and a majority of three quarters in value of the creditors or members present and voting would suffice\textsuperscript{457} rather than the unanimity mandated in the loan agreement.\textsuperscript{458} Nonetheless, objections may also be raised by other junior lenders which could threaten the sanctioning of the scheme of arrangement\textsuperscript{459} in which case, a similar economic outcome to the one described above whereby senior lenders would become the new equity holders could be established through the incorporation of a new company (NewCo). This NewCo acquires the debtor’s business/assets and the senior lenders would become shareholders in exchange for releasing their claims against the debtor-company.\textsuperscript{460} As seen in the \textit{MyTravel}-case\textsuperscript{461} elaborated on in chapter 3, this can achieved by utilising a scheme of arrangement in conjunction with a pre-pack administration (enabling the debtor’s business to be sold to NewCo without having to put a proposal to creditors).

Although there are certainly valid reasons to structure the reorganisation in aforementioned way (i.e. by utilising a scheme of arrangement in conjunction with a pre-pack) such as maximising the survival of the debtor’s business and ensuring business continuity would be achieved to the extent possible, this restructuring technique raises questions as regards those junior (and thus

\textsuperscript{455} Ibid.
\textsuperscript{457} Companies Act 2006, s.899;
\textsuperscript{459} See for example: \textit{Re Sunbird Business Services Ltd} [2020] EWHC 3459 (Ch) where the scheme was opposed by creditors or \textit{Re All Scheme Ltd} [2021] EWHC 1401 (Ch) where the scheme was opposed by the FCA because of the company’s failure to fully and accurately inform the creditors.
\textsuperscript{461} \textit{Re MyTravel Group} [2004] EWHC 2741 (Ch).
not seldom unsecured) creditors who are being presented with a pre-agreed deal which they cannot adjust and where, apart from the opposing the pre-pack in court\textsuperscript{462}, they cannot exercise any authority to alter the terms of the pre-packaged deal nor can they influence the decision-making process.\textsuperscript{463} The inefficiency lies here in the fact that some more vulnerable creditors may be confronted (and will most likely accept) a deal which (i) they were not able to tailor to their interests and (ii) which, in the circumstances at hand, might not necessarily be the most optimal outcome for every creditor involved. Consequently, a ‘transfer of wealth’ may occur from those non-controlling creditors to the controlling (i.e. senior) creditors as those creditors bargaining for the pre-packaged deal are likely to have only had regard for their own (senior) interests, ultimately leading to the junior creditors ending up in a shell (i.e. the old company whose assets/business were sold to NewCo) whilst the senior creditors may, once the reorganisation is completed, share in the potential upswing of NewCo as shareholders/equity holders.\textsuperscript{464}

Although the Statement of Insolvency Practice 16 (SIP 16) was introduced as a regulatory tool by the insolvency profession to enable creditors to receive more information and to stimulate transparency as part of pre-pack administrations, questions remain as to whether the information requirements embedded in SIP 16 are sufficient.\textsuperscript{465} As will be discussed in chapter 8, this research also submits that more transparency requirements must be imposed on directors/office-holders during a pre-pack administration.

\section*{III. Remedies for unsecureds with regard to inter- and intra-group conflicts}
In case unsecureds allege to be disenfranchised as a result of inefficient and/or exploitative behaviour by other unsecureds, they have already got some legal avenues at their disposal which will be critically analysed here. In contrast to the procedures examined in chapter 4 which intended to recover any losses the debtor-company had suffered to benefit all the creditors as a whole\textsuperscript{466}, the procedures discussed here address situations where certain (groups of) unsecureds believe they are disenfranchised by other unsecureds’ factions.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{462} \textit{Clydesdale Financial Services Ltd v Smailes} [2009] EWHC 1745 (Ch), whereby, the procedure was initiated by a secured creditor however.
\item \textsuperscript{465} A.R. Keay and P. Walton, \textit{Insolvency Law Corporate and Personal} (Jordan Publishing Limited 2020) 129.
\end{itemize}
\end{footnotesize}
These procedures aim to enforce a ‘good governance’ relationship between creditors and can be divided into two types of procedures, namely material irregularity and unfair prejudice procedures. The former procedures are related to the procedural aspects of the decision-making process during an insolvency procedure as we will discuss below whilst the latter ones are more concerned with situations whereby one/some creditor(s) allege(s) to have been unfairly prejudiced vis-à-vis the other creditors.

3.1. **Unfair prejudice / unfair harm**

3.1.1. **IVA and CVA**

Starting with the unfair prejudice provisions, this is one of the primary grounds upon which disenfranchised creditors can rely in order to protect their interests if they were, allegedly, disenfranchised by other creditors. However, such unfair prejudice procedures only occur in either a CVA or IVA.\(^{468}\)

Courts will look whether the creditor (or faction of creditors) is unfairly prejudiced by the arrangement. Contrary to section 994 of the Companies 2006, which deals with member claims, this procedure (which is also called ‘unfair prejudice’) is not about the management of the company.\(^{469}\) Courts will not only establish whether a creditor has been prejudiced by the arrangement but also whether this prejudice was unfair.\(^{470}\)

3.1.2. **Administration and liquidation**

Section 994 of the Companies Act resembles more the situation which creditors could face during an administration or liquidation procedure. This is because, during such procedures, creditors could, seek recourse to ‘unfair harm’ procedures which also apply to the conduct of the office-holder who has to have unfairly harmed the interests of a (class of) creditor(s).\(^{471}\) In doing so, they can still offer a solution which will be to some extent comparable to the IVA/CVA situation discussed above (as part of part 3.1.1.) for creditors might rely on such procedures in cases whereby creditors perceive to have been victim of a differential treatment to them (or their

\(^{467}\) Which is not necessarily confined to unsecureds only.

\(^{468}\) For IVAs: Insolvency Act 1986, s. 262; For CVAs: IA 1986, s. 6.


\(^{470}\) *Re A Debtor (No 222 of 1990) ex parte Bank of Ireland* [1992] BCLC 137.

Although the unfair prejudice or harm provisions are designed to protect weaker factions of unsecureds, several challenges may mitigate the positive consequences of such provisions.

First, the onus of proof might be quite difficult to establish. Parties who feel disenfranchised do not only have to prove that they were harmed/prejudiced but also that this harm/prejudice was unfair. As a result of this ‘unfairness’-test, factions of unsecureds cannot expect to win a claim merely based on the fact that they have been treated differently vis-à-vis some other factions of creditors during the insolvency procedure. Such a different and unfavourable treatment has to be unfair towards this faction of unsecureds. This was for example the case in Re A Debtor (No 101 of 1999). In relation to an IVA, the Inland Revenue (which is now part of the HMRC) was the only unsecured creditor that saw its claim being reduced whilst all the other unsecureds, who were friends of the debtor, had their claims merely postponed and not reduced. In this case the court found that the HMRC had been unfairly prejudiced by the IVA. The ratio decidendi was that the voting rights of the friends of the debtors had been used to approve an arrangement which significantly curtailed the rights of the HMRC while completely preserving and perhaps even improving the rights of these friends of the debtor. This created a differential treatment which – taken all circumstances into account – was not fair towards the HMRC. If there is such a differential treatment, it ought to be justified and in this case, there was no legitimate justification for the more beneficial treatment of the debtors’ friends as opposed to the treatment received by the HMRC.

This means that even if there is a differential treatment between different (factions of) creditors, this does not ipso facto mean that an arrangement could not be approved anymore. However, without suggesting a shift in the burden of proof, it must be acknowledged that for such an arrangement (with differential treatment amongst creditors) to be approved, one has to provide legitimate reasons to justify such differential treatment. For example, in Doorbar v Alltime Securities Ltd, the court decided that there was no unfair prejudice despite the fact that the

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472 For administrations: IA 1986, schedule B1, para. 74; Coniston Hotel (Kent) LLP [2013] 2 BCLC 405 at [36]. For liquidations: IA 1986, s.112 (voluntary liquidation) and s.168 (compulsory liquidation); Re Capital Project Home Pty Ltd [1992] 10 ACLC 75; Re Chevron Furnishers Pty Ltd (receiver and manager appointed) (in liquidation) [1992] 10 ACLC 1537.
473 Hockin v Marsden [2014] 2 BCLC 531 at [19].
475 Re A Debtor (No 101 of 1999) [2001] 1 BCLC 54 Ch.D.
476 Ibid.
477 Lazari Properties 2 Ltd v New Look Retailers Ltd [2021] EWHC 1209 (Ch).
landlord saw his rights restricted. The landlord wanted to petition for bankruptcy so that he could rely on a specific clause in a lease-contract that he had concluded with the insolvent debtor which required the debtor to take a new lease on his bankruptcy. A bankruptcy, however, would not have been beneficial for the other creditors. On the contrary, the general body of creditors would benefit from a voluntary arrangement. Given the latter considerations, the court held that it was not unfairly prejudicial to deny the landlord his right to petition for a bankruptcy. There was a differential treatment between the landlord and the other creditors but this differential treatment was not unfair because allowing the landlord to commence a bankruptcy procedure would have damaged all the other creditors and the arrangement provided clauses on future rent payments to the landlord as well. In a recent case, Lazari Properties 2 Ltd v New Look Retailers Ltd, the court repeated that differential treatment of landlords would not ipso facto constitute unfair prejudice. As determined in this research and explained in more detail in chapter 8, this research contends that if there is any differential treatment between unsecureds and, according to the business judgment of the director/office-holder, the affected unsecured would be non-controlling (e.g. because of a lack of influence on the outcome of the insolvency procedure due to, amongst others, the low value of the claim of that creditor in relation to all other unsecureds, the unsecured’s inability to form a coalition of unsecureds to strengthen its voting power etc.), the director should inform the non-controlling unsecured of its non-controlling position and disclose the reasons behind the decision that was taken to curtail its rights and why, according to the director/office-holder no alternatives would be available. If possible, it would be laudable to seek involvement of the non-controlling unsecured to ascertain whether the unsecured may have suggestions that would not only enhance its own position but would also not make the debtor and any other creditor of the debtor worse off. Although probably unlikely, if such a pareto-improvement would be suggested by the non-controlling unsecured, it would be up to the debtor to consider this proposal. In doing so (and as elaborated on extensively in chapter 8), directors/office-holders would identify non-controlling creditors, justify potential differential treatment and (try to) engage with them.

Next to ‘differential treatment’, the requirement of ‘unfairness’ for an unfair prejudice-claim to succeed must be considered as well. Whereas the aforementioned cases focused on ‘differential treatment’, the question as to what is considered “unfair” will be dealt with now.

479 Ibid.
480 Ibid.
481 Lazari Properties 2 Ltd v New Look Retailers Ltd [2021] EWHC 1209 (Ch).
482 Ibid.
483 There may be circumstances – for example during a pre-pack administration – whereby a director/office-holder may not want to disclose the upcoming decision ex ante to the creditors. This is because directors may fear that it could jeopardise the chances of keeping the going-concern value of the company’s business intact and, thus, enabling the company to be rescued.
When can one say that a differential treatment has been unfair towards the weaker/non-controlling unsecured creditor? Given the fact that a treatment has to be *unfairly* prejudicial it is quite important to look at when the courts might find a certain ‘prejudice’ (or harm towards another creditor) has been ‘unfair’?

In this regard, in *In re London & Westcountry Estates Ltd Hockin and others v Marsden*,\(^484\) the court decided that creditors (as a whole group)\(^485\) were treated unfairly by the administrator because they suffered a harm *‘they should not be expected to suffer’*.\(^486\) The administrator had not only refused to initiate a claim against the bank for mis-selling a swap agreement but it had also refused to assign the claim to some creditors. Their refusal to assign the claims resulted in the claims not being pursued at all. The court held that it was reasonable for the administrator not to pursue the claims himself, but it was *not reasonable* to decline the pursuit of the claims by creditors. The court’s reasoning behind this was that if some creditors would have been able to pursue the claim and would have won, a percentage of the recoveries should have gone to the insolvent estate without the insolvent estate bearing the costs. This would have benefitted *all* creditors because creditors must be treated equally so any recoveries of an insolvency procedure would have been for the benefit of the insolvent estate. If the creditors would have lost their claim, the insolvent estate would not receive any recoveries but it would not be worse off either because the costs of the procedure would have been borne by those creditors who had pursued the case. In such a scenario, at least the creditors who were willing to pursue the claim would have got the opportunity to try to swell the asset pool for the benefit of the whole group of creditors. The whole group of creditors would thus be unfairly harmed if the claims would not be initiated (even if this means that the applicant is not the office-holder himself but one of the other creditors).\(^487\)

Although the court’s discretion in deciding what is ‘fair’ or ‘unfair’ and the rather vague wording of the court that one should have suffered a harm you are not supposed to suffer might exacerbate the difficulty in proving that there was unfair prejudice/harm, the option to assign a certain claim (against the previous management). Permission to do this was introduced by the Small Business Enterprise and Employment Act 2015 and it has certainly improved the protection of (classes of unsecured) creditors.\(^488\) Nonetheless, as we will argue in chapter 8, in

\(^{484}\) [2014] EWHC 763 (Ch).  
\(^{485}\) *In re London & Westcountry Estates Ltd Hockin and others v Marsden and another* [2014] EWHC 763 (Ch) at [52].  
\(^{486}\) Ibid at [19]-[20].  
\(^{487}\) Ibid at [51]-[52].  
\(^{488}\) Small Business Enterprise and Employment Act 2015, section 118.
spite of the option to assign claims, it might still be worthwhile to consider giving unsecureds
the right to file a claim derivatively (as is possible in Canada\textsuperscript{489} and Singapore\textsuperscript{490}).

Secondly, as set out above, courts will consider all circumstances which might also make it
quite difficult to \textit{a priori} assess whether one should commence an unfair prejudice/harm
procedure. Especially, creditors who are risk-averse, lacking the necessary information or who
might not have sufficient financial resources might be reluctant to commence a procedure given
the uncertainty and difficult onus of proof which needs to be established in order to win a claim.

Thirdly, as set out earlier\textsuperscript{491}, many unsecureds do not sufficiently participate during the
insolvency procedure. Many creditors fail to ask for information, do not go to physical creditors’
meetings which have recently been abolished unless sufficient\textsuperscript{492} creditors requisition such
meeting\textsuperscript{493}, do not monitor or control the behaviour of the office-holder or previous management
of the debtor. Many suffer from a lack of financial resources and many others might fear that
the costs of controlling could quickly outweigh the benefits (dividends) they stand to gain from
the insolvency procedure. Especially creditors having only a small claim might feel that it is
economically justifiable to only engage in modest levels of monitoring\textsuperscript{494} (if they engage in
monitoring at all). Arguably, the lack of creditor engagement is one of the most important
drawbacks here. Namely, if creditors are not engaged and, thus, not aware of any wrongdoing,
how can one expect that they start an unfair prejudice/unfair harm procedure to protect their
rights? This is why chapter 8 will assess whether public enforcement might be useful to
strengthen the position of unsecureds and, in doing so, to mitigate some of the risks that exist
as regards private enforcement.

3.2. Material irregularity
3.2.1. Notion
In addition to unfair prejudice/harm, unsecureds may also try to challenge a decision of the
creditors based on material irregularity.\textsuperscript{495} Although the circumstances are very factual where a
material irregularity exists, it appears that irregularities generally occur when the provisions of
the Insolvency Act or the Insolvency Rules have been broken and/or when one was not able to
get the required approval for a CVA or an IVA (e.g. if one fails to obtain the right majority-
threshold).\textsuperscript{496}

\textsuperscript{489} Canada Business Corporations Act 1985, section 238.
\textsuperscript{490} Singapore Companies Act 1967, section 216A(1)(c).
\textsuperscript{491} Cf. supra chapter 4.
\textsuperscript{492} This is any creditor representing at least 10 percent of the value of creditors, 10 percent of the number
of creditors or 10 creditors. Cf. Insolvency Act 1986, section 246ZE (7).
\textsuperscript{493} Insolvency Act 1986, section 246ZE.
\textsuperscript{494} V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 80.
\textsuperscript{495} Insolvency Act 1986, s.262(1)(b).
\textsuperscript{496} Smith-Evans v. Smailes [2014] BPIR 306.
3.2.2. Conditions

However, only the existence of an irregularity does not necessarily invalidate a decision of the creditors’ meeting in relation to the CVA or IVA. The claimant must also provide evidence that the irregularity is ‘material’. In Cadbury Schweppes plc v Somji it was defined that this ‘materiality’ test meant that, objective assessed, the “error or omission would be likely to have made a material difference to the way in which creditors would have considered and assessed the terms of the proposed IVA”.

An illustration of the application of the ‘materiality test’ is the Re Sweatfield case in which the landlord aimed to invalidate a decision due to the fact that the chairman of the meeting had quantified the landlord’s claim at a lower figure (i.e. £200,000) than the figure upon which the landlord wanted to base his voting rights. However, the court held that there was not only no irregularity (because the rules had been properly complied with) but even if there would have been an irregularity, it was definitely not material. The reason why it was not material was because it would not have made any difference if the landlord’s claim would have been allowed at a higher figure (i.e. £381,469) given the fact that even this higher figure would have been below the figure needed (i.e. £426,000) to block the approval of the decision of the creditors’ meeting.

Hence, an irregularity must have such an impact on the decision of the creditors’ meeting that without such irregularity another decision could have been taken. If the (group of) creditor(s) is unable to influence the decision-making procedure, it seems thus unlikely to challenge the decisions taken by the creditors’ meeting based on material irregularity.

3.2.3. Critical analysis

Although the rationale behind the materiality test is without any doubt the willingness to avoid some small creditors obtaining a veto power which could jeopardise the possibility of achieving an arrangement to rescue the insolvent debtor, rather akin to holdouts, it could put many non-controlling unsecureds with a small claim at risk. This is because individually one unsecured creditor might not be able to attack an arrangement for suffering from an irregularity due to the lack of materiality but a whole class of unsecureds in the same boat (e.g. a group of consumers or small trade creditors) might collectively be able to challenge such an arrangement. Although

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500 Ibid.
501 Ibid.
it would still depend on the question whether the class of unsecureds would have reached the threshold to make the irregularity ‘material’, it could certainly increase the chances creditors have got to invalidate irregular decisions. As a collective faction of unsecureds, one can assume that their rights and interests are not too dissimilar in acting together in order to rectify the “wrongdoing” whilst benefitting from their collective power to obtain (as a collective) a higher percentage of voting rights during the insolvency procedure. However, such a solution would not solve all the issues given that it is not sure whether the class/faction of unsecureds would collectively achieve the threshold (to make an irregularity ‘material’). Nor can one be sure that there will always be a class of different creditors sharing more or less the same interests.

Furthermore, as already emphasised above, the lack of creditors’ participation exacerbates the problem to obtain the required threshold to object to certain decisions even if there would have been a certain sub-faction of unsecureds with similar interests. For example, as in the Farepak-case many consumers might not know that they are, as a group collectively, possibly able to object whilst individually only having too small a claim to influence the insolvency procedure (or the arrangement approved by the creditors’ meeting).

In addition, another quite important pitfall is the fact that unsecureds only seem to be able to challenge the decision of a creditors’ meeting a posteriori once the decision (to approve an arrangement) has been taken. This flows, according to Doyle and Keay, from the words used in section 262 of the Insolvency Act 1986 in relation to an IVA. As section 262(1)(a) of the Insolvency Act 1986 refers to ‘a voluntary arrangement approved by a decision of the debtor’s creditors…’ and section 262(1)(b) of the Insolvency Act 1986 implicitly refers to section 262(1)(a), it can be inferred that creditors are only entitled to challenge an arrangement once it has been approved. Surely, this may lead to an inefficient way of rescuing the company and could lead to a waste of time (and costs) if an anticipated material irregularity (or unfair prejudice) cannot lead to a re-evaluation of an arrangement (before it has been approved). It also increases the burden on unsecureds which are already in a non-controlling position to initiate legal procedures in order to be able to influence a yet already approved arrangement by imposing additional enforcement costs on them. This could be avoided if these non-controlling creditors were given the power to object earlier to these kinds of arrangements. However, although this might certainly be true for a creditor which has been treated in an unfairly

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504 Insolvency Act 1986, section 262(1)(a) (which covers the unfair prejudice-principle).
505 Which deals with the material irregularity.
prejudicial way, the situation might be a bit more complicated for material irregularities. Namely, due to the requirement that an irregularity has to be “material”, one could question why a creditor or a faction of non-controlling creditors would not have objected to the approval of an arrangement during the creditors’ meeting in the first place. Consequently, one could argue that efficiency of insolvency procedures is strongly intertwined with enhanced insolvency governance, and more in particular creditors’ participation and involvement in the insolvency procedure.

However, the trouble in this regard is that until the event occurs creditors can do almost nothing. Unsecureds, however, could try to secure an injunction against the office-holder with respect to the use of any his powers during the winding-up procedure. Nonetheless, these sections seem more concerned with the conduct of the office-holder and whether she/he is performing well enough rather than granting the ability to stop an alleged wrongdoing by the debtor or another creditor. However, it has been claimed that using section 167(3) of the Insolvency Act 1986 could empower the creditors to stop a liquidator from making the wrong distributions among creditors and if a wrong distribution has happened, arguably it enables the creditors to obtain damages from the liquidator (if he has been negligent and/or in breach of his duties).

Nonetheless, as courts emphasise the importance of the pari passu principle, creditors would still be able to stop an unfair harm or material irregularity from happening by filing an injunction.

IV. Conclusion
After elaborating on the insolvency theories which underpin the current regulatory framework in the first chapters, having drawn a preliminary analogy between corporate and insolvency governance and having shown the perilous situation in which unsecureds may find themselves during an insolvency procedure, this chapter attempted to focus on their governance rights. More in particular, the chapter showed that majority-minority conflicts which, so far, have only been properly examined between shareholders may also occur between unsecured creditors.

Through case-law, the chapter showed that similar so-called ‘majority-minority’ conflicts may arise between unsecureds as they can with shareholders. However, because the terminology

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508 Cf. supra for the explanation of ‘materiality’.
509 Of course, the chair of the creditors’ meeting might reject such a claim.
510 In the next chapter (chapter 6) it will be explained what can be understood under ‘efficiency’. Furthermore, solutions to improve the current framework will be suggested in chapter 7 based on the principles set out in chapter 6.
511 Insolvency Act 1986, sections 112, 167(3) and schedule B1, section 74.
513 *Taggs Island Casino Hotel v Richmond-upon-Thames LBC* [1966] 1 WLUK 879.
‘majority-minority’ was not deemed fit because of its over-reliance on voting weight, we conceptualised the conflict by referring to ‘controlling’ or ‘non-controlling’ unsecureds. In doing so, this research innovatively attempted to appropriately define what can be understood under ‘controlling’ and ‘non-controlling’ from the perspective of unsecureds, something that has not been considered before in the literature.

After having defined that ‘controlling’ and ‘non-controlling’ meant the power (i.e. controlling) respectively lack of power (i.e. non-controlling) to influence the decision-making process prior to or during the insolvency procedure, we have elaborated on what the consequences could be for unsecureds, particularly having focused on not only the potential windfalls but certainly how any such conflicts could materialise. In this regard, we found that non-controlling unsecureds could be disenfranchised in situations of ‘exploitation’ and situations of ‘inefficiency’ whereby only in the former type of situation the controlling unsecureds would abuse their control by attempting to deliberately bypass the pari passu rules.

Although certain regulatory provisions are already in place from a governance-perspective, this chapter showed that non-controlling unsecureds nonetheless face significant obstacles to improving their position vis-à-vis the controlling unsecureds which is why the next chapters will examine how the regulatory framework could be reformed. Before designing and suggesting legal avenues that would do so, chapters 6 and 7 will first critically assess the necessary insolvency values that ought to underpin the regulatory framework and against which such newly suggested measures ought to be measured.
Chapter VI
Improving the Insolvency Governance model: Insolvency Values

I. Introduction

In chapter 2, this research gave an overview of some of the main insolvency theories that have been put forward as the theories that are either (currently) underpinning or that, arguably, should underpin the insolvency framework. Chapter 2 indicated that dependent on which theory one advocated more or less (legal) protection for unsecureds had been deemed necessary. The creditors’ bargain theory at one end of the spectrum, for example, puts a strong emphasis on the ‘collective’ nature of (unsecured) creditors and argues against additional insolvency protection for allegedly weaker factions. At the other end, we discussed the communitarian theory which strongly opposes the creditors’ bargain policies and strongly emphasises the need to give more legal protection to a wide range of stakeholders. In between these two theories some more moderate theories such as inter alia the multiple values theory have been elaborated on too.

Although both the multiples value and the communitarian theory argue that certain weaker factions of creditors such as consumers ought to be protected better, they did not explain how vulnerability ought to be determined and they thus failed to justify why certain groups of unsecureds would be in need for more protection than others.

Consequently, after having determined the existence of different factions of unsecureds in chapter 3 and having shown the legal, economic and practical challenges unsecureds still face both as a group (in chapter 4) and especially as a non-controlling faction within that group of unsecureds (chapter 5), this and the next chapter will seek to improve the regulatory framework by critically taking into account the insolvency theories that exist and by looking at the critical values that (ought to) underscore the regulatory framework. In doing so, this research innovatively contributes to the already existing literature that seeks to improve the regulatory protection for unsecureds.

Before setting out which regulatory improvements may potentially reduce the vulnerability of non-controlling unsecureds, this and the next chapter will first examine the insolvency values which ought to underscore the insolvency framework. This is crucial for these values will provide some abstract criteria/conditions (that must be met) against which such aforementioned suggestions can be measured. In doing so, this chapter will commence by giving a general overview of the principles which have currently been put forward by the literature followed by a critical assessment of the individual insolvency values this research deems necessary in a regulatory framework.
II. Why improve the insolvency governance model?

Due to the significant challenges unsecureds and, particularly, non-controlling factions of unsecureds still face (cf. chapters 4 and 5) and the scant attention currently only given by insolvency law to the (potentially) existing divisions within the group of unsecureds, it deemed necessary to improve the insolvency governance model. This emanates from the assumption that we ought to treat all creditors, at least all unsecureds, in largely the same way which proved to be the foundation for the current rules with regard to (i) distributions to (unsecured) creditors, (ii) accountability of directors and office-holders and (iii) their voting rights during an insolvency procedure are based upon (cf. chapter 2).

However, as extensively shown in chapters 3 and 5, in practice no such collective (homogenous) group of unsecureds exists. Different (factions of) unsecureds have both different legal and commercial interests which are currently insufficiently reflected during the insolvency procedure. As set out in chapter 5, from an economic point of view, this creates the risk that problems between unsecureds who are (more) in control of the insolvency procedure and unsecureds who are not/less in control of the procedure might arise. This shows that a “one size does not fit all”-approach, largely advocated by adherents to the creditors’ bargain theory, would not be ideal.

During the previous chapter, the issue of ‘exploitation’ and ‘inefficiency’ has been dealt with in this regard which showed that the (legal) interests of some non-controlling factions of unsecureds could be jeopardised by either inefficient or exploitative behaviour by the controlling unsecured(s). This conception, where we differentiate between ‘controlling’ and ‘non-controlling’ unsecureds, allows the enhancement of the regulatory framework in a much more comprehensive way. This is because it avoids the rather ‘one size fits all’-approach of the creditors’ bargain theory whilst not running the risk of failing to provide adequate protection for vulnerable creditors because they have not been deemed more vulnerable because of the nature of their claim (e.g. employment/consumer claim) which is one of the key flaws of both the stakeholder and communitarian model.

Consequently, it appears appropriate to assess whether the regulatory framework should be improved. In this regard, one may have to rethink the current regulatory framework in order to make sure that the existence of different legal and, perhaps, commercial interests of various (groups of) unsecured creditors get reflected during the insolvency procedure so that the insolvency procedure might be ‘governed’ in order to take into account the interests of this variety of unsecured creditors. In order to improve the current insolvency governance, it is, however, important to establish some principles or values against which the proposals to improve the current regulatory framework can be assessed.
Ill. Principles

In assessing how to reshape the insolvency framework, this research looks at the overriding principles/values to be able to have general/abstract values against which we can measure concrete proposals.

Finch and Milman made use of (i) efficiency, (ii) expertise, (iii) accountability and (iv) fairness as over-arching principles against which they measured both current and proposed or future Insolvency Laws. Although these principles are quite broad, they defend their position by seeking a liberal democratic “middle way” between several other less centrist views with which, according to them, fewer people are expected to agree. In their analysis, efficiency aims to secure certain goals which have been democratically mandated by the people at the lowest cost. Expertise ought to deal, according to Finch and Milman, with the allocation of policy and decision-making to persons with the appropriate competences and skills. Accountability has been defined by them as the principle which emphasises the control of those participating in an insolvency procedure by courts, democratic bodies (e.g. creditors’ meetings) or the openness of insolvency processes and the ability to hold them these insolvency participants to account. Finally, fairness deals with the variety of interests of parties being part of an insolvency procedure and more, particularly, with issues of justice.

Finch and Milman’s approach and determination of principles is well-developed stressing various important factors which need to be dealt with during the insolvency procedure (such as issues of efficiency, accountability, expertise, fairness, balancing the interests of various participants).

However, they have to concede that their more abstract ‘centrist middle-way’ might make it less clear as to how the regulatory framework ought to be applied in practice or in what way it should be reformed. Whereas communitarianism or contractarianism take a clear stance, Finch and Milman’s centrist approach may sound more open/vaguer and might be perceived less authoritative. Although Finch and Milman argue that, despite not being completely authoritative, their approach sets a normative framework with which everyone, according to

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514 V. Finch and D. Milman, Corporate Insolvency Law (Cambridge University Press 2017) 45.
515 Ibid.
516 Ibid.
517 Ibid.
518 Ibid.
519 Ibid.
520 Ibid.
521 Ibid.
them, can agree, their ‘explicit values’-approach creates the risk that there is no single Insolvency vision which can be posited and this results in trade-offs between differing/competing values being open-ended and ultimately solved by either the judiciary and/or the particular insolvency participants (such as the office-holders). Although this does not have to be problematic per se, an insolvency vision that lacks some clarity might make it difficult to provide the necessary guidance as to what the regulatory framework ought to be so that insolvency governance can be considered to be sufficiently fair and efficient.

Furthermore, it can be questioned to what extent ‘expertise’ should be treated as an over-arching principle against which Insolvency rules are to be measured.

Surely, the appropriate expertise of insolvency practitioners is of crucial importance when analysing the current and future Insolvency framework. Nonetheless, the principle of expertise seems to be more related to the concrete measures (instead of the abstract over-arching values) which will be considered, in our research, as being part of the requirement to have an efficient and fair insolvency framework. This is because an insolvency framework which is efficient ought to make sure that the right decisions (throughout the insolvency procedure) can be taken at the lowest cost in the interests of the insolvency participants which is beneficial for the insolvency participants. As an efficient system is often seen as a system which would maximise the value for the residual risk-bearers, this would ipso facto require the right expertise of those upon which the decision and policy-making power rests throughout the insolvency procedure.

This approach to Finch and Milman’s value of ‘expertise’ contrasts with the other three values (i.e. efficiency, fairness and accountability) which will be deemed crucial when revising the insolvency governance model. Fairness can be divided into substantive fairness which seeks to guarantee that the laws are ‘just’ for the interested parties and procedural fairness which aims to make sure that the processes (such as procedures) enable to achieve the ‘just’ result which the rules envisaged. Although Mokal argues that accountability should be treated as part of ‘fairness’ as it merely aims to attain the substantive goals (of achieving a ‘just’ regulatory framework), it would probably be better to state that there might be an overlap between fairness and accountability as an insolvency procedure which is procedurally and substantively fair can be deemed to encapsulate the requirements to have the required accountability procedures in order to make sure that those who did not abide by the Insolvency laws (such as

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524 What “fairness” entails, will be discussed below.
trying to bypass the *pari passu* rules) are held to account.\(^{527}\) Or in other words: if the rules would stipulate that an office holder could not be held to account (even if (s)he did not act in the interests of the insolvent company), this would surely be deemed procedurally unfair. Completely encapsulating accountability under the ‘fairness’-principle would, however, not be correct as this would ignore the particular character and, henceforth, necessity of ‘accountability’ as a third over-arching insolvency principle. While we can argue that fairness is more about the question what the ‘just’ processes and laws (including rules related to accountability) are or should be, accountability is more concerned with the question how and whether these ‘just’ processes and rules can be and have been properly followed and adhered to by those who had to adhere to these rules.\(^{528}\) In this regard, accountability provides different mechanisms (which will be discussed below) to monitor/control, evaluate and assess the attitude of other actors making sure that these actors can be sanctioned or be made subject to consequences if they did not abide by the ‘just’ rules.\(^{529}\) This, however, depends on what the rationale is for accountability. Agency theory says that it is to control those with a lot of power in the company while Keay and other scholars argue that it also provides legitimacy for the power of the accountor (i.e. the one who needs to be held to account).\(^{530}\)

As ‘efficiency’, ‘fairness’ and ‘accountability’ seem to be three necessary values against which a regulatory framework ought to be assessed, only ‘expertise’ which is a separate over-arching principle under the ‘explicit-values’-model adopted by professor Finch and Milman\(^{531}\) will not be used as an over-arching principle in our analysis. However, its importance will be stressed as part of our discussion of ‘efficiency’, ‘fairness’ and ‘accountability’ which will be the three core over-arching values against which we will measure the appropriateness of the current and future Insolvency framework.

### 3.1. Efficiency

#### 3.1.1. Importance of the notion

Efficiency relates to the effects of the rules which have been created or which are being proposed. In this regard, efficiency is often seen as one of the primary goals of ‘corporate governance’\(^{532}\) because it determines the most cost-effective economic expectations of the governance of a company.

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\(^{527}\) Ibid.

\(^{528}\) Cf. *infra* – Accountability will be discussed later in the chapter.


\(^{530}\) Cf. *infra* – under the part ‘accountability’.

\(^{531}\) Ibid (fn. 514) 311-312.

When merely focusing on policy-making, efficiency aims to create rules of which the aggregate benefits should outweigh the aggregate costs. Whilst the aggregate benefits of a rule should outweigh its aggregate costs from an abstract point of view, the rule itself should also foster economic efficiency for the corporate actors and the enterprise from a more concrete (micro) point of view. By the latter, we mean that the rules should not impose undue restrictions or requirements on market participants (such as directors or unsecured creditors for example) in order to make sure that the most optimal result can be achieved without imposing a (too) high cost on certain people. In other words, given the fact that efficiency tends to make an aggregate cost-benefit analysis, it seems necessary to look also at the more concrete (micro) level of the business in order to assess whether the rule – despite perhaps being efficient from an aggregate perspective – might not impose too high costs on certain corporate players which could damage open and free entrepreneurship which a regulatory framework ought to preserve.

In this regard, it should be emphasised that the notion of efficiency sits at the heart of the law and economics debate as these scholars argue that ‘efficiency’ is one of the core objectives of corporate governance. Under the law and economics’ nexus of contracts theory, the interests of all corporate actors are viewed from a “contractual” perspective. In order words: the behaviour and the duties of these corporate actors (office-holders, creditors, directors etc..) and the expectations flowing from their actions are embedded in a contractual framework in which the (abstract) notion of ‘efficiency’ is, according to the proponents of the nexus-of-contracts and contractarian positions, the glue between the responsibility of the corporate actors on the one hand and the maximisation of their financial interests on the other.

Although the focus of the ‘efficiency’-debate has predominantly been centred on the discussion and development of Corporate Governance, a similar reasoning with regard to the necessity and importance of ‘efficiency’ can mutatis mutandis be employed with regard to Insolvency Governance. Akin to the analysis of efficiency within Corporate Governance, rules designing

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535 The definition of ‘efficiency’ will be set out below.


the insolvency framework should also aim to be cost-efficient from an aggregate perspective whilst at the same time preserving an economically liberal climate for those involved in the insolvency procedure from a micro-economic perspective. As said, even if the rules are cost-efficient aggregately, they should not impose undue restrictions or obligations on the corporate actors (such as e.g. unsecured creditors or the office-holder). Nevertheless, if rules are cost-efficient aggregately, it seems quite likely that they will also be efficient on a micro-economic scale, although that might depend on what brand of efficiency is employed (i.e. Pareto or Kaldor-Hicks).

3.1.2. Economic notion(s) of efficiency

This begs the question how efficiency could (or should) be described. Although we gave a definition of ‘inefficiency’ in chapter 5 while focusing on the position of non-controlling unsecured creditors who might, in certain occasions, lose out due to inefficient behaviour by the controlling unsecured creditors, the notion of efficiency which we are concerned with here will be considered in a more abstract way as this concept of ‘efficiency’ is considered to be one of the guiding principles in designing and evaluating the regulatory framework.

From this viewpoint, efficiency is seen from a transaction cost-perspective whereby the aggregate benefit of a certain legal rule must, in order to be efficient, outweigh the aggregate costs it is imposing. Economists have developed two theories through which one can measure this. One the one hand the Pareto efficiency and on the other hand the Kaldor-Hicks efficiency.

‘Pareto optimality or efficiency’ relates to the description of a certain state of affairs and can be defined as the situation where, all things being equal, any future changes would not make any person better off whilst making at least one person worse off. This would mean that if the

538 This relates to the general understanding that the aggregate costs of rules designed to improve the insolvency framework should not outweigh the costs they may create. If the costs would outweigh the benefits of the rules, these rules could be argued not to be sufficiently cost-efficient.

539 When referring to the micro-economic perspective, we refer to individual firms and market actors.

540 Cf. infra for the definition of both types of efficiency.

541 See chapter 5 above.


current regulatory framework for unsecured creditors during an insolvency procedure would be pareto optimal at the moment, any legislative reforms would not make any unsecured creditor better off while it would make at least one unsecured creditor worse off. Next to Pareto efficiency, there is also the notion of ‘Pareto superiority’ which relates to a certain change of action whereby the change of action benefits at least one person without making any other person worse off. The superiority of a certain type of action is judged by the person’s individual standards.

Pareto efficiency relates to three different kinds of efficiency, namely (i) exchange efficiency, (ii) production efficiency and (iii) information efficiency. First, exchange efficiency questions whether (in a situation of goods trading) there can be no rearrangement of ownership claims in order to increase the utility of at least one person without reducing it for anyone else. Second, production efficiency relates to the allocation of resources and questions more in particular whether the resources have been deployed in such a way so that no individual can be made better off without making someone else worse off. An important question in this regard is whether the resources a firm has got at its disposal ought to be deployed in such a way as to maximise its market value. Although contractarian scholars see wealth maximisation as the core goal of Corporate and Insolvency Governance, Stiglitz questions both the fact whether (i) wealth maximisation of the firm is pareto-optimal and (ii) what the pareto-optimal outcome would be if shareholders would want to pursue another goal rather than maximising the firm’s value. Third, information efficiency determines how information can be conveyed in the market and questions whether the allocation of information has happened in a pareto-optimal way (i.e. a change in the way of conveying information could benefit any person without making at least one person worse off).

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549 Ibid.
550 Ibid.
551 Ibid.
Kaldor-Hicks efficiency, on the other hand, means that a transaction or a law reform is efficient if the aggregate benefits outweigh the aggregate costs it would create.\textsuperscript{557} In concrete terms, this would mean that any insolvency reform with regard to the position of unsecured creditors which is not able to improve the position of all unsecured creditors would have to improve the position of non-controlling unsecured creditors to such an extent that their gains would outweigh the potential losses incurred by the other (i.e. controlling) unsecured creditors. A transaction (or reform) would be Kaldor-Hicks efficient if the winners could fully compensate the ‘losers’ while still being better off.\textsuperscript{558}

The main difference between Pareto optimality and Kaldor-Hicks efficiency lies thus in the fact that in order to be Pareto-efficient there has to be an \textit{actual} compensation whereas a \textit{potential} compensation would be sufficient for a transaction or reform to be Kaldor-Hicks superior.\textsuperscript{559} How corporate actors will evaluate ‘efficiency’ depends on the value they attach to certain transactions.\textsuperscript{560}

\textbf{3.1.3. Importance and benefits of an ‘efficiency’-principle}

The law and economics literature which focuses on efficiency has had a great influence on Corporate Law and Corporate Governance throughout the years.\textsuperscript{561} Although Insolvency Law has been influenced by economic scholarship as well, it appears that Corporate Law\textsuperscript{562} has been influenced a lot more by the Law and Economics movement whereby economic scholarship influencing Insolvency Law often seems to be rather limited and mostly derived from the already existing economic doctrines developed in relation to Corporate Law.

Nonetheless, the emphasis on efficiency as advocated by law and economics scholars is quite important, not in the least in relation to unsecureds who want to get the highest return possible (within the limits of their claim). There are some good reasons why efficiency is a critical objective to take into consideration.\textsuperscript{563}

\begin{itemize}
  \item \textsuperscript{558} Ibid (fn. 236) 22.
  \item \textsuperscript{559} Ibid (fn. 236) 22.
  \item \textsuperscript{563} This, however, has been contradicted by Mokal who sees fairness as the ultimate objective while efficiency is taking into account in obtaining fairness.
\end{itemize}
First, in a free market system, it is assumed by neoclassical economists that all decisions taken by corporate actors are based on the question what the most efficient outcome would be for them which is rooted in the assumption that all persons are rational maximisers. This is because it is inferred that the more efficient resources are being used, the more likely this will increase the wealth of the particular corporate actor. What the most efficient use of certain resources is, is something that will be determined by the actors themselves based on the value they attach to certain transactions. Critics, such as proponents of the stakeholder theory and communitarians would, however, argue that this would produce a selfish and morally wrong approach for it, so goes the argument, does not (sufficiently) address the interests of other stakeholders but merely focuses on maximising wealth for the shareholders. Furthermore, it could be argued that businesspeople may not always act as rational maximisers for they may attach more importance to other values rather than merely maximising wealth (such as e.g. expanding the business, maximising growth rather than profits).

More concrete, during an insolvency procedure, one can presume that unsecureds will weigh their chances of getting a certain dividend. If the costs of controlling the office-holder or getting involved in the insolvency procedure outweigh the dividends the creditors might gain, it is highly likely that they would perceive monitoring as inefficient, namely on a cost/benefit analysis. Reforming insolvency law in order to compel creditors to undertake such actions would, as a result, be perceived to be inefficient as well by the creditors (and other corporate players) who would become subject to these (reformed) rules.

Secondly, it has been argued by economists that rules only need to guarantee that parties are able to engage in economically efficient transactions or in other words, the law must guarantee and promote efficiency. What the contracts, transactions or economic arrangements are, is something that must be determined by the economic actors themselves. The rationale behind this is that in a free market society, voluntary exchange and voluntary decisions depend on the ability to freely engage in bargains/negotiations. Individuals ought to be able to freely enter into the transactions or bargains to which they attach the most value or which they believe to be the most beneficial to further their cause. In an insolvency context this would, from the perspective of creditors, mean that unsecureds ought to get the best bargain while the law, according to law and economics theorists, should merely assist the unsecureds in being able to obtain the economically best outcome.

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566 Ibid.
3.1.4. Criticisms of an ‘efficiency’-approach

Although efficiency and more in particular the freedom to decide for one’s own how to obtain the most benefits based on the resources available both prior and after insolvency, ought to be based on the core principles underpinning insolvency governance for it avoids market distortions as a result of government intervention while seeking to provide the (unsecured) creditors with the best possible outcome, there are still some criticisms or adjustments which have been made in the legal and economic literature in relation to the principle of ‘efficiency’.

First, if the markets cannot operate efficiently by only relying on the principle of ‘freedom of contract’, some legal rules seem necessary to guarantee that ‘contracting’ (amongst economic players) does not become inefficient. Related to the topic of this research, this would, for example, be the case if there is an information-asymmetry causing some factions of creditors to contain or to have (access to) more information than other factions of unsecured creditors or in case of bargaining inequality between different (factions of) unsecured creditors. A good example of this are unsecured creditors who have no or almost no legal/financial knowledge and whose market consent might be rather illusory. One of such scenarios would be where an administrator is influenced by the bank’s interests in the administration of a company as a result of the bank (in its capacity as a secured creditor) being able to appoint an administrator and the administrator usually being a person interacting more often with banks while performing his job. Although assumed to be impartial, the administrator could well be less neutral than one assumes potentially leaving weaker or non-controlling unsecured creditors, arguably, in a less enviable situation.

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572 However, the bank might in the same procedure be both secured and unsecured which would immediately lead to a conflict between a controlling unsecured creditor (i.e. the bank) and the other non-controlling unsecured creditors.
Secondly, economists such as *inter alia* Milton Friedman have acknowledged that one can only achieve an optimal/efficient economic outcome if there is no occurrence of fraud or deception.\footnote{575} In case of fraud\footnote{576} or deception, there can be no efficient outcome. This would, for example, be the case if controlling unsecureds exploit their controlling position to gain a higher dividend than they were actually entitled to get based on the *pari passu* rules.\footnote{577} Surely, this also relates to the information-asymmetry mentioned under the previous point. Namely, if non-controlling unsecureds are in possession of all necessary information to make a balanced judgment during the insolvency procedure with regard to the position they should defend\footnote{578}, it seems quite likely that they would make a different judgment/decision if they see that, based on the information, some other creditors have been acting exploitatively against their interests. However, it is important to distinguish between creditors who are merely benefiting from their legally held position and controlling creditors abusing their position in a way detrimental to the interests of non-controlling unsecureds (whereby the latter non-controlling unsecureds see their vulnerable position being (ab)used in order to further the controlling creditors’ interests). An example of the latter situation would be if there is ‘fraud on the minority’, a concept used in corporate governance if majority shareholders abuse their power to the detriment of the minority shareholders.\footnote{579}

Thirdly, related to the way in which ‘transaction cost efficiency’ has been described (i.e. through either Pareto-optimality or Kaldor-Hicks efficiency), it has been asserted that these ways of measuring efficiency fall short by failing to acknowledge that the economic players involved always depend on the resources they have got prior to this ‘transaction’.\footnote{580} More specifically, under both models, efficiency is measured through the ability of one party, B, to compensate the other party, A. In this regard, Mokal states that it might be a lot easier for someone who was already wealthy prior to the transaction to offer a greater compensation than someone who might not have similar financial resources at his/her disposal. Furthermore, in order to be

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\footnote{575} M. Friedman, *Capitalism and Freedom* (Chicago University Press 2002) 133.  
\footnote{576} Milton Friedman does not clearly define what he means by ‘fraud’ but relying on other analyses where he used the word ‘fraud’, it seems that he refers to criminal fraud.  
\footnote{577} Gertner v CFL Finance Ltd [2018] EWCA Civ 1781; Charnesh Kapoor v National Westminster Bank plc, Kian Seng Tan [2011] EWCA Civ 1083; Cf. *supra* (chapter 5) for the discussion of these cases.  
\footnote{578} During a corporate rescue procedure, this might for example relate to the question whether they should or should not back the CVA as proposed by the office-holder. During a winding-up procedure, this could relate to the making of a decision as to whether they can accept the dividends as proposed by the liquidator or not (in which case they might want to challenge the office-holder as discussed in the previous chapters 4 and 5).  
‘efficient’, both models presuppose at least a potential\textsuperscript{581} ability by one party to compensate the other which, in reality, might not be the case at all.\textsuperscript{582} In addition, the value each party attaches to a certain transaction might be completely different as well which makes it almost impossible to apply these models of efficiency.\textsuperscript{583} This also relates to the ascertainment that both Pareto-efficiency and Kaldor-Hicks efficiency do not (sufficiently) take the real world into account where markets continuously adapt themselves to new economic and financial situations/developments\textsuperscript{584}. Consequently, using Pareto or Kaldor-Hicks efficiency as the only criteria for policy standards would almost be impossible\textsuperscript{585}, if we want to suggest sound policies to ameliorate the position of the unsecured creditors.

Fourthly, although efficiency is a very valuable principle of insolvency law (as set out above), it has been argued that it does not have to operate to the exclusion of other principles which may also influence policy-making.\textsuperscript{586} Other principles (which will be discussed below) may include the principle of ‘fairness’ and/or ‘accountability’. However, whereas ‘efficiency’, by which we mean to achieve the highest return at the lowest cost, tends to focus on ‘freedom of contract’\textsuperscript{587}, other principles have been argued to be intrusive into the economic environment in which creditors are operating. It has, therefore, been argued that one ought to be cautious and refrain from imposing certain ‘outcomes’ on the economic actors (creditors) but by merely trying to create a legal environment in which the economic actors themselves are able to find a solution they perceive to be the most suitable for them.\textsuperscript{588} Henceforth, other values such as fairness or accountability might conflict with the value of efficiency, which is why trade-offs between all the over-arching values could potentially be necessary and which will be discussed below.

Fifthly and allied to the previous point, it has been contended by several authors that ‘efficiency’ might lead to harsh results if no other values (such as fairness for example) have been taken

\textsuperscript{581} As set out before (cf. part 3.1.2.), unlike Pareto efficiency, Kaldor-Hicks does not require compensation to be paid but only that it could be paid.

\textsuperscript{582} Ibid.

\textsuperscript{583} Ibid.


\textsuperscript{585} Ibid.


\textsuperscript{588} F.A. Hayek, \textit{Law, Legislation and Liberty} (Routledge 2013) 274; T.H. Jackson and D.A. Steel, ‘Bankruptcy and Economic Recovery’ (2013) University of Pennsylvania Law School: Legal Scholarship Repository p. 2 and 35-36 available at https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1475&context=faculty_scholarship; Schumpeter, not being a neoclassical scholar such as Hayek, also acknowledges the necessity of leaving at least some managerial liberty to managers. See: J.A. Schumpeter, \textit{Capitalism, Socialism and Democracy} (Wilder Publications, Floyd Va) 81.
As will be explained below, solely relying on efficiency might, according to some scholars, lead to weaker parties (such as e.g. tort creditors) losing out whereas other values may have granted a better protection to them. This, however, will be more an issue of who should be protected and will therefore be discussed below.

Nonetheless, despite the worthy criticisms of ‘efficiency’, the benefits of it and, more in particular, the ability to further a regulatory environment which seeks the best outcome at the lowest cost, it is a value which ought to be preserved.

In this regard, many law and economics scholars, in common with and often building further on contractarianism, have expressed the view that ‘efficiency’ in Corporate Law equals the aim of maximising the firm value. The contractarian theory has been brought into Insolvency Law through the creditors’ bargain theory developed by scholars such as Jackson and Baird. According to this theory, as explained more in detail in the second chapter, the (now financially distressed) firm is seen as nothing more than a complex web of contracts entered into by individuals who are all seen as rational economic actors aiming to maximise their wealth. In this regard, Jackson argues that, in order to maximise their individual wealth, all these rational economic actors will agree to act collectively by sharing the remaining amount of assets rateably and equally once the company ought to be liquidated. As insolvency regimes ought to reflect this “hypothetical bargain”, insolvency law, he argues, should, in principle, not get involved in distributional objectives. Hence, according to this argument, the relationships between these rational economic actors on the one hand and the financially distressed firm on the other hand will predominantly be subject to laws than other Insolvency Law. For example, the relationship between the company and an employee is said to be covered by employment law while the relation between the company and suppliers will be subject to Contract and Commercial Law. Consequently, Insolvency Law should, according to Jackson and proponents of the creditors’ bargain theory building further on the law and economics scholarship, not be concerned with distributional fairness. In fact, “losses lie where they fall” according to these scholars,

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590 B. Black and R. Kraakman, ‘A Self-Enforcing Model of Corporate Law’ (1996) 109 Harvard Law Review 1911, 1921; However, as mentioned above, instead of maximising firm value, efficiency might for some businesspeople or corporate actors also be defined differently for they might find other values such e.g. business growth more important.
591 T.H. Jackson The Logic and the Limits of Bankruptcy Law (Beardbooks Washington D.C. 2001) 14
592 Ibid.
although it should be acknowledged that Jackson and Baird do accept collectivity and the fact that unsecured creditors share *pari passu* in the proceeds.\textsuperscript{594}

However, given the ‘open-ended’ character of ‘efficiency’, one can ask whether law and economics scholars were not misguided in drawing the conclusion that efficiency equals shareholder or creditors’ wealth maximisation. In other words: if efficiency is open-ended and leaves the individual at liberty to act in his/her own interests, why would the individual necessarily opt for the creditors’ wealth maximisation? The reason behind this lies in the assumption that an individual’s interests can be limited to short-term financial considerations without considering other principles such as non-economic or more long-term economic values. This rationale would be reasonable in liquidation but not, perhaps, in a rescue scenario. In this regard, Baird argues for an auction of assets (which is synonymous to ‘a liquidation’) as the most efficient approach. The reasoning behind this is the idea that if someone else has got the assets, they might be better placed to use them to good effect.

Nonetheless, in reality creditors may want to pursue a different path. Creditors may want to consider non-economic values or they may have more long-term economic interests which are at stake once their debtor becomes insolvent, particularly where rescue might be possible. For example, some small trade creditors may be satisfied with receiving a more limited amount of their *current* claim in exchange for the (possibility of) the financially distressed company being rescued. In the long-run this could be financially more opportune for them, especially if they have got a long-standing commercial relationship with the firm and if they would benefit more from being able to continue trading with it. Similarly, employees may care more about losing their job (and the risk of being unemployed) than about receiving a still regrettable lower wage for a limited period of time.

Finally and allied to the previous point, arguably the biggest criticism against efficiency is the one according to which ‘efficiency’ itself does not hold any or a sufficiently normative claim as to *how* the regulatory framework should be constructed.\textsuperscript{595} Apart from emphasising that the rules should enable markets (and businesses) to function in the most efficient way, it is argued that ‘efficiency’ as a value does not (sufficiently) explain *what* the most efficient outcome might be which in turn is said to make it difficult (if not impossible) to determine the appropriate policy by solely relying on ‘efficiency’.\textsuperscript{596}

\textsuperscript{594} As will be explained below (as part of ‘fairness’), the *pari passu* – principle might itself be problematic as it treats all unsecured creditors equally while different factions of unsecured creditors might be in need for different treatment.


\textsuperscript{596} Ibid.
However, even if one would argue that ‘efficiency’ defends a normative policy of promoting ‘creditors’ wealth maximisation’, it still leaves open many questions with regard to distributive allocation and it would not solve problems caused by the creditors’ lack of bargaining power or their weaker position. Especially non-controlling unsecured creditors would be at risk of losing out in a system which solely would rely on efficiency. Furthermore, if insolvency law – as argued for by the creditors’ bargain theory – is not allowed to consider other values in order to protect the rights of (weaker) unsecured creditors, how would it be able to guarantee that stronger (more controlling) unsecured creditors would not use or abuse their controlling position? It is here that the creditors’ bargain theory, relying on ‘efficiency’, merely ignores the possibility that weaker creditors may lose out which is an outcome even harsher than prominent neoclassical economists such as M. Friedman and F. Hayek would defend who both agreed that protections should be in place to protect economic actors against fraud or deception.

### 3.2. Fairness

#### 3.2.1. What is fairness?

##### 3.2.1.1. General background

Given the open-ended character of ‘efficiency’, the questionable grounds upon which ‘efficiency’ alone would be able to provide a complete normative policy for insolvency law and the flaws in a policy solely relying on efficiency, it is, as indicated above, deemed necessary to include other values/principles against which the regulatory insolvency framework ought to be measured.

As solely relying on efficiency has been argued to pave the way for possible unfair situations, ‘fairness’ could be a value able to complement the aforementioned value of ‘efficiency’. When discussing the value of ‘fairness’, we aim to look at the way how rules can be designed in a substantially and procedurally fair way. However, that begs the question what is meant by ‘fairness’. Korobkin defines ‘fairness’ as ‘a moral, political, personal, and social value’. However, this remains still very abstract and does not clarify what ‘fairness’ actually means.

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599 By which I refer to the criticism of Mokal that efficiency alone cannot provide a normative policy and the analysis supported by Keay that if efficiency can provide a normative policy it would be flawed and in need of other values.
600 This principle should not be confused with the value of ‘accountability’ which will be discussed below and which is concerned with the issue whether one has adhered to these (substantially and procedurally fair) rules or not, and if not, which enforcement mechanisms should be in place and how one can incentivise people to adhere to the rules.
In general, it can be expected that for the purposes of insolvency law people would describe ‘fairness’ as treating persons equally if they are in an identical situation or at least proportionately. As mentioned above, Finch also makes use of ‘fairness’ as one of the four key values which legitimise a certain insolvency policy but apart from saying that ‘fairness’ relates to the variety of different interests amongst individuals being part of insolvency procedure and issues of ‘justice’ she glosses over the concept of ‘fairness’. Although clarifying the distinction between procedural and substantive fairness, Finch also fails to appropriately define ‘fairness’. In fact, the majority of the scholars are quite superficial with regard to their description of ‘fairness’. It can be assumed that authors believe that readers understand what they mean by ‘fairness’ but given the lack of definition of fairness and perhaps the impossibility of defining the concept of fairness (which can probably be seen as a quite subjective or intuitive value), it seems advisable to give some explanation about the concept, especially when it is argued that ‘fairness’ should be used as one of the key values against which insolvency policies should be measured.

3.2.1.2. Fairness as equality?

According to Keay, fairness in a commercial context is a principle is concerned with the end distribution of wealth while seeking to provide protection for more vulnerable creditors and other stakeholders. If the law is fair, this means that it should meet the reasonable and legitimate expectations the interested parties would have got prior to contracting. In this regard, ‘fairness’ as a principle is a contract-based idea filling the gaps that parties have left open which might, to a certain extent, overlap with the notion of ‘good faith’, which is a legal term more employed on the European continent. It is based on the argument that contracts are incomplete. Parties often fail to implement all the necessary terms and definitions, clauses may be badly worded

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603 Cf. *supra*; V. Finch and D. Milman, *Corporate Insolvency Law* (Cambridge University Press 2017) 45
605 As described above, fairness can be divided into substantive fairness which seeks to guarantee that the laws are ‘just’ for the interested parties and procedural fairness which aims to make sure that the processes (such as procedures) enable to achieve the ‘just’ result which the rules envisaged. See: Ibid (fn. 514) 45; R.J. Mokal, ‘On fairness and efficiency’ (2003) The Modern Law Review 452, 457.
607 Ibid, 678.
608 Although many people might probably share a certain vision of what fairness entails, one can still assume that everyone will have his/her own definition of what he/she sees as ‘fair’.
611 Ibid, 679.
and there is often too much room for interpretation due to its vagueness. Furthermore, unsecureds often lack market power to actually obtain a better position. Rules designed to meet the objectives parties had prior to contracting ought to ensure that more vulnerable parties will not lose out when something unintended (or an unforeseen event) happens. For example, a contract between a debtor and a creditor may have given scant attention to the possibility of the company entering into an insolvency procedure and the impact such an insolvency may have on the payment of the debts to the creditor.

i) Recovery

Fair rules then aim to assure that the creditor will get the amount of money (s)he was entitled to receive and if the full amount cannot be repaid, the highest amount possible without creating unlawful wealth transfers from for example creditors to shareholders or connected parties. The latter description of fairness also seems to fit in the way the current UK government appears to look at fairness in the legal and commercial area of corporate governance and insolvency given the fact that in the government’s response to the March 2018 consultation on insolvency and corporate governance, they announced to introduce several mechanisms which would reduce the risk of creditors being unfairly financially disadvantaged. Although the UK government did not indicate any specific/concrete actions it would undertake, the government agreed to inter alia look further at preferential payments (such as preferential payments made to connected parties), other methods employed to extract value from unsecured creditors and ways to enhance already existing recovery powers. Importantly, ensuring that business activities are conducted in a fair way is seen by the UK government as an opportunity to grant the UK a competitive advantage by continuing to be a reliable and dependable place to invest and to do business.

Nonetheless, when discussing the issue of a ‘fair recovery’, an overlap with ‘accountability’ can be ascertained. As fairness, according to Keay, rules out any illegitimate wealth transfers from

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616 Ibid.
617 Ibid.
creditors to shareholders through the actions of directors\textsuperscript{618}, there should be appropriate rules which enable directors to be held to account avoid ‘cheating’ or behaving opportunistically. The principle of ‘accountability’ will be assessed below.

ii) Public interest perspective

Furthermore, fairness as an over-arching insolvency principle can also be defended from a public interest-perspective. The requirement to ensure that the insolvency framework is ‘fair’ entails that the interests of creditors will be taken into account by the directors and office-holders. This ought to avoid or minimise the risk of a ripple-effect whereby creditors who are also debtors themselves are no longer able to pay off their own debts as a result of the first debtor entering into an insolvency procedure (and not being able to satisfy his creditors)\textsuperscript{619}. Furthermore, a fair insolvency framework is also expected to reduce the risk of creditors not willing to provide debtors with credit.

Flowing from the previous point the question still remains how “fairness” ought to be defined. As indicated above, Keay states that ‘fairness’ is concerned with the end distribution. in order to ensure this end distribution is fair, the insolvency laws made use of an ‘equality’-principle\textsuperscript{620}. This equality principle enshrined in the regulatory framework through the pari passu principle ought to lead to more fairness for (or a fairer distribution amongst) unsecured creditors. This reasoning has also been endorsed by other insolvency scholars such as Finch\textsuperscript{621} and Korobkin.\textsuperscript{622}

3.2.1.3. Fairness as justice?

However, this vision whereby fairness can be obtained through the principle of equality has been strongly criticised by Mokal. In principle, creditors are equal to the extent that they are unsecured (leaving aside the preferential creditors). However, along with the fact that the pari passu-rule has got so many qualifications to it, Mokal argues that the pari passu principle is an example of formal equality whereby the same rule applies to everyone regardless of any differences amongst these people\textsuperscript{623}. More in particular, all creditors subject to the pari passu rule will see their debts reduced by the same proportion.\textsuperscript{624} This formal equality is, according to Mokal, absurd given the fact that it treats creditors who are not in the same or similar situation
Unequal parties are treated equally and hence, 'equality' only tends to achieve the opposite of what it aimed to achieve.

Rather than seeing fairness as a form of 'equality', fairness ought to be seen as 'justice' according to Mokal. In this regard, he develops a new insolvency model, the authentic consent model, drawing on the theory of justice as outlined by Rawls. Rawls defines 'fairness' as the principle applying to all individuals obliging these persons not to gain from the cooperative efforts undertaken by their fellow contract parties with whom they voluntarily decided to enter into a 'mutually cooperative venture'. In order to obtain a fair outcome, all individuals are being placed behind 'a veil of ignorance' which Rawls defines as the 'original position'. Behind this veil of ignorance, the actors/parties do not know what their status is, what their bargaining power will be, how much money they are owed etc… There is an absolute lack of information which ought to guarantee that all parties, during their hypothetical bargain, think and act in a mutually cooperative way because they do not know (at the original position whether they will be on the stronger or weaker side).

Based on this Rawlsian theory, Mokal designed the 'authentic consent model' based on which all creditors are argued to stand behind a veil of ignorance as well. The question then is whether creditors, who do not know what their position post-insolvency will be, would agree to the 'equality' or pari passu principle. Mokal argues that they would not as both strong and weaker unsecured creditors would be treated equally despite not being equal. Only in a pre-insolvency setting claims can be treated equally as there is the general expectation that the debtor will be able to pay off all creditors so that no claims ought to be reduced. This, however, changes once the debtor becomes insolvent as creditors will see their claims being reduced. It is at this stage, according to Mokal, that creditors in a hypothetical bargain ex ante would have determined that weaker factions of creditors would be given more protection than stronger factions of creditors. Nonetheless, such a reasoning could be criticised as both Rawls and Mokal assume that parties or creditors would obtain a mutually cooperative or beneficial solution during the hypothetical bargain in which they are engaged. This does not necessarily have to be the case. Creditors may for example agree to retain their rights to enforce their claim against the debtor, even if this would likely reduce the going-concern value of the debtor (ultimately

625 Ibid.
626 Ibid 61.
627 Ibid.
629 Ibid, 118.
630 Ibid, 118-119.
632 Ibid 119.
resulting in a lower dividend for some or many creditors). Furthermore, although Jackson makes use of a ‘hypothetical bargain’ between creditors to sustain the creditors’ bargain theory, he would not agree with Mokal for the hypothetical bargain should, according to Jackson, not be used to differentiate between different factions of (unsecured) creditors but merely to maximise the entire group/collective which ties in to the aforementioned criticism that a ‘hypothetical bargain’, as defended by Mokal, does not necessarily mean weaker (unsecured) creditors would be granted a better position.

A similar criticism has been raised against Korobkin’s value-based theory. According to Korobkin, creditors would, behind a Rawlsian veil of ignorance, put more emphasis on the rights of more vulnerable creditors but according to Finch, there is no indication whatsoever to assume that creditors would take such a position, even if they lack all necessary information about their position / vulnerability. After all, the actions of individuals remain uncertain and are difficult to predict, no matter what circumstances the individual finds itself in.

### 3.2.1.4. Other ways to define ‘fairness’?

However, both descriptions of fairness, it could be argued, make the same error. They may both create an unrealistic situation. This is whether the description of fairness as a matter of equality during the end phase of the distribution process or the description of fairness ‘as justice’ is employed, assuming that creditors behind a veil of ignorance would miraculously come up with an agreement respecting or improving the position of vulnerable creditors. It is right to say that treating unequal creditors equally could exacerbate the inequality as the weaker position of some factions of unsecured creditors could be abused by some less vulnerable (controlling) unsecured creditors aiming to take advantage of the weak position. As explained in the previous chapter, this would for example be the case if some connected parties would use their majority position to pass a voluntary arrangement guaranteeing full repayment of their debts at the expense of some other minority creditors who may not be aware (for example due to a lack of engagement) that they find themselves in a disenfranchised position. However, believing that all issues could/would be solved by relying on a hypothetical bargain between creditors taking place behind a veil of ignorance which never happens in reality, is quite unrealistic and seems to conceal the lack of solution for the vulnerability problem of which some creditors may suffer. Hence, the reason why one could wonder how his authentic consent model could work in practice, if at all.

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636 *Re A Debtor (No 101 of 1999)* [2001] 1 B.C.L.C. 54 Ch D.
The problem lies in the fact that on the one hand businesses operate in a free market whilst on the other hand not necessarily using their liberty to achieve a ‘fair’ or ‘morally accepted’ outcome.\textsuperscript{637} Trying to intervene in these markets relying on the meritorious ideal to make business operations and free enterprise ‘fairer’, however, may create legal and commercial uncertainty as ‘fairness’ might be described differently by different governments due to its rather vague and open-ended character which may ultimately only increase arbitrariness and distortions of the rule of law.\textsuperscript{638} Although Hayek argues that given these criticisms ‘fairness’ should not be used as an over-arching policy principle\textsuperscript{639}, a clear description of ‘fairness’ taking into account the risks and criticisms raised may provide clarity, more certainty and might eradicate the vagueness which currently pervades many policy debates. Henceforth, fairness ought to make sure that (i) the rule of law\textsuperscript{640} is protected, (ii) that persons may not abuse their right by acting opportunistically such as e.g. engaging in deceit and/or equitable or criminal fraud\textsuperscript{641} and that (iii) formal equality does not get mixed up with ‘substantive equality’ so that different factions of persons (or unsecured creditors) are not subject to equal treatment.

3.3. Accountability

3.3.1. Definition

3.3.1.1. General observations

Having rules which are efficient and fair, is however, not enough for parties ought to abide by these rules. Consequently, the third over-arching principle which this research will elaborate on is accountability. As the scope of this research is confined to the question whether more vulnerable/non-controlling unsecureds are in need of more protection (and if so, what protection?), accountability is critical for accountability of directors/office-holders aims to provide a good distributional outcome for all the unsecureds. This is in particular when the non-controlling unsecureds could bear significant consequences if either the directors and/or the office-holders fail to take into account the interests of these non-controlling groups (as shown in chapter 4) who might be disenfranchised by exploitative and/or inefficient actions taken by the controlling unsecureds (as shown in chapter 5).

\textsuperscript{638} F. Hayek, \textit{The Road to Serfdom} (London and New York: Routledge 2001) 81.
\textsuperscript{639} F. Hayek, \textit{The Road to Serfdom} (London and New York: Routledge 2001) 81.
\textsuperscript{640} With rule of law, this research refers to the requirement (for anyone) to comply with the applicable laws (including case-law), rules and regulations (i.e. national and international). Although the concept of the ‘rule of law’ is very interesting and has itself been subject to a lot of doctrinal research (see for example, R. Gosalbo-Bono, ‘The significance of the rule of law and its implications for the European Union and the United States’ [2010] 72 University of Pittsburgh Law Review 229; S. Humphreys, \textit{Theatre of the Rule of Law. Transnational Legal Intervention in Theory and Practice} (Cambridge University Press 2011), R. Stein, ‘Rule of Law: What Does it Mean?’ [2009] 18 Minnesota Journal of International Law 293), it is deemed outside the scope of this research to elaborate further on this notion of the Rule of Law.
\textsuperscript{641} For example, by unlawfully taking advantage of the ‘minority creditor’.
As well as the notion of fairness, accountability is also quite a difficult principle to define. Although the word ‘accountability’ is very often used in relation to corporate governance\(^\text{642}\) and in many other areas not in the least in political matters, it is key to assess what is actually understood by ‘accountability’ as the notion tends to have a positive connotation and is widely seen as conducive to enhancing the (corporate) environment.\(^\text{643}\)

Starting with the notion of accountability as employed by policy makers, the UK government seems to indicate that accountability forms an important and integral part of corporate governance with the UK’s Department for Business, Innovation and Skill describing corporate governance as “the system by which companies are directed and controlled. It deals largely with the relationship between the constituent parts of a company – the directors, the board (and its sub-committees) and the shareholders. Transparency and accountability are the most important elements of good corporate governance”.\(^\text{644}\) However, although the government attempted to provide a definition of corporate governance, the definition does not provide much more clarity as to what is actually understood by ‘accountability’ and what function is has got or should have within corporate governance. In the most recent report on Insolvency and Corporate Governance\(^\text{645}\), the government regularly highlights the importance of ‘accountability’ again without attempting to provide a clear(er) definition.

A similar lack of clarity can often be determined in the academic literature where the importance of accountability is stressed, once again often without properly explaining what one actually understands by it. Although it might again be the case that one assumes that everyone has got an idea what should be understood by ‘accountability’ (as was the case with ‘fairness’ too)\(^\text{646}\), it seems still quite important to determine the meaning of this notion which is deemed to be a key aspect of corporate governance for the lack of a definition might result in difficulties while assessing whether certain corporate governance mechanisms are conducive to creating a

\(^{642}\) The importance of ‘accountability’ has been stressed in several Corporate Governance reports such as the Cadbury Report, the Hampel Report and several other studies undertaken in the area of corporate governance.

\(^{643}\) A. Young, ‘Frameworks in regulating company directors: rethinking the philosophical foundations to enhance accountability’ (2009) 30 Company Lawyer 355 at 355, 356 whereby accountability has been described as “a cornerstone of effective governance”; E. Andrews, ‘Board accountability is a key element of strong corporate governance’ available at https://www.granthorntonnii.com/news-centre/board-accountability-is-a-key-element-of-strong-corporate-governance/.


\(^{646}\) Cf. supra.
better corporate climate or whether they have to be improved.\textsuperscript{647} This problem will only be exacerbated by the widespread amount of different interpretations given to the notion of accountability.\textsuperscript{648} Furthermore, the lack of a clear definition may also lead to corporate governance debates being at cross-purposes while there is also a risk that without a proper definition, directorial or managerial shortcomings may not get noticed and, hence, will not be challenged which could lead to a lower rate of return for those who might be the most vulnerable (i.e. the non-controlling group of unsecured creditors).\textsuperscript{549}

Although not many attempts have been undertaken to rigorously define ‘accountability’ in corporate governance\textsuperscript{650}, Boven argues that there are two conceptions of accountability. On the one hand, there is the \textit{normative} conception whereby accountability is described as a general framework or set of standards designed to evaluate the behaviour of those who take certain decisions affecting other people who are the beneficiaries of the decisions taken by the former ones\textsuperscript{551}. Accountability, according to Boven, is seen as a ‘virtue’ or ‘good quality’ in this conception\textsuperscript{652}. This is, however, quite a vague and high-level approach and does not grant any useful guidance as to how a company ought to be managed in line with such ‘normative’ conception in practice.

On the other hand, there is the narrower \textit{institutional} conception according to which accountability is seen more as an institutional mechanism making sure that an agent can be held to account by either another agent or the principal\textsuperscript{653}. Although both the normative and institutional conception of accountability are consistent with accountability, the latter (narrow) description of ‘accountability’ provides more useful guidance to avoid the ‘agency conflict’ which the agency theorists warn could happen between i.e. shareholders and directors (as set out in the first and second chapter).\textsuperscript{554}

Leaving aside the discussion whether the ‘agency theory’ is the most appropriate theory underpinning corporate governance for a moment, Bovens describes, as part of the narrow conception of accountability, a procedure with several stages which, according to him, have to

\textsuperscript{651} Ibid.
\textsuperscript{652} Ibid.
\textsuperscript{653} Ibid, 946, 948.
\textsuperscript{654} For a more elaborate explanation of the various theories underpinning Corporate Governance and Insolvency Law, see supra chapter 2.
be followed in order to obtain an appropriate accountability framework. First, it is deemed key for the actors to provide the necessary information to the ones in whose interests they are acting so that the former ones (i.e. the third parties) can verify the information they received. Secondly, once having received the information the actors must explain and justify the decisions they have taken. In this stage the actors can be questioned in terms of ‘what’ and ‘how’ they have done what they have done while explaining ‘why’ they believed these decisions to be the rights decisions, hereby trying to persuade the third parties of the ‘rightness’ of their decisions. Thirdly, the third parties must get the opportunity to (dis)approve the decisions taken by the actors and finally there must be the possibility of some consequences in order to make sure that the actors know that their behaviour will be controlled which is not necessarily confined to legal actions.

Given the vagueness of the broader conception and the clearer and more accurate narrower conception, this research will adopt the narrower conception as described by Bovens.

### 3.3.1.2. Transparency

Flowing from the above analysis, a crucial aspect of accountability is undoubtedly the need for transparency because transparency involves the requirement for actors to inform third parties by disclosing appropriate information and candidly reporting about the necessity, usefulness and impact of their decisions. As will be discussed below, in a company this requires the directors to inform the shareholders of the decisions they are taking, although there might be some limitations as to what directors/managers can or are allowed to disclose to shareholders and/or investors for they might for example want to protect some knowhow or business knowledge.

Despite the seemingly simplicity of the notion ‘transparency’, there still happens to be some confusion as to what ‘transparency’ effectively entails and how it relates to ‘accountability’. Some argue that transparency and accountability are to be regarded as unrelated concepts, others see it as an aspect of accountability while some also seem to contend something which

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comes close to seeing that transparency and accountability as synonymous. The latter view could be observed in the Cadbury Report in which it had been stated that "boards of directors are accountable to their shareholders and both have to play their part in making that accountability effective. Boards of directors need to do so through the quality of the information which they provide to shareholders (...)."

The latter view is problematic for transparency is a necessary but not a sufficient condition to have effective accountability. Transparency and, hence, the requirement to provide the shareholders with accurate information is only the first (important) part of the accountability process for it reduces the information asymmetry between directors/managers and shareholders. This, in turn, allows shareholders to interrogate and question the directors. Following the receipt of accurate information and the further questioning/examination of directors, shareholders can then determine whether to (dis)approve what directors have done. In case, shareholders do not approve, directors might face consequences in the final stage of the process of accountability. So, receiving accurate information is crucial for it is the starting point of the accountability process but it is not the endpoint, however, surely it may also be beneficial aside from accountability. Nonetheless, without accurate and transparent information accountability would not be workable.

To conclude, the concept of accountability can best be described as a control and sanction mechanism given in exchange for the bestowal of power or some authority on a certain person. While a company is solvent, directors are bestowed with the authority to manage the company. In exchange, it is expected from them that they can be held to account for their managerial activities which entails that those to whom the directors are accountable should be able to (i) monitor and control the managerial activities, (ii) to cross-examine the directors while (iii) being able to approve or disapprove of the actions taken by the directors, potentially leading to consequences for the directors in case they fail to live up to the company’s expectations.

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3.3.2. Rationale and relevance

3.3.2.1. Controlling managerial performance

As already touched upon above, it is deemed necessary to emphasise the importance of accountability as accountability for directors has already come under fire or the necessity of 'accountability' has at least already been questioned by some scholars.

The general rationale behind ‘accountability’ is the necessity to make sure that directors (or office-holders once the company has become subject to an insolvency procedure) who are bestowed with the authority to lead or govern the (financially distressed) company can be monitored and, if necessary, sanctioned.

This rationale is rooted in the 'agency theory' which, although criticised by several scholars necessitating some nuance\textsuperscript{666}, still provides a comprehensive framework of the conflicts which potentially may arise in a corporate (or business) setting. The agency theory, as explained more in detail in chapter 1 and 2, is a law and economics theory, which, without rehearsing what has been said before, is closely related to the contractarian and nexus of contracts theory which define the company as a nexus of contracts. Hence, the reason why they treat the relationship between the director (or office-holder) and the shareholder (or the unsecured creditor) as a contractual relationship whereby, according to them, directors are to be seen as the ‘agents’ of the shareholders-principals. As they start from the assumption that all individuals are self-interested rational individuals who want to maximise their own interests\textsuperscript{667}, they argue that there is a significant chance that the agents-directors might engage in opportunistic behaviour by shirking or self-dealing.\textsuperscript{668} Accountability is therefore necessary to make sure that the ‘agent’ does not engage in opportunistic behaviour but remains committed to acting in the interests of the ‘principal’.

However, the former rationale for accountability has been criticised. Those in favour of the stewardship theory\textsuperscript{669} acknowledge that directors have an agency-relationship with the shareholders, but they differ from the agency theorists by arguing that directors are not ipso

\textsuperscript{669} The notion of fairness differs from our over-arching insolvency principle of ‘fairness’ in the sense that the latter notion of fairness is related to our question what the rules should be (and how the rules should be) while ‘fairness’ in this section will be employed to describe a certain attitude or belief held by an individual (i.e. in our case the director).
facto rational-maximisers seeking to further their own interests. Either the interests of directors and shareholders are aligned or, if they are not, the director will act in the interests of the shareholder because this would be better for the firm. In contrast with the agency theory, stewardship theorists argue that directors are merely interested in the firm goal with cooperation and collaboration being central to achieving their goal. Contrary to the agency theory, stewardship theorists submit that directors are more likely to be guided by their belief in ‘the higher good’ or fairness. Hence, while the agency theory focuses on conflicts of interests between shareholders (or unsecured creditors) and directors (or office-holders), the stewardship theory tends to focus on the ‘collective’ and assumes loyalty of the directors towards the company in order to further organisational utility rather than their own self-interests. Hence, the question: if the stewardship theory applies, is there still any need for accountability? Or does accountability as an over-arching insolvency value suggest that agency theory ought to be the underlying theory?

Addressing this issue, stewardship theorists are definitely right in saying that directors might not ipso facto be in a conflict-situation with shareholders for their interests might indeed be aligned or directors might ‘sacrifice’ their self-interest for the betterment of the company. The argument that directors might not necessarily be guided by self-interest but (also) by other principles such as loyalty and fairness in order to maximise the utility of the company (rather than one’s own) should thus be commended. However, despite starting from the assumption that directors are ‘stewards’ which are guided by principles of ‘fairness’ and who will aim to work in the interests of the shareholders by enhancing the operational utility, stewardship theorists do accept that conflicts between directors and shareholders may exist. Hence, although some commentators do believe that the stewardship theory and agency theory are mutually exclusive, it seems far more likely that both theories ought to be combined in terms of explaining an agent’s behaviour for a director might sometimes act in his own interests while at other times acting in the interests of the company with some directors always acting in the interests of the company while others might merely seek to further their own interests. In reality, it seems thus more likely that both the agency theory and the stewardship theory meet

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673 Ibid, 1299.
each other somewhere in the middle for in most cases a director will not always and in 100% of the cases be the perfect steward upholding ‘the higher good’ while it seems unlikely as well that a director would always be in a constant conflict-situation with i.a. the shareholders as assumed by agency theorists. Hence, there remains a risk that when not being guided by ‘fairness’, directors might end up in an economic conflict-situation as predominantly advocated by agency theorists.

3.3.2.2. Legitimacy

Although the rationale of the agency theory\(^{676}\) remains thus one of the explanations why ‘accountability’ as a guiding principle must apply, it is not the only one. Indeed, as acknowledged that some ‘agents’ might not be in conflict with their ‘principals’, there must be a more compelling reason why ‘accountability’ ought to be one of the over-arching principles. In this regard, ‘legitimacy’ provides another primary justification why accountability must be an over-arching principle\(^{677}\). As the directors, but also the office-holders, are vested with a lot of power and it is very difficult for shareholders to intervene in the management\(^{678}\), it is important that directors are seen as ‘legitimate’ by giving an account. Giving an account will increase their credibility and is likely to build trust among both shareholders and other stakeholders (such as creditors).

Although office-holders are often in a slightly different position to directors with a different set of managerial activities, a lot of prior legal (and financial) knowledge and courts being extremely reluctant to interfere with their performance\(^{679}\) (as long as they are officers of the court which excludes office-holders in voluntary liquidations for example)\(^{680}\), the argument that one needs to give an account also applies to them for legitimacy will also be crucial for them as they need to either rescue or liquidate the company, hereby affecting a wide range of other stakeholders who are affected by the office-holder’s actions. Surely, it is important for office-holders to uphold their credibility and to be trustworthy which also grants them a ‘licence to operate’.\(^{681}\)

Consequently, accountability can be argued to be crucial to make sure that there is good governance for it not only grants legitimacy to the agent’s actions (enhancing one’s credibility

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\(^{676}\) Meaning the need for control of directors as a result of their inherent conflicts of interests with shareholders.


\(^{678}\) John Shaw & Sons (Salford) Ltd v. Shaw [1935] 2 KB 113.


and trustworthiness), it also creates the framework in which the agent will be monitored and controlled by those with whom the agent might have a conflict of interests.

Such good governance for which accountability is key is very important for unsecureds. At the time when the distressed debtor might still be rescued, good governance, by enhancing trustworthiness, might make a rescue procedure more likely to succeed. Furthermore, on both occasions, whether the company can be rescued or not, good governance is expected to enhance the second over-arching insolvency principle of fairness because (secured and unsecured) creditors are more likely expected to get the money they are owed (if possible) while both the directors or office-holders endeavour to act in the company’s interests for their benefit.

Surely, the increased likelihood of fair treatment is good for the whole group of unsecured creditors, including the non-controlling unsecured creditors. However, even if neither the office-holder nor directors have performed badly (and, hence, do not face any liability procedure), the behaviour of controlling unsecureds might still jeopardise the interests of non-controlling unsecured creditors, hence the reason why it might be necessary to adjust the current managerial duties without infringing the first over-arching principle of ‘efficiency’.

3.3.3. To whom is one accountable?

3.3.3.1. Accountability of directors

It is presumed that directors perform better once their work is scrutinised. Consequently, it is being asserted that an improved corporate governance leads to improved managerial performance which ultimately makes companies more successful. Similarly, one could infer that an improved insolvency governance may also maximise the dividend outcomes as a result of an ameliorated managerial activity by either the directors and/or the office-holder and increased control by the unsecured creditors.

According to section 172(1) of the Companies Act 2006, directors ought to promote the success of the company ‘for the benefit of its members as a whole’ while taking into account the interests of other stakeholders such as inter alia employees, suppliers, the environment. This has been called the enlightened shareholder value principle. However, once a company enters into

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682 Cf. infra chapters 6 and 7 on the insolvency values and the potential trade-offs amongst them.
683 Cf. infra chapter 8 on possible solutions to improve the protection of the non-controlling unsecured creditors.
686 Companies Act 2006, section 172(1).
financial difficulties, the duties of the directors ought to focus on the interests of the creditors instead of the members. While the duties are quite shareholder-centred before insolvency, there is still some focus on the interests of other stakeholders. However, the duty to take into account interests of other stakeholders has not been repeated under section 172(3). Consequently, one could seemingly infer that once a company becomes insolvent, directors are only accountable to the creditors. One could argue that directors continue to be accountable to the shareholders but that the substance of the accountability has become different since the company became insolvent, namely the directors have to see the interests of creditors as paramount.

### 3.3.3.2. Accountability of office-holders

However, as emphasised in chapter 1, once a company becomes subject to an insolvency procedure, it is quite likely that the incumbent management will be replaced by an office-holder who will have to take over the management's role in governing the company. Economically speaking, the (potential) ‘agency conflict’ which previously existed between the management and the unsecured creditors has now become a (potential) conflict between the office-holder and the unsecured creditors.

However, there is a key difference between insolvency practitioners, practising as office-holder, and directors/managers for insolvency practitioners do not only have a slightly different role (i.e. in general either rescuing or liquidating the firm) but are also deemed expert in their field (as long as they are authorised insolvency practitioners). Given the importance of their job and the expertise required, their role has been regulated and monitored quite strictly through both hard-law and soft-law. Hard-law has given both creditors and courts the tools to monitor the

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690 This applies most commonly to administrations but not to CVAs as the management continues to play a substantial role in CVAs (in contrast to administration procedures). Cf. Insolvency Act 1986, Schedule B paragraph 1 for administrations; Insolvency Act 1986, section 1 according to which directors make a proposal for a composition in satisfaction of the company’s debts to the insolvent company and its creditors. The nominee appointed to oversee the CVA is rather limited to acting as an intermediary between the creditors and the debtor and to opine on the proposal prepared by directors, although, in practice, the nominee is likely to be in the drafting of the proposal as well. Cf. A.R. Keay and P. Walton, Insolvency Law: Corporate and Personal (Lexisnexis 2020) 148, 154; See also: J. Vananroye, “Organisatiericht: werkbezoek aan een onvoltooide piramide”, Acta Falconis, 2014, 30-33 (translated: J. Vananroye, “Organisation Law: A Site Visit to an Uncompleted Pyramid” [2014] Acta Falconis 30-33).
office-holder. If necessary, courts can remove the office-holder. Unsecureds may start a misfeasance claim against the office-holder or commence a claim for unfair harm. However, in certain occasions office-holders may even be removed without court involvement. Furthermore, office-holders are also overseen by recognised professional bodies and the Secretary of State. In this regard, office-holders also need to abide by the Insolvency Code of Ethics and SIP-codes which both provide guidance as to the office-holder’s advisory work, his way of conducting the insolvency procedure and inter alia the business judgments he ought to make. If insolvency practitioners do not abide by these ethical standards, complaints can be made to the Gateway which may refer them to recognised professional bodies such as, inter alia, the ICAEW or IPA which is without prejudice to the possibility for creditors to try to remove the office-holder if deemed necessary.

Nonetheless, despite all these regulatory safeguards (which are consulted upon by the UK government at the moment), there is still some concern as to the whether the current regulatory protection would be sufficient. Important in this regard is the fact that, as already emphasised, the group of unsecured creditors are often, as a whole group, in a weak position to monitor the office-holder and to influence the insolvency procedure whilst insolvency practitioners indicate themselves that they have little faith that the current system would appropriately deal with misconduct.

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692 Insolvency Act 1986, s.172, s. 108, s. 45, Schedule B1, para 88, 7(5), Schedule B1 para 7, 26, 33; Insolvency Rules 2016.
693 Holgate v Reid [2013] EWHC 4630 (Ch).
701 Ibid 12.
One of the more important and influential creditors are often the secured ones such as the bank\textsuperscript{702}. However, as the \textit{Gertner} and \textit{Kapoor} decisions showed in chapter 4\textsuperscript{703}, even absent security interests, some unsecured creditors might be more influential than others. This creates a significant risk that those creditors who are deemed non-controlling might find it more difficult to access vital information.\textsuperscript{704} Although this might sometimes be necessary to protect market information the firm might not want to share with e.g. competitors or employees\textsuperscript{705}, there is a concern that unsecured creditors, or certain weaker factions of unsecured creditors, could be left out.\textsuperscript{706} This issue is undoubtedly exacerbated by the rather low creditors’ engagement with the OFT reporting in 2010 that only 3 to 5\% of unsecured creditors attend creditors’ meetings\textsuperscript{707} and many worrying that the economic costs of getting engaged (and monitoring the office-holder) would outweigh the benefits they stand to gain as unsecureds.\textsuperscript{708}

The amount of complaints (almost 2000 during the first two year of the Complaints Gateway)\textsuperscript{709}, however, indicates that there is a need to have a proper accountability framework.

The latter is even more pertinent taking into account the following practical hurdles of the current framework. First, applicants who wish to remove the liquidator must show that it is in the interests of the liquidation (i.e. the whole company) that the liquidator should be replaced.\textsuperscript{710} Although understandable that the interests of the company (and its other creditors) are taken into account, it does create quite a high burden for vulnerable factions of unsecured creditors to have the office-holder removed if necessary. Secondly, as touched upon above, controlling creditors (such as banks) might have a good or better understanding with the insolvency practitioners compared to other non-controlling factions of unsecured creditors for they have the market power, knowledge and arguably financial means or, at least, influence to control the office-holder.\textsuperscript{711} This could potentially be beneficial for non-controlling unsecured creditors if their interests would be aligned with the controlling (unsecured) creditor but if their interests

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{703} Cf. \textit{supra}, chapter 5.
\item \textsuperscript{705} Ibid.
\item \textsuperscript{706} Ibid (fn. 699).
\item \textsuperscript{707} Ibid, para 1.15, 3.16-3.23 and 4.47.
\item \textsuperscript{708} Ibid, para 1.15, 3.16-3.23 and 4.47.
\item \textsuperscript{709} Ibid, para 1.15, 3.16-3.23 and 4.47.
\item \textsuperscript{710} Ibid (fn. 699).
\item \textsuperscript{711} Cf. \textit{supra}, chapter 5.
\end{enumerate}
\end{footnotesize}
differ the office-holder could potentially be steered in a direction jeopardising the interests of the weaker creditors.\footnote{712}{712} 

Thirdly, where the previous conflict occurred between controlling and non-controlling creditors, some scholars also point out that the office-holder might be in direct conflict with the creditors by behaving “as commercial animal hunting work”\footnote{713}{713} by which Paterson means, we assume, that insolvency practitioners might sometimes be more interested in gaining money from an insolvency procedure rather than conducting the procedure in the best interests of the creditors. In the same vein, a recent INSOL International report also highlighted the importance of the officer holder’s remuneration to be subject to adequate scrutiny by both courts and creditors.\footnote{714}{714} 

Although the remuneration of the office-holder has recently been reviewed and updated to make it easier for creditors to challenge the remuneration of the office-holder\footnote{715}{715}, the low number of claims in practice about office-holders overcharging\footnote{716}{716} and their relatively low priority ranking\footnote{717}{717}, office-holders could nonetheless, in a way and in spite of various control mechanisms\footnote{718}{718} and regulatory requirements\footnote{719}{719}, try to “circumvent” the low priority in a distribution of company funds, ranking by for example appointing solicitors of the law firm they are part of in order to manage the distressed company (and inter alia realise the assets, conduct legal procedures etc.) in which case the office-holder’s law firm would be allowed to claim the expenses made as winding-up expenses which have a high(er) priority ranking than the ordinary remuneration\footnote{720}{720} and which might arguably could give an incentive to the office-holder to continue an insolvency procedure even if this would not be in the best interests of the unsecured creditors. Although legally the law firm would be doing the work, in reality it would be the office-holder who had been appointed who would be in charge, although, rather than claiming remuneration (with a low priority), the office-hold can, by appointing her own law firm, try to claim a higher amount of winding-up expenses (for the work conducted by the office holder’s law firm). Particularly, when

\begin{itemize}
\item \footnote{712}{Ibid.}
\item \footnote{713}{S. Paterson, ‘Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards’ [2014] Journal of Corporate Law Studies 333, 359; Given the fact that no explanation was given for the, arguably, bold statement we had to speculate as to what was meant by the author.}
\item \footnote{714}{INSOL International, Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy? (INSOL Special Report – August 2020) 37-63.}
\item \footnote{715}{Insolvency (England and Wales) Rules 2016, r.18.34, r.18.16(4) and 18.30.}
\item \footnote{716}{Only 2% of the complaints were related to the office-holder’s fees according to R3; Insolvency Service, Index of Insolvency Practitioner Regulation and Fee Structure Consultation Responses (IS, London, 16 June 2014) 17 available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/360946/public-responses-ca-ud1.pdf.}
\item \footnote{717}{Insolvency (England and Wales) Rules 2016, r.7.108(o) and r.7.108(q).}
\item \footnote{718}{INSOL International, Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy? (INSOL Special Report – August 2020) 37-56.}
\item \footnote{719}{Mirror Group Newspapers plc v Maxwell (No 2) [1998] I BCLC 638; ICAEW Insolvency Code of Ethics, R2320.3; R2320.4; R2320.6.}
\item \footnote{720}{Insolvency (England and Wales) Rules 2016, r.7.108(a).}
\end{itemize}
no ‘strong’ creditors are part of the insolvency procedure to control, the weaker factions of unsecureds may run the risk to lose out in such case. However, recent changes in accounting regulations gave more weight to the independence of the insolvency practitioner (who is, usually an accountant in the UK) and are expected to make aforementioned practices of cross-selling (or the act of ‘selling’ other services to the same (insolvent) debtor) more unlikely. Future research will have to ascertain whether (and if so, to what extent) the objectives of the changed accounting regulations have been met in respect of the required independence of the insolvency practitioner (accountant) and how this has affected unsecureds.

IV. Conclusion

This chapter started to critically examine how the regulatory framework could be improved in the interests of such weaker/non-controlling groups of unsecureds. Before suggesting any such solutions, this chapter looked at the insolvency values that ought to underpin the insolvency framework and against which regulatory improvements ought to be measured.

This research hereby focused on three critical insolvency values, namely efficiency, fairness and accountability.

As regards efficiency, this concept was addressed from a transaction cost-perspective which requires that the aggregate benefit of a certain legal rule ought to outweigh the aggregate costs it would entail in order to be efficient. This notion had been focused on to a large extent by law and economics and neoclassical scholars and proponents of insolvency theories such as the creditors’ bargain theory and contractarianism which are rooted in economic analysis of law. Nonetheless, it was contended that, despite its merits, predominantly focusing on efficiency could lead to an over-reliance on market forces hereby potentially not providing the necessary legal safeguards to non-controlling/vulnerable unsecureds. Therefore, it was submitted that an appropriate insolvency framework also had to ensure that its rules ought to be a reflection of fairness and accountability.

In this regard, fairness was held essential as, in contrast to efficiency, this value would be more concerned with the protection granted to vulnerable unsecureds while attempting to ascertain

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722 Inter alia in relation to the remuneration the practitioner would receive.
how every (and not only the strong) unsecured(s) would be able to get a dividend as high as possible. In other words, fairness would try to ensure that the regulatory framework would provide the necessary safeguards for all creditors so that the legitimate expectations of especially weaker factions of unsecureds could be met to the extent possible. As fairness hereby relates to both the question ‘what just rules are’ (i.e. substantive law) and which processes could try to achieve such just outcomes (i.e. procedural law) a distinction was made between substantive and procedural fairness. Substantive fairness would be a critical insolvency value against which regulatory reforms should be measured to determine whether they will like produce a just outcome. On the other hand, procedural fairness would help to determine whether accurate procedures are in place to ensure that the aim of the substantive rules to achieve a just outcome could be met.

When determining which rules would arguably provide a just (or fair) outcome for vulnerable factions of unsecureds and whether accurate procedures are in place, an overlap between fairness and accountability exists. This is because an insolvency procedure which is procedurally and substantively fair can be deemed to encapsulate the requirements to have the required accountability procedures in order to make sure that those who did not abide by the Insolvency laws (such as trying to bypass the pari passu rules) are held to account. Although some scholars would therefore categorise ‘accountability’ as falling under the scope of fairness, this argument was not followed because accountability has got its own particular nature which is, in spite of some overlap with fairness, nonetheless distinct from it. Namely, while ‘fairness’ is concerned with ensuring that the substantive and procedural rules are deemed ‘just’, accountability ensures that compliance with such rules can be enhanced.

Accountability was therefore determined to be the third over-arching insolvency value which was described as encompassing four crucial elements. First, this research argued that transparency was key and that, as part of accountability, the necessary information to the ones in whose interests they are acting (i.e. non-controlling unsecureds) had to be provided. Secondly, once the relevant information had been received it was argued to be important to explain and justify the decisions that were considered or that, potentially, had already been taken. The ability for accountees (i.e. those who are given account) to question the accountors (i.e. those who need to give account) was deemed an essential part for accountability to work appropriately. Thirdly, it was argued that the accountee also had to get the opportunity to (dis)approve the decisions taken by the accountors and finally there must be the possibility of some consequences (and potential remedies) in order to ensure compliance with rules that substantively and procedurally ought to be ‘fair’ and ‘efficient’ in line with the aforementioned insolvency values.
The next chapter will build further on this by looking at how these three values interact with one another and thus whether there should be a hierarchy between them or whether they have all equal importance and thus how trade-offs between these values must be dealt with if these values would conflict with one another. Chapter 8 will then critically examine solutions that could improve the non-controlling unsecureds’ position.
Chapter VII

Improving the Insolvency Governance model: balancing the insolvency values

I. Introduction

The previous chapter elaborated on the different insolvency values – efficiency, fairness and accountability – which ought to form the basis of a regulatory framework.

This chapter will build further on this by setting out how these insolvency values interact with each other. Dependent on the way they do, these values could potentially come in conflict with one another. If such conflicts were to happen, there is a question as to whether and how trade-offs between these values must be made. In this regard, this chapter will critically evaluate whether a hierarchy between these insolvency values must be established (and if so, how) or whether these insolvency values need to be balanced against one another and what the impact of such interactions would be for the regulatory framework and the suggested reforms emanating from this insolvency framework in order to enhance the regulatory position of (non-controlling) unsecureds.

Following and expanding the analysis made in the previous chapters, determining how these insolvency values interact with each other and what the implications are for the regulatory framework is vital in order to be able to assess potential reforms against which is what will be assessed in the following chapter. Namely, only by knowing what the insolvency framework ought to be and, thus, having this foundation/basis, one can defend reforms rooted in these values. In doing so, this chapter will first embark on the trade-off between ‘efficiency and fairness’ and ‘efficiency and accountability’ before evaluating the trade-off between ‘fairness and accountability’ and reaching a conclusion as to whether a hierarchy between said values must be established.

II. Balance between over-arching Insolvency Values

Having elaborated on the notions of ‘efficiency’, ‘fairness’ and ‘accountability’ in the previous chapter, it is, however, key to question how these values should shape/influence the regulatory framework and how one should deal with these values in case of potential overlaps and/or conflicts between these values. Would it be best to apply those three over-arching values cumulatively, in which case, these values need to be balanced against each other or should there be a hierarchy? The former option would mean that if a legislative reform or a certain insolvency law would have to be fair, efficient and, in case the issue which would be regulated involves an ‘agency-relationship’, would have to make sure that those who need to be held to account will be able to be held to account. If the law, however, would only be ‘fair’ and thoughtful of ‘accountability’ but not be efficient, it would have violated the cumulative character of the
over-arching insolvency values and could, consequently, not be endorsed. The latter option (of a hierarchy) would involve trade-offs between the three values whereby, in case of a conflict, one value might be given more weight than another. In this scenario an insolvency regulation which would be fair and thoughtful of accountability procedures but which would not be efficient could still be defended in case fairness would be considered more important than efficiency. This research will opt for the former option whereby insolvency legislation should take into account all three values in a cumulative way which, however, does not eradicate the fact that these values may come in conflict with each other in which case compromise might be necessary. The reasons behind this are twofold. It is perceived that all aforementioned insolvency values have merit and should thus all be taken into account. As a result, if one were to prioritise one insolvency value over another, it becomes immediately self-defeating for a regulatory system would then at least to a certain extent lack the required features of the other insolvency values. In the latter scenario (where there would be a hierarchy of insolvency values), the regulatory framework would not improve but rather deteriorate for it would miss (at least aspects of) the values which are deemed necessary to underpin a constructive and properly functioning regulatory framework.

Nonetheless, this prompts the question as to what the right balance is in a scenario where these values conflict\textsuperscript{724} and, particularly, how legislation or an IP can consider all three values at the same time. This question of the trade-off/compromise between these over-arching insolvency values lays bare the difficult balance which needs to be struck between rules which ought to make sure that an efficient\textsuperscript{725} outcome for unsecureds can be guaranteed on the one hand and the rules which ought to provide a fair outcome for these unsecureds, the vulnerable factions amongst them and, dependent on which insolvency theory one prefers perhaps also all the other stakeholders. Critical hereby is also that those who are in charge of the debtor (e.g. directors/office-holders) adhere to such efficient and fair rules and that, if they breach these rules, can be held to account by the aggrieved parties (such as e.g. vulnerable unsecureds). Nonetheless, in designing appropriate accountability procedures, one must also avoid creating rules that would have an over-deterrent effect and would be too costly/burdensome and, thus, inefficient, and unfair. The next parts of this chapter will elaborate further on this balance between these different insolvency values.

\textsuperscript{725} We mean hereby that the firm’s resources ought to be put to the best effect leading to a superior outcome for the non-controlling unsecured creditors compared to the outcome under the current legislative framework without creating so many additional economic costs for the other parties that ultimately the aggregate costs of the new legislation would outweigh the benefits the non-controlling unsecured creditors stand to (or were perceived to) gain from it.
2.1. Abstract balance between efficiency and fairness

In abstract terms, it could be argued that rules ought to be efficient in the sense that they must allow directors/office-holders to reach the best possible outcome for unsecured creditors at the lowest cost possible while at the same time making sure that the information asymmetry from which unsecured creditors often suffer, is reduced (or, if possible, eradicated) and that their legitimate expectations are met taking into account the vulnerable position in which they may find themselves. If the latter aspects are honoured and the rules continue to be efficient, it is argued that a good trade-off or balance between efficiency and fairness has been reached.

However, tackling the aforementioned issues in order to enhance fairness might require the imposition of an additional duty on directors (and office-holders) to take into account the creditors’ interests (e.g. a duty of care and/or a fiduciary duty vis-à-vis other stakeholders). From an efficiency point of view, it has been submitted that such a duty could enhance efficiency for, so goes the argument, it would reduce the monitoring, inquiring and bargaining costs of the unsecured creditors (which they would face in the absence of such a directors’ duty). This economic gain unsecured creditors receive from not having to get engaged in lengthy negotiations, long inquiries into the company’s financial situation and consistent monitoring before and after credit has been granted can be passed on to the company. The argument is that directors will take appropriate steps to consider the interests of creditors and the benefits (unsecured) creditors gained from this can result in either a greater chance of the company receiving credit and/or a larger amount of money being granted to the debtor (as a result of the reduction in economic costs including interest).

Although the rationale behind the aforementioned reasoning is correct, it only shows one part of the equation. More in particular, it has been argued that the cost reduction from which unsecured creditors would benefit, might be offset by the cost increase the company will face as a result of the directors/managers becoming subject to more requirements (such as more specific and/or additional duties imposed on a director towards creditors or a supplementary liability). This could then lead to inefficiencies due to a suboptimal use of the company’s resources as a result of the fact that company directors will now be obliged to monitor everything more closely whereas these economic (monitoring) costs could have been better spent elsewhere. Furthermore, such additional duties being imposed on the directors/office-holders

\[726\] In which creditors’ interests this best possible outcome should be and how other stakeholders fit in, is something which will be discussed later in this chapter.


\[728\] Ibid.

\[729\] Ibid.


could, according to critics, lead to a more risk-averse behaviour of directors/office-holders which could have a negative impact on their managerial performance.\textsuperscript{732} Especially, in relation to assetless insolvent estates, the increased risks that some unsecureds may want to take\textsuperscript{733} (because they have nothing to lose apart from the costs of monitoring the former directors or office-holder) could exacerbate the risks of any additional duties that were to be imposed on directors/office-holders.

2.1.1. Risk-aversion?

Subsequently, the latter criticism that more managerial duties could lead to managerial risk-aversion is quite important given that it could influence behaviour of managers at a time when their role might be crucial to rescuing the distressed company. If the hypothesis that more duties lead to a weaker performance would be correct, this could be quite negative for both the firm’s survival and the unsecured creditors.

In this regard, it had been argued in the past that creating legislation to impose an equitable or fiduciary duty on the directors to act in the interests of creditors would result in “the inability of directors to take risks with corporate assets for the purpose of extinguishing or minimizing the firm’s temporary financial distress”\textsuperscript{734} which would transform directors’ roles from an active role to a mere passive role confined to preserving the assets\textsuperscript{735}. The rationale behind this would be the fact that directors would worry more about their own position rather than thinking about what would be best for the company (and its shareholders)\textsuperscript{736}. Although the fiduciary duty might still be a bit contentious, in English Law the preponderance of authorities\textsuperscript{737} say that creditors’ interests are paramount, however, in the recent Sequana-case\textsuperscript{738} Richards LJ declined to express a view (as to when exactly directors should start considering the interests of creditors) other than when the company is actually insolvent by stating that “[h]e […] [expresses] no view on it, save to say that where the directors know or ought to know that the company is presently

\textsuperscript{734}A.E. Conway Stilson, ‘Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors’ (1995) 20 Delaware Journal of Corporate Law 1, 91.
\textsuperscript{735}Ibid.
\textsuperscript{738}BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112.
and actually insolvent, it is hard to see that creditors' interests could be anything but paramount.”

Despite any clear view expressed by the court in the Sequana-case as regards the specific moment as of when directors should consider creditors' interests, more than a decade ago a director’s duty to take into account the creditors’ interests in certain occasions (i.e. when a company is insolvent but also close to insolvency) has been implemented in section 172(3) of the Companies Act 2006.

Nonetheless, it would be detrimental to a firm if directors are too constrained by the rules and if directors would become too anxious to make (important) decisions for taking risks might be vital for the firm to prosper. In this regard, rather than avoiding or solving market problems or a supposed lack of fairness, it has been argued that too much government intervention in a market (and, applied to our scenario, imposing too many rules on a firm’s management) could actually create or exacerbate the problems the rules sought to avoid. Also, such government intervention could be harmful from an investment point of view as those who have invested capital in a company would see the influence they have got reduced as directors would be obliged, by law, to follow a certain direction the shareholders or investors may not like.

Nonetheless, the negative impact of rules to create a ‘fairer’ commercial environment on firms and managerial behaviour should perhaps not be exaggerated given the fact courts often try to avoid hindsight bias and apply a business judgment rule to the decisions taken by directors. Indeed, judges tend to look at the commercial environment in which directors took their decisions at the time while trying to refrain from putting themselves in the position in which the directors found themselves at the moment when directors took the contested or allegedly unlawful decision or expecting directors to foresee the results of their actions where they were unforeseeable at the time.

However, the threat that directors could become more risk-averse in case they have to adhere to more legal requirements is therefore not non-existent. For example, as indicated in the government paper on ‘Corporate Governance and Insolvency’, respondents clearly indicated that the government proposal to extend personal liability to directors of the holding company in case they sold the shares the holding company held in a distressed subsidiary to a third party,

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739 BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112 at [222].
740 Companies Act 2006, s.172(3).
would lead them to take a more risk-averse decision trying to shield themselves from liability. In this situation, this meant that a large majority of legal practitioners indicated that they expected directors to prefer an insolvency procedure for the subsidiary over a sale to avoid a potential conflict between the director’s duty towards the parent company and the subsidiary’s stakeholders, even though this would mean that there are fewer chances for the subsidiary to get rescued whilst at the same time discouraging inward investments.  

Furthermore, also some US empirical studies show that imposing an additional duty on directors to act ‘prudently’ in the interests of the residual owners (i.e. unsecured creditors) could have a stifling effect making directors more risk-averse and, therefore, diminishing the firm’s wealth. These examples show that despite good intentions to enhance fairness by imposing a new liability on directors the practical outcome might be the exact opposite.

However, the latter empirical studies only concern large corporations and it has been argued that this evidence, therefore, does not apply to smaller closely-held enterprises. Small companies are indeed different to big public corporations for the roles of shareholders and managers are often exercised by the same people who have invested a lot of capital, energy and savings in their company. However, the remarks made by the respondents in the recent ‘Corporate Governance and Insolvency’ proposal by the current UK Government indicate that the fear of being personally liable might lead to entrepreneurs or managers taking a decision (such as placing their firm under an insolvency procedure) which they will be most comfortable with in terms of avoiding personal liability even if such a decision would not necessarily serve the interests of the firm and other stakeholders (such as creditors, employees etc.) relying on the firm’s survival. This could potentially lead to a premature-administration, an issue where directors become so risk-averse that they place the firm in a premature administration which could, paradoxically and in contrast to the wishes of the incumbent management, precipitate  


insolvency. Nonetheless, the fact is that it might just be more in the creditors’ interests for directors to be more risk-averse.

Having said this, in case directors were to become more risk-averse as a result of additional duties conferred upon them, they also have got the opportunity to secure insurance which may give them additional protection, provided they can afford the insurance costs.

Nonetheless, managers’ ability to get insurance, does not take away the fact that one should aim to avoid the value of ‘fairness’ jeopardising an open entrepreneurial society whereby firms are allowed to bolster their ambitions by taking, in their eyes, appropriate risks. Furthermore, even if you get insurance, you can still get your reputation damaged. As such reputational damages might have a negative impact on directors (and, quite probably, the company they are working for) this will most likely be one of their concerns too. This also applies to both directors/managers and office-holders.

Subsequently, when addressing the issue of ‘fairness’ and the implications of rules that could reduce ‘efficiency’, it seems necessary to find a balance as to what the appropriate risk is that directors should (or should not) take. Although it would be impossible for anyone, including the legislature and government, to cover and/or include all different types of risks that might occur in a legislative framework, it would also not be commendable to aim for such a thing for it should ultimately be left to those who manage the firm to determine what, according to them, ought to be the appropriate risks that need to be taken to advance a firm’s prosperity, wealth and/or growth. In this regard, the risks are also different for each business/firm. They differ dependent on inter alia the timing, the type of business and the commercial area in which the firm operates. Regulations tend to lead to uniformity whereas businesses are argued to benefit more from diversity and less top-down government planning. Consequently, without aiming to cover all sorts of risks, one should aim to design a regulatory framework where the rules encourage and reward taking risks while discouraging participation in ill-thought-out business projects or blatantly irresponsible risk-taking which would harm the firm’s and unsecured creditors’ interests, provided the interests of both the firm and the unsecured creditors are aligned. The latter might be initially the case at the time when the company should be rescued but, over time if the firm continues, the interests of both the firm and the unsecured creditors might quite likely diverge more and more.

In this case, it is important to stress that the value of ‘fairness’ aims to make sure that the rules which are designed create a commercial environment where all actors are treated fairly, or in other words, where individuals or classes of unsecured creditors are not (un)willingly placed in a disenfranchised position.\textsuperscript{753}

\subsection*{2.1.2. Increased economic transaction costs}

Another critique with regard to imposing additional duties on directors, is that this could lead to higher economic bargaining costs for the firm as these costs will no longer be (entirely) borne by the creditors while directors will be compelled to have more regard for creditors’ interests. As a result of these additional directors’ duties, directors would be expected to monitor their firm’s activities more closely which would quite likely require more internal investigations and which would presumably also involve taking more expert opinions on the firm’s solvency and profitability to make sure that unsecured creditors’ interests are sufficiently protected.\textsuperscript{754}

Although contractarian scholars argue that such monitoring and investigatory duties would impose an economic cost on the firm, it is important to bear in mind, as mentioned earlier, that courts tend to avoid hindsight bias\textsuperscript{755} when considering the judgments of directors made quite some time in the past\textsuperscript{756} and in addressing the question whether directors have lived up to their duties (i.e. duty to take reasonable and considerable care) while taking certain entrepreneurial decisions which afterwards may have turned out badly and for which they are afterwards accused of a breach of duties.

Furthermore, there is already some case-law stipulating that directors ought to monitor and follow-up the business decisions they have taken.\textsuperscript{757} Furthermore, despite some ongoing confusion as to the exact moment at which the fiduciary duty shift\textsuperscript{758} takes place, it is generally accepted that once a company enters in financially dire straits, directors have in addition to the aforementioned duty also a fiduciary duty owed to the company to take account of the interests of the creditors.\textsuperscript{759} In this regard, the Court of Appeal seems to have given an answer to this

\begin{footnotesize}
\textsuperscript{753} Cf. supra for a more elaborate description of ‘fairness’.


\textsuperscript{757} Re Barings plc (No5) [1999] 1 BCLC 433; Re D’Jan of London Ltd [1994] 1 BCLC 561.

\textsuperscript{758} A duty shift meaning that directors from a certain moment will have take the creditors’ interests into account instead of the shareholders’ interests.

\textsuperscript{759} Liquidator of West Mercia Safetywear v Dodd (1988) 4 BCC 30; Facia Footwear Ltd (in administration) v Hinchiiffe [1998] 1 BCLC 218; Re Pantone 485 Ltd [2002] 1 BCLC 266; Colin Gwyer v London Wharf (Limehouse) Ltd [2002] EWHC 2748 (Ch); Re MDA Investment Management Ltd [2003] EWHC 227 (Ch); [2004] as referred to by A.R. Keay, ‘Financially distressed companies, restructuring and creditors’
\end{footnotesize}
issue in the recent Sequana-case where it held that directors may have to have regard for creditors’ interests even if the company is not actually insolvent yet.\textsuperscript{760} Although the case was predominantly concerned with transactions defrauding creditors (and currently subject to an appeal to the Supreme Court)\textsuperscript{761}, the decision is still useful for it clearly stated that the moment when this duty to have regard for creditors’ interests arises when the “the directors knew or should have known that the company was or was likely to become insolvent” whereby ‘likely’ is understood to be ‘probably’.\textsuperscript{762} Despite some more clarity, the question, however, still remains how it will be determined post factum whether directors should have known that the company was becoming insolvent and how directors themselves should see in practice when their company is ‘probably’ becoming insolvent. Where is the line between insolvency being a mere possibility or becoming a ‘probability’?

\textbf{2.1.3. Do Creditors need additional protection?}

In addition, not only the question whether an additional duty of care to the creditors ought to be introduced, also the question whether a fiduciary duty vis-à-vis creditors should exist at financially difficult times, remains the object of debate.\textsuperscript{763} An argument often invoked in this regard is the fact that creditors are deemed to already possess the appropriate legal tools to protect themselves through several insurance mechanisms\textsuperscript{764} for involuntary creditors and contractual pathways for voluntary creditors via which they can \textit{inter alia} raise interest rates or seek to obtain a security or quasi-security interest.\textsuperscript{765}

Furthermore, without being able to be exhaustive, Company Law provides several regulatory measures such as \textit{inter alia} financial assistance and capital maintenance rules aiming to protect creditors against potentially zealous or reckless actions which might be favoured by shareholders/investors\textsuperscript{766} while requiring directors to take into account creditors’ interests once a company is likely to become insolvent.\textsuperscript{767} And also Insolvency Law provides (unsecured) creditors with several mechanisms such as \textit{inter alia} material irregularity or unfair prejudice

\begin{itemize}
\item[\textsuperscript{760}] BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112.
\item[\textsuperscript{761}] Ibid (n 654).
\item[\textsuperscript{762}] J.W. Callison, ‘Why a Fiduciary Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice’ (2007) 1 \textit{Journal of Business and Technology Law} 431, however, it should be noted that the American scholars argue about a direct duty to creditors while the UK, Commonwealth and Irish approach is to merely shift the content of an already existing duty to creditors.
\item[\textsuperscript{763}] R. Mokal, \textit{Corporate Insolvency Law: Theory and Application} (Oxford University Press 2005) 151-152.
\item[\textsuperscript{766}] BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112; Companies Act 2006, s.172(3).
\end{itemize}
procedures (as regards CVAs/IVAs)\textsuperscript{768} or unfair harm procedures (regarding administrations\textsuperscript{769} or liquidations\textsuperscript{770}) and procedures to remove the office-holder so that they can legally protect themselves against either the company’s directors, other creditors and/or office-holders who do not want to stay “within the rules of the game” and try to exploit (other classes of) creditors. However, as already emphasised above, several issues such as the incompleteness of contracts enabling parties to act opportunistically\textsuperscript{771}, an existing information-asymmetry between controlling unsecured creditors and non-controlling unsecured creditors\textsuperscript{772} (and between unsecured creditors and the office-holder), a lack of creditors’ engagement, financial costs and procedural difficulties remain which lead to the potential disenfranchisement of certain factions of arguably weaker unsecured creditors.

The seemingly easy solution would be to (i) impose more duties (such as an additional duty of care) on the directors and (ii) to try to regulate managerial behaviour in favour of weaker creditors\textsuperscript{773}. Proponents of the stakeholder theory would welcome such an approach whereby additional duties (i.e. such as a duty of care) would be imposed on directors and/or whereby directors would have a fiduciary duty to act in the interests of stakeholders\textsuperscript{774} (such as consumers or employees). Although leaving scope for EU Member States to establish a hierarchy amongst the parties whom directors should have due regard to, the recent EU Directive on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt (“the EU Insolvency Directive”) is probably quite a clear example of a more stakeholder-oriented course of legislative action as it requires EU member states to implement a duty of care for directors to have, as a minimum, due regard to \textit{i.e.} “the interests of creditors, equity holders and other stakeholders”\textsuperscript{775}. Although the term ‘stakeholders’ has not been defined by the EU Insolvency Directive, it appears that a wide range of third parties are

\textsuperscript{768} As regards unfair prejudice procedures: For IVAs: Insolvency Act 1986, s. 262; For CVAs: IA 1986, s. 6; As regards material irregularity procedures: Insolvency Act 1986, s.262(1)(b). Specifically regarding IVAs, a creditor may also petition for the bankruptcy of the debtor (which is an option not available to creditors bound by a CVA): cf. Insolvency Act 1986, section 264(1)(c) and 276.

\textsuperscript{769} Insolvency Act 1986, schedule B1, para. 74(1); L. Doyle and A.R. Keay, \textit{Insolvency Legislation: Annotations and Commentary} (Jordan Publishing 2017) 845.

\textsuperscript{770} Insolvency Act 1986, s.112 (voluntary liquidation) and s.168 (5) (compulsory liquidation).


\textsuperscript{772} Gertner v CFL Finance Ltd [2018] EWCA Civ 1781; Charnesh Kapoor v National Westminster Bank plc, Kian Seng Tan [2011] EWCA Civ 1083; Cf. supra (chapter 5) for the discussion of these cases.

\textsuperscript{773} Cf. infra for the trade-off between efficiency and accountability.

\textsuperscript{774} For the sake of the argument, this research will confine itself to focusing on particular groups of unsecured creditors.

assumed to fall under the scope of it as recital 3, while emphasising the rationale of the directive (i.e. restructuring businesses), refers to “creditors, workers and other stakeholders.” 776

However, such a more stakeholder-oriented approach would not be the right course of action for it will require more government and judicial intervention in the way a company is being managed as new regulations (and courts) would be required to determine what directors ought to do and for whom (e.g. weaker creditors) they ought to have regard (or, economically speaking, in whose interests the company ought to be governed). In a market economy, it seems better not to broaden the content of the duty of directors and to leave the company’s management up to managers so that they can try to turn it around at a moment when the company faces financial difficulties. If the managers are free to maximise the wealth of the residual owners (i.e. the unsecured creditors when the company is insolvent), the argument goes that ultimately the whole society will benefit (i.e. if the company can turnaround then workers see their jobs being preserved and consumers get the products/services they want to buy). 777 Therefore, once could argue that the EU directive goes too far in compelling directors to have regard to a wider amount of stakeholders at a moment when the company is already quite financially troubled. If directors are free to determine the course of action in the company, some might opt for a stakeholder-oriented approach whilst other might not and, arguably, directors know better themselves how to manage the company in the market in which it has been operating than the legislator.

Furthermore, every company is different and imposing more legislative duties on managers (such as a duty of care or a fiduciary duty towards particular stakeholders/creditors such as consumers) creates the risk that directors may become too constrained by regulations whereby they risk losing the flexibility and freedom they need to maximise the interests of the company in a manner the managers, who (ought to) know the company best, see fit. 778

In addition, it has also been argued that a stakeholder-oriented approach would be unworkable as managers would find themselves unable to balance between all the conflicting interests (i.e. between consumers and employees) 779. The latter might also lead to directors being answerable

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to no one given the fact that by not appealing to one faction of stakeholders (or predetermined\textsuperscript{780} faction of creditors such as consumers, small trade creditors or employees), they might appeal to the other and vice versa\textsuperscript{781}. This would lead to increased agency costs for directors might play off different constituent groups against each other\textsuperscript{782} while those affected become unable to hold directors to account given the fact that directors can always justify their actions by claiming to have acted in the interests of (at least) one particular group of stakeholders (or creditors in our case)\textsuperscript{783}. The result would be the opposite of the one aimed for: directors would get a free pass to ‘violate the rules of the game’, (unsecured) creditors would be less protected and the company, at a moment when it is already in distress, would lose out consequently.

Consequently, while both efficiency and fairness are deemed important when designing a regulatory framework, it is important that fairness does not become an impediment to having rules stimulating an efficient outcome for the company. This could be the case if another notion of ‘fairness’ than the one employed in this research were to be used for it could create an undefined ‘catch-all’ term under which more rules interfering in the governance of a company (by, for example, imposing more directors duties such as a duty of care or a fiduciary duty to have regard for certain predefined types of creditors) could be enacted. The reason behind this is that this could have detrimental effects for the wider community/society (not in the least the more vulnerable factions of unsecured creditors) if inefficient though assuming fair reforms would jeopardise the company’s restructuring\textsuperscript{784} or if this could lead to the company’s residual owners losing out in case of a liquidation (e.g. if some allegedly vulnerable groups of unsecured creditors would get preferential treatment while other equally vulnerable factions may not receive the same or a similar treatment).\textsuperscript{785}

2.2. Balance between efficiency and accountability

Efficiency may, however, not only come into conflict with fairness. As accountability is, as described above, an over-arching insolvency value ensuring that the appropriate mechanisms to hold directors/office-holders to account, this could also quite easily come in conflict with the ‘efficiency’-requirement if a lack of or wrong regulations/reforms would not increase the overall

\textsuperscript{780} Cf. infra.
\textsuperscript{782} Ibid (n. 670), 284.
\textsuperscript{784} F.H. Easterbrooke and D.R. Fischel, \textit{The Economic Structure of Corporate Law} (Harvard University Press 1991) 38; From a more abstract and political economic point of view: cf. F.A. Hayek, \textit{Law, Legislation and Liberty} (Routledge 2013) 230-231 whereby Hayek argues that, although meritorious, the belief in ‘social justice’ (or ‘fairness’) as guidance for designing rules could place too much power in the hands of the government threatening the liberal values upon which a free society (and a free market) is based.
benefit of the vulnerable groups of unsecured creditors to such an extent that they, in theory, could compensate those who stand to lose (if there are losses to be borne by some at all).

The issue here comes to down the question how one can ensure that directors/office-holders stay “within the rules of the game” (i.e. appropriate accountability mechanisms) without imposing rules on office-holders/directors which would in reality further exacerbate the position of non-controlling unsecured creditors by being too economically costly (or inefficient). In general, there are three broad mechanisms one can look at when determining whether the accountability framework is functioning efficiently. The first mechanism are the market forces (such as *inter alia* capital, labour, product and services markets), the second and third mechanism are respectively soft-law and hard-law.

### 2.2.1. Market forces

Contractarian scholars heavily rely on market forces and, based on Coase’s theory, argue that there is a risk that regulations would increase transaction costs leading to inefficient outcomes as resources can no longer be used in the most effective way as a direct result of these increased transaction costs. Narrowing this down to corporate governance these scholars warn against strong directors’ duties for this may make them more risk-averse as such duties could create over-deterrence. According to them, the shareholders would, ex ante and based on hypothetical assumptions about the situation they are confronted with, have agreed with the directors not to impose such strong duties.

Although based on another rationale, in insolvency governance, contractarian scholars within insolvency law, such as Jackson, initially also argued that there is no need for elaborate duties imposed on the office-holder/directors for their only task, according to them, is to wind-up the company in the interests of the collective group of creditors in accordance with the hypothetical bargain *all* (both secured and unsecured) creditors would have agreed prior to the occurrence of insolvency. In this hypothetical bargain, different from the hypothetical bargain used in corporate governance, creditors would ex ante have agreed not to engage in a Darwinian race to collect the assets of the distressed company but they would have preferred a stay on

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individual actions while prebankruptcy entitlements (such as security interests) would be respected.\textsuperscript{791}

Although Jackson acknowledges that transactions defrauding creditors\textsuperscript{792} (which he described as “fraudulent conveyances” referring to debtors dissipating or concealing parts or the entire asset pool)\textsuperscript{793}, his approach is heavily skewed in favour of efficiency with almost no focus on either accountability procedures or corporate rescue.

The latter approach, however, started to change in the nineties with American scholars starting to defend corporate rescue by focusing on more market-oriented practices (such as the use of auctions to dispose of (some) assets of the business)\textsuperscript{794}. While market forces (such as inter alia the market for corporate control and capital markets) play an important role in disciplining managers as long as the company is solvent, the general idea is that once a company becomes distressed the occurrence of an insolvency procedure might damage the ability of markets to penalise poor-performing managers\textsuperscript{795} and, as a consequence, one often tends to resort to more regulatory and/or judicial intervention in the company (i.e. through the displacement of the management by an office-holder for example).\textsuperscript{796}

However, although it has been argued that the general body of creditors would be better off with the incumbent management which knows the firm best (even if they are the cause of the company’s financial distress)\textsuperscript{797}, market forces do not take into account weaker parties who do not have sufficient information to monitor the behaviour of their ‘agents’\textsuperscript{798}, arguably leaving non-controlling unsecured creditors in a potentially detrimental position. Furthermore, although market forces\textsuperscript{799} remain important at a stage when a company is insolvent, especially during corporate rescue procedures, solely relying on market forces would be insufficient to adequately

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\textsuperscript{792} This is similar to claims under the action pauliana in civil law jurisdictions.

\textsuperscript{793} T.H. Jackson, \textit{The Logic and Limits of Bankruptcy Law} (Beardbooks Washington D.C. 2001) 147.


\textsuperscript{799} Such as \textit{inter alia} the capital market for rising share prices may indicate that the company is recovering, the market for corporate control as takeovers may still happen and the market for compensation policies affecting the incumbent management of the distressed firm.
monitor and effectively control directors for markets are not without flaws\textsuperscript{800}, there can be over- and underreactions to certain market changes or managerial performance\textsuperscript{801} and markets neither monitor nor give guidance to managers as to how their conduct could (or should) be improved.\textsuperscript{802}

2.2.2. Regulatory intervention

Absent perfectly functioning markets, the question how efficiency (i.e. introducing legislation granting a superior outcome to vulnerable unsecured creditors without increasing the aggregate costs on business and other creditors to such an extent that it would outweigh the benefits of legislative reform) and accountability (i.e. the requirement to have the right procedures to monitor and, if necessary, sanction directors/office-holders) becomes all the more relevant. As indicated above, there are generally two types of regulatory intervention, i.e. soft-law and hard-law, however, in order to provide a good/appropriate regulatory framework, one must start from the right foundation.

2.2.2.1. Foundations of the current regulatory framework

Currently, the regulatory framework in insolvency law seems to predominantly\textsuperscript{803} emanate from a ‘creditors’ bargain’-perspective for no differentiation or distinction has been made between unsecured creditors and, aside for some exceptions, all unsecured creditors are seemingly perceived to be in an equal position without any attributes which could possibly further their own interests at the expense of others by the legislator.

This clearly resonates with Jackson’s theory who argues that this ‘collective’ system would have been the system unsecured creditors would have hypothetically agreed to in private before the occurrence of insolvency\textsuperscript{804}. However, this underlying assumption that ‘unsecured creditors are all equal’ which has underpinned insolvency law up until now does not find proof in reality. By starting from this incorrect assumption, one could end up treating different unsecured creditor in an equal way which – as cases such as the Kapoor or Gertner-cases indicate – could disenfranchise non-controlling unsecured creditors.\textsuperscript{805}

\textsuperscript{803} Of course, Jackson would be against employee preferences.
\textsuperscript{805} However, courts are there to stop that. Nonetheless, for unsecureds, it would mean the cost of making an application and being engaged in the insolvency procedure.
Although the latter point also overlaps with our procedural and substantive fairness-requirements it is clear that an appropriate accountability framework should differentiate or provide mechanisms for directors and office-holders to differentiate among unsecured creditors (if necessary) instead of merely tailoring the accountability requirements to the whole group of unsecured creditors.

2.2.2.2. Hard-law regulation

Looking first at hard-law regulations, some scholars might argue that hard-law should resolve the issue for it imposes legally binding duties on the persons (i.e. directors/office-holders or shareholders/unsecured creditors) subject to these regulations. Aggrieved parties can make use of hard-law to sanction\(^\text{806}\) the wrongdoer (through inter alia court enforcement) and aim to improve their own situation in doing so\(^\text{807}\). Following this, it is then assumed that directors (but, arguably, also office-holders) would be more likely to perform better which would, so goes the argument, also enhance market trust.\(^\text{808}\)

However, hard-law does not seem to be the most preferred route for it would increase transaction costs for directors/office-holders (and for unsecured creditors if new rules would be imposed on them)\(^\text{809}\). This is because of a number of reasons such as inter alia the fact that (new) rules would probably require directors/office-holders to seek legal advice in order not to be in breach and to take greater time over tasks.

Furthermore, these newly imposed duties would involve time directors would not be able to spend on other managerial activities which could be more beneficial to the already troubled company. This argument ties in to the following argument, namely that it is difficult for the legislator to determine these rules for markets\(^\text{810}\) which are very different and within these already differing markets every company is once again different from one another. Hence, there is always a considerable risk that rules would lead to a ‘one size fits all’ solution which could ignore the wide diversity of firms\(^\text{811}\). In reducing the managerial ability to tailor one’s duties into

\(^\text{806}\) Although creditors cannot enforce directors’ duties themselves, directors are still legally bound to abide by the duties as set out in inter alia the Companies Act 2006 which can be enforced by the office-holder on behalf of the general body of creditors.


\(^\text{810}\) This is terms of the ‘type’ of the market (such as i.a. capital, labour and product markets) but also in terms of location for markets differ from place to place (i.a. influenced by cultural and regulatory standards).

the (diverging) interests of its already troubled firm, there is a clear risk that the proposed legislation would not solve the problem at all and that any benefits the new legislation could have would be outweighed by its additional costs on the director/office-holder (or the creditors)\textsuperscript{812}, and by extension, on the company which will be negatively affected.

Additionally, this is exacerbated by the fact that hard-law legislation could create over-deterrence and managerial risk-aversion, especially if the rules are perceived to be very strict and/or the sanctions very severe (e.g. criminal sanctions)\textsuperscript{813}.

Nonetheless, the latter issue could be attenuated for directors (but to a lesser extent for office-holders) will already be subject to market forces (such as the labour market) and enforcing a claim against inter alia former directors at the time when a company is insolvent also remains a difficult issue for a variety of reasons such as a lack of funding. It could also involve a double penalty for directors, namely a claim for breach of their duties and a loss to their reputation. Having said this, adjusting the already existing fiduciary directors’ duty to have regard to factions of non-controlling unsecured creditors might, however, be advisable for without legally enforceable right arguing that directors/office-holders should take into account the interests of non-controlling groups of unsecured creditors seems to become rather illusory.

\textbf{2.2.2.3. Soft-law regulation}

Next to hard-law mechanisms, accountability could also be enhanced through soft-law mechanism. As soft-law regulations can resemble market functioning, there is an argument to say that the risk of a collision between efficiency on the one hand and accountability on the other (akin to the one described above between efficiency and accountability imposed through hard-law mechanisms) is reduced. However, when a company is involved in a winding-up procedure they have, arguably, almost left the market strengthened by the fact that liquidation might even be a direct consequence of market mechanisms having pushed the firm out of the market. Nonetheless, this could be very different in restructuring or corporate rescue, especially as more and more entrepreneurs/traders discover that there is a market for ‘troubled debt-trading’\textsuperscript{814}.

Although the UK, as a country, has been an advocate of soft-law in relation to corporate governance (hence the Corporate Governance and Stewardship Codes), they lack a proper enforcement mechanism. Making use of the ‘comply or explain’-mechanism requiring directors

\textsuperscript{812} Dependent on whom the new duties are aimed at.
to comply with the soft-law regulations or to explain why they did not (if they did not)\textsuperscript{815} has been criticised in recent years for directors often make use of standard boilerplate phrases which in reality don’t explain at all why they did not adhere to these soft-law rules.\textsuperscript{816} An empirical study of Grant Thornton also shows that, despite the laudable efforts of the Stewardship Code and compliance with corporate governance codes being at an all time high, shareholder engagement still seems to be quite low with Grant Thornton finding that only “\textit{31\% of FTSE 350 companies provide strong accounts of shareholder engagement}” and only 27\% of the companies showing good insight into the manner how they applied corporate governance principles as embedded in the corporate governance codes\textsuperscript{817}. As an updated UK Corporate Governance Code has been applied since 01 January 2019\textsuperscript{818}, it remains to be seen to what extent the regulatory changes have been conducive to an improved corporate governance.

Relating to insolvency governance, making use of similar insolvency governance codes could on the one hand provide the necessary flexibility which directors (and, arguably, office-holders) need during the restructuring or winding-up of the company while on the other hand providing some preliminary guidance as to what the expectations from the public (or other stakeholders involved) are and, importantly, how directors/office-holders could comply with any requirement to have regard to non-controlling groups of unsecured creditors while managing the company.

A ‘stewardship code’ for unsecured creditors could also try to enhance creditor engagement/activism. However, this begs the question what kind of push unsecured creditors would need. Do they need the push that shareholders do? Or is perhaps an even stronger push required? In this regard, if compared to the Stewardship Code similar soft-law regulations would apply to unsecured creditors, there still seem to be a big question why unsecured creditors would feel compelled to control the board/office-holder? Not only is there an information-asymmetry, many do not have sufficient legal or financial information and their claims are often quite small. In addition, while shareholders have a residual claim in the profits of the company, unsecured creditors are confined to their claims’ limit.\textsuperscript{819} If their claim is relatively small, the

\textsuperscript{816} A.R. Keay, ‘Comply or Explain in Corporate Governance Codes: in Need of Greater Oversight?’ [2014] Legal Studies 279.
economic costs of getting involved in extensive controlling and monitoring would soon outweigh the benefits of trying to get a debt payment as high as possible given the circumstances. For the latter reasons, it would seem counterproductive to impose hard-law legislation (to control/monitor the directors/office-holders) on unsecured creditors, however, flexible soft-law rules targeted at both directors/office-holders and unsecured creditors might potentially enhance creditors’ participation to a certain extent. In other words it would be critical how this soft law would be couched which we will elaborate on in the next chapter.

2.2.2.4. Enforcement

As indicated above, not only market forces but also both hard- and soft-law mechanisms are fraught with drawbacks for a number of reasons when it comes to enforcing what is being expected of directors.

While addressing enforcement, it also important to bear in mind the courts’ general attitude to try not to judicially interfere in a company while aiming to avoid hindsight bias. Consequently, it could be questioned whether a regulator or public enforcement mechanism (e.g. employing civil sanctions such as in Australia) could be useful to reconcile the need to address enforcement problems while still making sure that directors have got sufficient freedom to manage the company in the way they believe it to be necessary. Such a public enforcement approach could, for example, assess whether corporate and insolvency governance requirements have been properly complied with.

Nonetheless the latter suggestion has been criticised as well and will be addressed more in detail in the next chapter.

2.3. Balance between fairness and accountability

2.3.1. Accountability as a key component of a fair regulatory framework

Having elaborated on the balance between efficiency and accountability, the latter principle must also be balanced against the ‘fairness’ principle. As indicated above, accountability is about creating a framework in which the management (or office-holders) of the company can be properly held to account, preferably through the four different stages (described above) in order to avoid opportunistic behaviour or management decisions which could be detrimental to (factions of) unsecured creditors while aiming to be able to improve dividend outcomes for the group of unsecured creditors.

From this perspective, having an appropriate and good-working accountability framework is an important feature for a fair insolvency framework. Rather than a conflict between ‘fairness’ and

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'accountability', accountability can be seen here as a prerequisite to obtaining a fair regulatory framework.

2.3.2. Procedural fairness and accountability as complementary/overlapping principles

In addition to this, accountability may not only be the prerequisite for having a fair insolvency model but there might also be an overlap between those two values for, in designing the appropriate regulatory framework, one of the questions raised will be whether 'the right procedures' are in place to hold the directors to account if necessary.

This question looks into the types of accountability procedures but at the same time it also considers whether (i) these procedures itself will be conducive to a fair(er) regulatory framework and whether (ii) they, themselves, are an exponent of this fair(er) regulatory framework. The first (more procedural) question looks into the issue whether the accountability procedures will lead to a fair outcome for *inter alia* unsecured creditors by holding those who need to be held to account, to account if necessary while the second (more substantive) question examines whether the accountability procedures themselves are a result of fair insolvency legislative provisions applying to those involved (such as the directors of the company and, by extension, whether the implications of the accountability procedure will enhance creditors' welfare).

Procedural fairness, as discussed above, examines whether the right procedures are in place to obtain a fair or 'just' outcome for the parties involved, and more in particular, the more vulnerable factions of unsecured creditors. Hence, a procedurally fair insolvency framework should undoubtedly have appropriate accountability procedures in place. The crucial procedural question here, which will be discussed in chapter 8, is 'who' should be held to account and by whom can this person be held to account? In looking into the question 'who' needs to be held to account, directors and the office-holder spring to mind first as they are managing the financially distressed company in the interests of the company for the benefit of the creditors but there is an interesting question whether there could be an argument to impose some duties on unsecured creditors as well. Similarities could for example be drawn from corporate governance whereby some limited duties and responsibilities are imposed on shareholders (such as through the Stewardship Code). Related to the question 'who' needs to be held to account is also the question who should be allowed to hold the accountant to account? Currently, it is the office-holder who (generally) starts claims against former directors but unsecured creditors.

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821 Cf. *infra.*

creditors do not have the right to start a derivative claim. The office-holder faces a variety of obstacles in commencing claims\textsuperscript{823} with funding being one of the most important ones.\textsuperscript{824}

2.3.3. Substantive fairness and accountability

Finally, the question ‘when’ accountants ought to be held to account by their accountees leads to the ‘substantive fairness’ and the trade-off with accountability. While there is a certain amount of convergence between procedural fairness and accountability, the question of substantive fairness (i.e. what ‘just’ rules are so that a ‘just’ outcome can be guaranteed\textsuperscript{825}) will determine how the accountability framework will operate. Different insolvency theories as discussed in chapter 2 tie into this for it will depend on one’s definition of ‘substantive fairness’ as to how accountability procedures would work.

In this regard, this research has defined fairness as the principle enabling an insolvency framework that (i) protects the rule of law, (ii) discourages individuals from abusing their rights by acting opportunistically and, for example, engaging in deceit, shirking and/or equitable or criminal fraud and that (iii) avoids formal equality to get mixed up with ‘substantive equality’ making sure different factions of unsecured creditors are not subject to equal treatment if that could jeopardise the opportunity to get the best possible outcome at the lowest cost for these vulnerable factions of unsecured creditors.\textsuperscript{826}

From a substantive fairness point of view this requires us to look at the question in whose interests the troubled company must be governed\textsuperscript{827} and how a variety of conflicting interests between several stakeholders could affect (i) our substantive fairness-requirements and, by extension, (ii) the accountability procedures which aim to guarantee that the former requirements have been complied with by those who need to adhere to them.

\textsuperscript{823}V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 478-479.
\textsuperscript{824}There is, however, the option to assign a claim to a(n unsecured) creditor but this requires the claim to be assigned to the creditor first before the creditor can start enforcing it. In contrast to e.g. Canada and Singapore, the UK does not provide creditors with the option to derivatively initiate a claim.
\textsuperscript{826}Without jeopardising the lawful interests of all the other unsecured creditors.
\textsuperscript{827}Different corporate and insolvency theories point into different directions here. Broadly spoken and without purporting to be exhaustive, those in favour of the stakeholder theory advocate that the interests of a wide group of stakeholders will have to be taken into account by managers/office-holders while managing the troubled firm. Cf. M.M. Harner, ‘Corporate Control and the Need for Meaningful Board Accountability’ [2010] 94 Minn. L. Rev. 541, 548; M. Huse & D. Eide, ‘Stakeholder Management and the Avoidance of Corporate Control’ [1996] 35 Business and Society 211. Although stakeholder theorists put forward a wide range of arguments why stakeholders’ interests are important to have regard to, other theorists such as the contractarian scholars or shareholder primacy theorists propagate a completely different managerial attitude for they see stakeholders’ interests, arguably, merely as a means to benefitting the corporation for the interests of the shareholder (or unsecured creditors). Cf. A.R. Keay, ‘Stakeholder Theory in Corporate Law: Has It Got What It Takes?’ [2010] 9:3 Richmond Journal of Global Law and Business 249, 257.
2.3.3.1. Rules compliant with ‘substantive fairness’-principle

In terms of the appropriate rules which should be an expression of the underpinning (substantive) fairness principle, a dual approach seems appropriate with regard to the applicable corporate duties. One the one hand one should look at (i) the issue of stakeholders’ interests, and more in particular, to what extent directors ought to have regard for stakeholders’ interests while managing the company and (ii) to what extent further duties might need to be imposed on inter alia shareholders (while the company is still financially solvent) and/or unsecured creditors (at a moment when the company becomes distressed). The latter issue strongly relates to the second part which deals with accountability for if certain duties (e.g. duty to actively monitor and participate in the restructuring or winding-up of the company) will be imposed on, say, the unsecured creditors an appropriate accountability framework should then make sure that the unsecured creditors would abide by the duties imposed them (in case that would seem relevant).

Without rehearsing all the arguments in favour and against the stakeholder theory, this research will not advocate the stakeholder theory although recognising the merits and, arguably, laudable intentions of stakeholder theorists. The general rationale of stakeholder theorists is that by broadening the scope of the amount of people directors have regard for while managing the company, they serve the idea of ‘fairness’. Although admirable, the pitfalls arguably outweigh the benefits of it. First, it remains a question ‘who’ should be considered a stakeholder. The line between stakeholder theorists and communitarian scholars becomes quite thin for one can include as many interest groups as one ought necessary into the group of ‘stakeholders’. Allied to this (and as a result of this), the stakeholder theory also suffers from a lack of clarity and some vagueness as to what is actually meant by ‘protecting stakeholders’ or ‘acting in the interests of stakeholders’. Trying to determine beforehand who should be considered as a relevant stakeholder or not would as contended by Andrew Campbell, arguably, risks to create a ‘one size fits all’-rule which would go roughshod over the different interests and needs of different companies/firms. Furthermore, if directors (or the office-holder) have to have regard for the interests of a wide range of different stakeholders, it would compel them to engage in a

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828 Although this research focuses on the differentiation between unsecured creditors, the issue of stakeholder interests is deemed to be necessary to the extent that different stakeholders such as consumers, employees, the tax authorities etc. are all creditors and contribute to the (financially distressed) company through (human) capital/credit/investment in the company.

829 Although ‘fairness’ has not been properly defined by stakeholder theorists as set out before.


different balancing task at a moment when the company is already in a financially troubled situation putting directors even more under strain. Having to balance the interest of all these different interest groups would, arguably, impose a lot more transaction costs on the board diverting their attention to restructuring the company when it is still possible to making sure they have sufficient regard for the different groups of stakeholders\textsuperscript{832}. In this regard, and related to the accountability-issue, being compelled to have regard to all these different stakeholders could quite easily give a free pass to directors for they would almost always be able to escape liability by pointing out to have managed the company in the interests of one particular group of stakeholders\textsuperscript{833}. Following the previous arguments, it has been argued that the stakeholder theory (and, by extension, the communitarian theory) is (are) unworkable\textsuperscript{834} in which regard some contractarian scholars also point out that stakeholders are deemed to be able to bargain provisions in their own interests contrary to shareholders.\textsuperscript{835}

Although the latter argument would not be totally correct for inter alia involuntary creditors (such as tort creditors) are not able to bargain a better position for themselves at all while also some contractual creditors might be in a very unenviable situation (i.e. such as consumers or small trade creditors who usually do not have much bargaining power), there is one other reason why our research would not want to make use of the stakeholder (or communitarian) theory.

Without prejudice to the foregoing arguments, this is for the following two reasons. First, the stakeholder theory would ipso facto compel directors (or the office-holder) to have regard to certain types of unsecured creditors which would be defined by their sort of claim. For example, in determining that ‘an employee’ or ‘a consumer’ would be in need for further protection, the type of their claim will be deemed crucial to determining whether they are in need of further protection. This, however, would be wrong for not every creditor categorised as a vulnerable (unsecured) creditor (such as the small trade creditor or consumer) should be deemed to be in a vulnerable position in every situation (although many might be). It would also create a situation in which many other non-controlling unsecured creditors who cannot be confined to the pre-determined categories of unsecured creditors would risk losing out. For example, in the Kapoor-case, as explained in chapter 5, both the bank and the HMRC were put in a disenfranchised position as result of alleged collusion by both the debtor (Mr. Kapoor) and two main creditors.

\textsuperscript{832} ibid, 277-278.
\textsuperscript{835} Alexei M. Marcoux, A Fiduciary Argument Against Stakeholder Theory [2003] 13 Bus. Ethics. Q. 1, 17.
(i.e. Mr. Chouchen and Crosswoods Company). If we would make use of the stakeholder theory, there is an existential risk that, by confining oneself to predetermined categories of unsecured creditors (mostly based on the type of claim they have – such as consumer claims for example), neither the bank nor the HMRC would receive the necessary protection needed to protect vulnerable / non-controlling unsecured creditors for the simple reason that almost no one would consider either the bank or the HMRC to be in need for further protection or to be at risk of being the most vulnerable party or within the category of ‘vulnerable’. A similar reasoning also applies to other creditors who, at first sight, might be deemed to be stronger. The crux of the issue is that one can never ex ante determine which unsecured creditor will end up in a vulnerable or non-controlling position so it would not make sense to grant specific protection to some special categories of unsecured creditors while ignoring the fact that other unsecured creditors (potentially deemed to be stronger) could be in a similar position.

Secondly, each company is different and faces different types of risks. Although the rationale might be laudable, requiring directors to have regard to stakeholders while managing the company would remove a lot of their managerial freedom they might require to be able to restructure/rescue the company. While directors are, arguably, currently subject to the ‘creditors bargain model’, moving away towards a ‘stakeholder-influenced’-model would risk taking directors (and office-holders) from one legislative ‘straitjacket’ and putting them into another. Namely, while creditors’ interests (and not stakeholders’ interests) are paramount from the moment when directors knew or ought to have known that the debtor was likely going to become insolvent, shifting towards a stakeholder-oriented model would create the opposite outcome for stakeholder interests (and not creditors’ interests) would then be paramount. Surely, there would be an overlap to a certain extent for many stakeholders (such as employees or consumers) are also creditors but these stakeholders may also have interests which differ from their interests as a creditor (and might thus differ from their objective to obtain debts owed by

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836 Charnesh Kapoor v National Westminster Bank plc, Kian Seng Tan [2011] EWCA Civ 1083. 837 Admittedly and as set out before, there are already some rules they could make use of (such as the existing unfair prejudice or material irregularity procedures), however, it would be discriminatory to treat unsecured creditors in the same (or a similar situation) in a different way merely because of the type of claim they have got. This would violate our definition of fairness as defined above. 838 C. Mayer, Prosperity: better business makes the greater good (Oxford: Oxford University Press 2018) 113-115. 839 Companies Act 2006, s.172(3) only mentions ‘creditors’ while Companies Act 2006, section 172(1) does require directors to have regard to other stakeholders as well (while managing the company). 840 Which is what current EU Law seems to require: cf. supra and Directive (EU) 2019/1023 of the European Parliament and of the Council on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), article 19 iuncto recital 71. 841 BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112 whereby, as stated above (cf. supra chapter 7, part 2.1.1.) Richards LJ declined to express a view other than when the company is actually insolvent. Cf. BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112 at para. [222].
the company to them). Hence, the latter criticism (of creating a ‘one size fits all’-scheme) towards the stakeholder-theory would equally apply to the creditors’ bargain theory. The reason behind this is that in both situations the law would predefine ex ante in ‘whose’ interests the company should be managed or ‘whose’ interests directors/office-holders should have regard for.

In this regard, following the above analysis, we have both rejected the application of the stakeholder/communitarian and the creditors’ bargain theory for inter alia being too ‘narrowly’ defined, which risks creating a commercially unsatisfactory ‘one size fits all’-mechanism and, hence, removing fundamental managerial freedoms of directors/office-holder while managing the company. In line with our definition of ‘fairness’, from a substantive point of view, appropriate rules compliant with our definition of ‘fairness’ should enable directors/office-holders to have regard to non-controlling factions of unsecured creditors while not (i) discriminating against other (factions of) unsecured creditors who might be in a similar position and (ii) ensuring that appropriate accountability mechanisms are in place to avoid opportunistic behaviour and/or directors/office-holders not performing their duties properly. Both the following section and, more in detail, the next chapter will examine what sort of accountability mechanisms could (and should) be provided.

The aforementioned (normative) analysis is innovative as it requires a new approach to addressing issues within insolvency governance for not merely looking at (i) different corporate and insolvency theories and/or (ii) tailoring rules to (unsecured) creditors’ type of claims (such as a government debt, tort or consumer claim) would not solve the problem non-controlling unsecured creditors face at all. As determined in chapter 5, it is contended that the unsecured’s controlling or non-controlling position is key to assessing whether additional protection is necessary. In this regard, more focus ought to be placed on the concrete/practical circumstances of the unsecured’s position rather than merely having regard for abstract factors (such as e.g. the nature of one’s claim). Allied to this new determination of an unsecured’s vulnerable position, this innovative approach which will be elaborated on further in chapter 8 also argues, different from previous literature, that much more emphasis must be put on governance rights.

842 For example, employees may also want to continue working for the troubled company as long as possible while consumers who had prepaid for certain goods may want to get their money back or receive the goods they have ordered (if possible at all) as soon as possible.
843 In terms of the ratione personae. For the creditors’ bargain theory, this is because only creditors interests are paramount while for stakeholder theorists a predetermined set of ‘stakeholders’ risks discriminating against other unsecured creditors in a similar position but who fall outside the scope of the predetermined definition of ‘stakeholders’.
844 For example, what was the attitude of the unsecured during creditors’ meetings, was she able to form a coalition of unsecureds etc...?
2.3.3.2. Accountability requirements following substantive fairness-principles

In line with the aforementioned conclusions, it remains key to examining ‘which’ specific accountability mechanisms ought to be employed in order to (i) abide by both the procedural and substantive fairness and (ii) efficiency requirements.

Without rehearsing what has been dealt with before and avoiding going into too much detail, for this will be dealt with as part of chapter 7, several issues need to be looked at. First of all, whether, compared to corporate governance, some duties need to be imposed on unsecured creditors (for example to control the management, to inform other unsecured creditors if debts are being bought in order to sell them off at a higher rate and hereby, increasing transparency by granting more information of the implications of transactions which affect other factions of unsecured creditors). The question here will also be whether this can be achieved (if deemed necessary) through either soft or hard-law legislation (or perhaps a combination). In addition to this, it may also be conducive to an improved insolvency governance if more rights were to be granted to the unsecured creditors (i.e. predominantly in the area of enforcement/litigation such as the ability to buy off litigation claims, derivative actions in the interests of the whole group of creditors and/or class-actions against directors/office-holders).

Next to ‘unsecureds’, the company’s management (either the directors or the office-holder) is also crucial. As set out before, rather than starting from the legislative assumption that the group of unsecureds is one homogenous group, the starting point should, arguably, be different so that it reflects the reality in which unsecureds are not the same. In this case, a managerial fiduciary duty to have regard to non-controlling factions of unsecureds (not predetermined based on type of claim but based on the facts) could be considered while also reflecting this adjusted approach in soft-law rules granting some preliminary guidance to the directors.

If regulatory adjustments are proposed the issue of enforcement must also be considered. As we have been quite critical towards imposing more hard law legislation and aim to provide the management of the company with the flexibility and managerial freedoms necessary to manage the company to the best of their ability through soft law mechanisms (if possible), an interesting policy to consider would be the usage of a public regulator to oversee and impose sanctions if there is a breach of accountability standards. This also ties in with the civil sanctions-regime Australian corporate law makes use of which will also be addressed in the following chapter.

III. Conclusion

Having elaborated on the different insolvency values (efficiency, accountability and fairness) in chapter 6, this chapter built further on these values by examining how they interact with one another which prompted the question whether a hierarchy between said values should be established and if not, how they can be balanced against one another. This analysis as to the interactions between these insolvency values gives insight into how the insolvency framework should be structured and provides a basis against which potential reforms can be assessed.

In response to the issue whether a hierarchy between the insolvency values must be established, this research argued that all insolvency values hold merit and, subsequently, one value should not be sacrificed for another value as this would have a negative impact on the overall insolvency framework. This is because the framework would then lose the benefits of at least one of the values that have been deemed vital to a proper, modern and good-functioning regulatory framework.

Rejecting a hierarchy between values, the research therefore continued at the potential conflicts between insolvency values and, if necessary, how any trade-offs were to be established.

With regard to the trade-off between efficiency and fairness, this research advocated that a too strong focus on efficiency could be harmful for non-controlling unsecureds whilst a too strong focus on fairness might also be counterproductive and may thus have an equally harmful impact on the interests of unsecureds. This is why it has been submitted that a balance needs to be struck between efficiency and fairness which, in summary, can be achieved by looking at the implications of the regulatory decisions/reforms as to their (i) impact on managerial behaviour, (ii) the risk-aversion they may create, (iii) the economic costs of regulatory measures on the company, directors and other stakeholders and (iv) the already existing mechanisms that mitigate some unsecureds’ vulnerability.

With regard to the trade-off between efficiency and accountability our findings were such that solely relying on market forces (which scholars highly in favour of an ‘efficiency’-dominated approach tend to do) would be against the unsecureds’ interests for this could lead to the relevant persons (e.g. directors) not being held to account when needed. A regulatory framework, it is submitted, must ensure that unsecureds can control their debtors and that they can hold them to account when needed even though this would involve certain economic costs. Again, an appropriate balance between both values has been defended by trying to refrain from immediately imposing hard-law duties but rather emphasising the potential of soft-law duties and the potential benefits of public enforcement mechanisms.
Finally, regarding the balance between fairness and accountability it was submitted that good accountability measures are vital to having a fair insolvency framework. Although there could be a certain overlap between procedural fairness and accountability for both values are concerned with the most appropriate procedures that could be relied upon by commercial actors, in order to strengthen substantive fairness it has, innovatively, been advocated that the insolvency framework should distinguish between groups of unsecured creditors dependent on their controlling or non-controlling attitude (as determined in chapter 5). Accountability measures should then be a reflection of this distinction to ensure that the aims and rules that enhance the protection of non-controlling unsecureds can be secured and to ensure that those actors who fail to abide by the rules that underpin substantive fairness can be held to account.

The following chapter will continue to build further on our assessment as to how the regulatory framework ought be improved by critically examining several regulatory reforms and assessing them against the foundations (insolvency values) upon which an insolvency framework ought to rely as discussed in this and the previous chapter.
I. Introduction
During this research, it has been advocated that there are different factions among unsecureds whereby some of them could be more or less vulnerable (i.e., weaker or non-controlling which this research defines as lacking the power to influence (or alter) the decision-making process prior to or during the insolvency procedure) and this is dependent on whether they can influence the outcome of the insolvency procedure. If they have such controlling power, there is a risk that such controlling unsecureds could either exploit this control or at least use it in an inefficient way. In both cases, the non-controlling unsecureds could be negatively impacted.

Having looked at the crucial insolvency values and how they interact with one another in chapter 6 and 7, this chapter will now build further on this by critically evaluating different ways to improve the regulatory framework for non-controlling factions of unsecureds taking into account aforementioned insolvency values and trade-offs.

In this regard, it would be beyond the scope of this research to elaborate on how currently existing claims which swell the asset pool should be improved for the sake of unsecureds, although chapter 4 has to a great extent elaborated on the current drawbacks unsecureds face in that regard. The chapter will therefore confine itself to new regulatory measures that could be advocated/introduced. In doing so, it will first examine non-governance related measures before looking at regulatory reforms which could improve insolvency governance.

II. Regulatory suggestions to improve the Insolvency Framework
2.1. Non-governance suggestions
2.1.1. Preferential position
One of the suggestions often put forward to give additional protection to allegedly weaker unsecureds is the granting of a statutory priority. Although it would be beyond the scope of this research to elaborate beyond what has been discussed in previous chapters as regards such statutory priority, it appears, nonetheless, vital to explain why this research argues against granting a preferential position to vulnerable creditors. The arguments against can be divided into general and specific arguments against such a statutory priority.

From a general perspective, giving additional factions of unsecureds a preferential position could make insolvency procedures more complicated which could lead to lengthier procedures and could increase the costs of managing insolvencies. Additionally, there is a considerable risk that by creating a preferential position for certain unsecureds, other perhaps equally vulnerable creditors get an even smaller dividend than the one they would normally have received if no preferential position would have been granted. This could also affect their willingness to provide credit to the debtor for the unsecureds who are now entitled to a preferential position might be less inclined to monitor directors’ (and office holders’) behaviour, potentially necessitating more vigilance by those unsecureds who were not ‘lucky’ enough to receive a preferential position.

From a more specific perspective and, thus, looking at certain creditors’ particular claims, one of the main preferential creditors is the government (in the form of ‘HMRC’). In the UK, the HMRC has since the 1 December 2020 partially regained its preferential position as the HMRC as now a preferential claim as regards the collection of “VAT, PAYE (including student loan repayment), National Insurance contributions and Construction Industry Scheme deductions”. The rationale behind this was the alleged protection of the public purse through such a statutory priority. However, such preferential position could weaken creditors who provide credit on a floating charge basis which, although difficult to quantify precisely, could see debtors being more unlikely to receive credit, especially at a time when they might be most in need of more credit. Moreover, it would also prejudice the position of other unsecureds who are non-preferred and which, in turn, might also have negative implications on unsecured financing for there will be less to distribute pari passu among the non-preferential unsecureds.

In addition, the government is, arguably, more able than most other unsecureds to obtain

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848 Ibid, 16.
853 Ibid.
relevant information about the financial situation of their debtors, to act upon such information and to obtain funds elsewhere.854

Also, with regards to employees, consumers and tort creditors who have received, or should receive a preferential position according to some scholars, it could be questioned if and to what extent a preferential position is helpful. As regards consumers, the Law Commission advocated in 2016 a preferential position for some855 consumers who had made prepayments and were confronted afterwards with an insolvency procedure without having received the goods/services they had prepaid for.856 Consumers may be described as ‘vulnerable’ because even though consumer losses may be low in absolute terms, they may be very significant for the consumer concerned857 with consumers, on an individual basis, thus not being able to influence the decision-making procedure of the indebted company.858 The government, after having consulted with insolvency practitioners and R3, the association for insolvency practitioners, rejected this proposal inter alia because of consumers’ ability to find protection elsewhere and to avoid insolvency procedures becoming overly burdensome/complex.859 Also, as regards employees, their vulnerable860 position could be nuanced. This is because they do not only enjoy a (limited) preferential position based on Insolvency Law, but Employment and Social Security Laws have granted them even more protection. While unpaid wages and accrued holiday pay are preferential up to £800 based on Insolvency Law861, employees enjoy a more productive protection through the Employment Rights Act for the latter act guarantees a greater entitlement which employees can claim against the National Insurance Fund.862 Rather than


856 The Law Commission, Consumer Prepayments on Retailer Insolvency (Law Com No 368 2016) 69.

857 The Farepak-case – cf. Re Farepak Food & Gifts Ltd [2010] B.C.C. 735 – showed this very well. Although the losses for individual consumers were, arguably, not high in absolute terms, the collapse of Farepak just before Christmas caused a lot of distress for the individual consumers for whom the loss of their savings/money was very significant.

858 Collectively, however, consumers would have been in a majority position in Farepak (cf. Re Farepak Food & Gifts Ltd [2010] B.C.C. 735) allowing to achieve a controlling position. Such a controlling position – if they would have acted as a collective – could have enabled them to control the liquidator and to press for the commencement of insolvency litigation (e.g. a liability claim against the former directors of Farepak).

859 Ibid.

860 Vulnerable should be understood here as relating to the loss of their job and the caps on their recoveries as set out later in this paragraph. As with consumers, although the losses for the employee may not be high in absolute terms (and in relation to claims of other creditors during the insolvency procedure), it may be very significant for the individual employee.

861 Insolvency Act 1986, Schedule 6 para. 9(b); Insolvency Proceedings (Monetary Limits) Order 1986 (SI 1986/1996).

862 Employment Rights Act 1996, s. 186(1)(a); Employment Rights (Increase of Limits) Order 2021 (SI 2021/208).
being merely ‘preferential’, this higher entitlement in respect of unpaid wages (i.e. up to £544 per week for 8 weeks = £4,352 rather than £800), compensation for unfair dismissal, holiday pay etc.. is guaranteed.\textsuperscript{863} This means that the Secretary of State is compelled to make such payments to employees. This additional protection shows that the picture of employees as being ‘weak’ may not be entirely correct.\textsuperscript{864} Abolishing the preferential position for employees would therefore not significantly harm their position for the burden would fall on the Secretary of State, rather than the employee while an abolition of the employee’s preferential status could transfer some more money to other unsecureds.\textsuperscript{865} In a similar vein, tort creditors’ position may also be better off than believed at first sight. Namely, extensive protection through different regulatory means (such as Insurance Law)\textsuperscript{866} has been granted to tort creditors in the UK which must be factored in when assessing the need for (i) further protection and (ii) the grant of a preferential position.\textsuperscript{867}

\textbf{2.1.2. Insurance and trust mechanisms}

Whilst a statutory priority is not argued for, insurance and/or trust mechanism could potentially provide more solace for weaker factions of unsecureds. In both situations, the unsecured could rely on funds which, although not being part of the insolvent company (i.e. the insolvent estate) would grant them some financial relief. If such a solution would work, this could have the benefit of increasing market confidence amongst the more vulnerable unsecureds which could have a positive impact on the wider economy.

Both insurance and trust mechanisms have recently been examined as part of a government consultation on ways to protect consumers. Consumers are often deemed more vulnerable than other creditors because they are \textit{inter alia} not aware of their legal and financial position and are very much at the end of the repayment queue when their debtor becomes financially insolvent.\textsuperscript{868}

\textsuperscript{863} V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 647-648
\textsuperscript{864} As set out before ‘weak’ or ‘vulnerable’ is understood as the potential loss of the employee’s job and the caps on their recoveries.
\textsuperscript{866} See for example the following statutes: Third Parties (Rights against Insurers) Act 2010, section 1(3). The former act has recently been amended by the Insurance Act 2015; The Third Parties (Rights against Insurers) Regulations 2016;; The Employers’ Liability (Compulsory Insurance) Regulations 1998, section 3(1); Road Traffic Act 1988, section 151(5).
\textsuperscript{868} As indicated above, although the losses of consumers may not be high in absolute terms, they may be very significant for the individual consumer. This is not only in money’s terms but also in the resulting inability for the individual consumer to exercise authority over the insolvency procedure and the decision-making processes that are part of it (due to the consumer’s relatively low claim compared with claims of other creditors). See also: Department for Business, Energy and Industrial Strategy, \textit{Law Commission Report on Consumer Prepayments on Retailer Insolvency: Government Response} (December 2018) 5
Given the attention being given to such potential solutions, it appears worthwhile to question whether such regulatory means could be of assistance not only to consumers but perhaps to every non-controlling unsecured creditor.

2.1.2.1. Mandatory insurance

Starting with mandatory insurance, requiring this could increase legal complexity. There are already a lot of insurance options available to vulnerable unsecureds such as, amongst others, tort creditors and small trade creditors. In addition, some insurance protection could already be made use of voluntarily.

Furthermore, there is a question whether there would be sufficient demand for insurance protection.\footnote{The Law Commission, Consumer Prepayments on Retailer Insolvency: Summary of responses to consultation paper (Law Com No 221 December 2015) 17 at [4.32].} When the option was explored in the wake of the Farepak crisis in order to ascertain whether additional protection had to be granted towards consumers, the Association of British Insurers, ABI, one of the respondents to the government’s consultation paper on Consumer Prepayments on Retailer Insolvency indicated that consumer losses are usually relatively low on an individual level. Combined with the fact that some consumers are being paid back (e.g. through the use of vouchers) and that the risk of insolvency is usually quite low, it was argued by them that “the value of any loss is so low as to negate any demand for insurance or some form of protection.”\footnote{Ibid.} Undoubtedly, this argument is not confined to consumers only but also applies to other unsecureds such as small trade creditors, suppliers etc., who are often in a relatively similar position to consumers.

Moreover, insurance is deemed costly/expensive. Given the fact that most consumer claims are deemed to be relatively low, it seems questionable whether consumers would find it beneficial to insure their claim. Additionally, even if consumers are not required to insure their claims, suggesting that businesses should provide non-controlling unsecureds with insurance would be too economically costly too. This is because businesses would then be expected to pass on the additional costs (which they have to bear in providing their customers with insurance) to these same customers via increased prices.\footnote{Ibid 17 at [4.31].} Consequently, although intended to help vulnerable creditors, this could, in fact, exacerbate the problem because this could be expected to have wider market implications as it could undoubtedly reduce consumer confidence and, potentially, lead to more business failures.

\textsuperscript{869} The Law Commission, Consumer Prepayments on Retailer Insolvency: Summary of responses to consultation paper (Law Com No 221 December 2015) 17 at [4.32].

\textsuperscript{870} Ibid.

\textsuperscript{871} Ibid 17 at [4.31].
Finally, as we have argued that unsecureds should not be differentiated based on the type of their claim (i.e. a consumer claim or an employee claim etc..) but rather on the fact whether they are ‘non-controlling’ or not, it would appear that businesses would have to provide insurance for all their unsecureds because every unsecured creditor might end up as a non-controlling one at the time when the company is financially insolvent. Before the debtor has entered into financial difficulties, it is not feasible to ascertain who will or will not become ‘non-controlling’ for this depends on the specific circumstances of the case as outlined in chapter 5. Given the often great amount of different unsecureds, it would therefore be quite burdensome and difficult to administer for businesses to provide or ensure that every single unsecured creditor would have insurance which would, arguably, get even more costly than when they would be confined to providing insurance to only their consumers.

Nonetheless, although rejecting the idea that mandatory insurance should be required and in spite of the relatively low demand, businesses could certainly continue to provide voluntary insurance if their customers would want this protection.

2.1.2.2. Trust schemes

i) Public trust

Although rejecting mandatory insurance mechanisms, this research will examine if and to what extent the usage of trust-schemes may contribute to enhancing the regulatory protection of unsecureds. It will be contended hereby that trust schemes could be helpful to a limited extent for vulnerable or non-controlling unsecureds. In such a trust, a certain amount of money (i.e. funds – cf. *infra*) would be ring-fenced for non-controlling unsecureds. In this regard, a distinction will be made between trust accounts set up by the debtor-firm itself and public trusts which would be funded through the general public (as set out below).

Starting with public trusts, there are, however, considerable drawbacks in that regard.

Firstly, it would be rather arbitrary to quantify the amount which would have to be held on trust for each unsecured creditor individually. There would be a question whether the entire claim or only a part of the unsecured claim would have to be held on trust. Making this decision will inevitably be one that would be arbitrary and would be complicated by the fact that each insolvency is different for in some cases unsecureds will not be able to receive anything whilst in others they might be able to receive a (high(er)) amount. Additionally, it would also be difficult to quantify the total amount that would have to be held on trust for it is, *a priori*, impossible to predict (i) how many repayments will have to be made, (ii) to whom these repayments will have

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to be made (i.e. who is going to be non-controlling?) and, therefore, (iii) how much money will be needed to honour these repayments. This could also be confusing to unsecureds as they would not know how much they would get repaid in case of insolvency.\(^{873}\) Trying to “objectivise” the amount of repayment an unsecured should be entitled to receive by, for example, contending that every unsecured should be entitled to receive an equal amount of dividends, even though it would be legitimate during a rescue procedure to reduce the claims of some creditors but not of others\(^{874}\), would not work either. This is because this would likely violate the principle of ‘fairness’ which this research elaborated on in chapter 6 and 7 above as unsecureds would receive a differential treatment dependent on what their fellow unsecureds would receive. This would lead to some non-controlling unsecureds being entitled to get their entire claim repaid if the other unsecureds would be unimpaired whilst others would only get a small fraction if, as part of another CVA/IVA, their fellow unsecureds would have their claims reduced to large extent.

Secondly, allowing some non-controlling unsecureds to get repayment via a trust would arguably be akin to providing preferential treatment to these unsecureds via the backdoor.\(^{875}\) This is because these non-controlling creditors would be able to get (some) repayment through this trust-scheme which controlling unsecureds would not get (unless every unsecured creditor would be entitled to claim for repayment).\(^{876}\) There is, however, a significant difference with actual preferential creditors because in this case whereby some vulnerable unsecureds would get a ‘leg-up’ through a trust-scheme, their payment would not shrink the asset pool (which is what happens when a real, preferential creditor such as an employee gets paid before the other unsecureds).

Thirdly, there are also difficulties as to how such a trust would have to be financed, especially if one cannot know in advance how much money will be needed to repay the unsecureds that would be allowed to get a repayment out of this trust.

Fourthly, changing market circumstances could also impact the amount of insolvencies and could be (or become) a drain on the trust’s funds potentially making it harder over time to repay the qualifying unsecureds.

\(^{873}\) Ibid.
\(^{874}\) This was, for example, the case in Debenhams where the court determined that it was legitimate to reduce the claims of landlords but not of the other creditors (e.g. suppliers) as part of a CVA in order to ensure that the debtor-firm could continue doing business and, thus, to maximise the chances of rescue succeeding. Cf. *Discovery (Northampton) Ltd v Debenhams Retail Ltd* [2019] EWHC 2441 (Ch) at [102]-[111].
\(^{875}\) Ibid 14.
\(^{876}\) The ability to repay every unsecured creditor through a trust-scheme, however, only seems to be a theoretical suggestion for it seems entirely unfeasible to achieve this.
Fifthly, setting up a trust would raise additional questions as to who ought to manage and police such a trust which would thus lead to additional accountability questions for it is no guarantee that a trust would be properly governed itself.\footnote{Ibid (n 759) 13-14.} This could, arguably, also increase legal complexity and could lead to additional uncertainty for already vulnerable unsecureds.

Sixthly, setting up, administering (and policing) a trust would also be economically costly, especially if the governance of such a trust would be left to businesses/debtors themselves, again leading to increased transaction (economic) costs\footnote{Ibid.} which could be passed on to customers and, thus, similar to argument made in relation to mandatory insurance, have a negative impact on the market.

Finally, using trusts could reduce business standards. If debtors know that unsecureds – potentially all of them\footnote{Depending on who would qualify to claim repayment – only the non-controlling unsecureds or all the unsecureds.} – would be able to get some sort of repayment, they might be inclined to engage in riskier activities, potentially jeopardising the firm's, shareholders', creditors' and other stakeholders' interests.

However, in spite of the arguments against trust schemes, an argument could be made that a public trust could be useful to help finance insolvency litigation. As seen in chapter 4 (part 3.1. and 3.2.) and below (part 2.2.1.5.), there are still funding issues which might be remedied if an office-holder or unsecured could apply to a public trust to support the financing of procedures (such as e.g. claw-back procedures or recovery procedures against the former management of the debtor).

It is acknowledged that this would not be without concerns or limitations.

First of all, there remain questions as to whether unsecureds would apply to a public trust in order to finance the commencing and pursuing of an insolvency procedure, especially in light of the existing information-asymmetry between the insolvent debtor and the unsecured.

Secondly, although the insolvent estate or the unsecured creditor could benefit from a successful claim, the unsecured will still need to be active and engaged with the insolvency procedure and, especially if the unsecured creditor's claim is low, this may not be the case. On the other hand, other unsecureds may want to start reckless procedures\footnote{This could, for example, occur if they are frustrated with the debtor's insolvency.} against e.g. the former management, especially if they have almost nothing to lose due to the fact that the
procedure is financed by a public trust. In such case, unsecureds would be gambling with money from the ‘public purse’.

Thirdly, there is also a question as to the amount of money an office-holder (or an unsecured) would be entitled to claim. Arguably, it seems advisable to only allow the financing of the legal costs and not any of the economic/transaction costs (such as e.g. the time they could not spend on projects of their own by being engaged in the insolvency procedure) incurred by the unsecured in monitoring and pursuing the claim.

Nonetheless, there are clear benefits of allowing the financing of insolvency procedures through a public trust.⁸⁸¹

First, it would avoid discussions as regards the amount of money an unsecured could be entitled to claim and would, thus, not lead to unfairness whereby some unsecureds in procedure X may be treated differently than unsecureds in procedure Y, merely because of e.g. a different CVA/IVA proposal of the insolvent debtor (cf. supra).

Secondly, it could enhance engagement of unsecureds for they would not have to bear the risk that they need to bear the costs of a potentially unsuccessful claim.⁸⁸² In doing so, it could also enhance accountability of directors (and office-holders) for it could make the initiation of a claim more likely.

Thirdly, it would allow for a differentiation in terms of insolvency procedures. As part of a liquidation or administration procedure, an office-holder (or an unsecured) could apply for the financing of an insolvency claim. Surely, an unsecured would only be able to initiate a claim if they would commence a misfeasance claim against the director (or office-holder) pursuant to section 212 of the Insolvency Act 1986 or if the office-holder would have assigned a cause of action to the unsecured⁸⁸³ unless, as argued below, creditors would be entitled to initiate derivative actions. In the event creditors would be entitled to file a derivative claim (i.e. a suggestion advocated by this research), the creditors would have to inform the office-holder of the steps they have taken to avoid the initiation of the same procedure (by them and, perhaps, also the office-holder). As part of CVAs/IVAs where the office-holder only plays a more limited role, it would entitle the unsecured to seek funding to commence a material irregularity or unfair

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⁸⁸² In Australia, pursuant to Corporations Act 2001, section 564 a preferential position is given to the creditor who funded an insolvency claim, however, giving a preferential position would not address the risk of the creditor bearing the costs of an unsuccessful claim which, in contrast, the reliance on a public trust would achieve.

⁸⁸³ Insolvency Act 1986, section 246ZD.
prejudice procedure if the unsecured believes that (s)he has been treated unfairly and/or if irregularities have had a material impact on the CVA/IVA-proposal.

Fourthly, relying on a public trust for insolvency litigation would not be inefficient for it would not place an additional burden on directors or office-holders. On the contrary, it would, arguably, only encourage them to comply with already existing duties.

Nonetheless, there remains a question as to how a public would be funded. This research contends that a small levy could be imposed on everyone incorporating a company. Furthermore, charging a small levy from every individual who has committed a criminal offence and found guilty by the court might potentially be considered but would, arguably, not be justified for it could be seen as another burden/sanction imposed on a criminal which might not be proportionate. This leaves aside the issue that the criminal may also not have any money himself/herself which is an additional reason why the suggestion to charge a levy from a convicted criminal does not seem workable.

Furthermore, in order to avoid giving a ‘blank cheque’ to applicants, there must be some limitations placed on when an application to receive funds can be granted. Similar to the checks undertaken prior to allowing a derivative claim, one could argue that in this scenario a successful outcome of a claim must be likely. Furthermore, the lack of funds (e.g. in case of an insolvent estate without material assets or a financially poor creditor) could also be deemed a valid requirement.

In imposing such limitations, the burden on society would be limited whilst the reliance on public funds for the initiation of insolvency claims (that are likely going to be successful) seems justified for it could, as set out before, enhance the public interest. This is because it would, arguably, stimulate accountability and incentivise creditors to be more engaged with the insolvency procedure and, as a result, encourage directors (and office-holders) to comply with their duties. In doing so, it could also enhance market trust and increase the chances that creditors can get the dividend they are entitled to receive.

ii) Trust account

In addition, a debtor-company could also set up trust deposit account to ensure that some additional funds will be available for those creditors who will be deemed non-controlling in the advent of (potential) insolvency. However, this would once again raise similar criticisms akin to

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884 This leaves aside the issue that the criminal may also not have any money himself/herself which is an additional reason why the suggestion to charge a levy from a convicted criminal does not seem workable.


886 In a situation where the insolvent estate would be ‘assetless’, unsecureds may be more willing to take risks, especially if that would be the only chance of getting a dividend. Consequently, in order to avoid unsecureds “gambling” with publicly funded trusts, the requirement, similar to derivative actions, to have a claim which is likely going to be successful is very important.
the ones expressed against public trust schemes, not in the least because it would again be unclear for which vulnerable creditors this needs to be set up. Also, directors who are ring-fencing money for certain creditors potentially risk breaching their directors’ duties by unlawfully giving preferential treatment to certain creditors. In addition, requiring directors to set up trust schemes or trust accounts for every faction of unsecureds that might be deemed vulnerable would seem cumbersome and not conform our efficiency-requirement as set out in chapters 6 and 7.

Nonetheless, in order to ensure that equal creditors are treated equally and “unequal” (i.e. strong v. weak) creditors are not, we suggest that a trust account might be able to offer some additional protection to those who are effectively in a weaker position.

This would be, when – as in the Kayford case – it has become very clear to directors that a certain group of creditors would, according to them, be more at risk (i.e. the non-controlling/vulnerable unsecureds) than other creditors and, arguably, in need for additional protection.

In order to ensure that our ‘efficiency’ requirement would be honoured, we therefore submit that the decision to set up a trust-account to protect non-controlling unsecureds should be considered as part of the directors’ fiduciary duty to act in the interests of the company for the benefit of the whole group of unsecureds, hereby having regard to the non-controlling (or deemed more vulnerable) unsecureds.

Consequently, it is submitted that the use of a public trust and trust accounts set up by directors of the debtor-company may contribute to enhancing the protection of vulnerable factions of unsecureds. Nonetheless, due to the limitations and existing concerns set out above, it would, however, not be “the silver bullet” (if existent at all) that would eradicate all problems an unsecured could get confronted with.

2.2. Governance-related suggestions

All the suggestions above were non-governance-related. However, despite the importance of trust mechanisms to the extent argued above, this research submits that, different from past literature, much more emphasis should be placed on governance-related solutions as well. This is because good corporate and insolvency governance may reduce the risk of a debtor becoming insolvent. In this case, a debtor-firm would be able to continue trading and there would thus be no (or less) need to rely on the aforementioned non-governance measures (as the debtor remains solvent). Also, good governance could increase the chances of rescue

GHLM Trading Ltd v Maroo [2012] EWHC 61 at [168].
procedures succeeding and, even if rescue would not be feasible anymore, good (insolvency) governance may still increase the returns to unsecureds or may at least ensure that the unsecured gets the appropriate dividend (without having to seek recourse to insolvency procedures). This research will therefore now look at several governance-inspired regulatory suggestions. This will be divided into two parts whereby the first part will look into several solutions from the perspective of the creditor and creditor engagement and the second will critically examine the duties of the directors/office-holder and the remedies in case of a potential breach of such duties.

2.2.1. Creditor control and engagement

First, suggestions to improve creditor control and engagement will be critically examined. Such creditor engagement is crucial for two primary reasons, namely (i) the ability for unsecureds to control the managerial activities of the directors or office-holder(s) if the debtor has become subject to an insolvency procedure and (ii) the guarantee that the interests of particularly weaker factions of unsecureds will have been appropriately addressed.\(^{888}\)

2.2.1.1. Preferential voting position for non-controlling unsecureds

When examining creditor control and avenues to increase creditor engagement, one of the first potential solutions could be to grant preferential voting rights to certain weaker unsecureds. This is because such measure would enable them to exercise more power and potentially get them more involved during the rescue or winding-up process. As explained in chapter 4 and 5, the number of votes an unsecured creditor carries, is currently determined by the size of their claim in relation to the total of all other unsecured claims. Compared with corporate governance where deviations to the principle of “one share one vote” have been enacted (i.e. through the usage of non-voting shares and loyalty shares attracting more voting rights than regular shares for example)\(^{889}\), one could question whether something similar could be advocated regarding non-controlling unsecureds whereby the latter ones could get a disproportionate amount of votes compared to (stronger) unsecureds.

Although the argument could hold some merit at first sight, it should, nonetheless, be rejected for the following reasons.

\(^{888}\) Cf. infra, part 3.2.2. about directors’ duties and how directors should have regard for more vulnerable factions of unsecureds.

First, it is questionable to what extent it would actually increase creditor participation. Although difficult to measure, it can be assumed that the chances are quite low that it would activate unsecureds. The reason is simple. Unless additional votes would enable the (class of) unsecureds to influence the outcome of the insolvency procedure, it seems unlikely that they would feel encouraged to get more involved in the procedure. Furthermore, as the Farepak-case showed, even if there is a majority of unsecureds (in this case: consumers) they might still not feel encouraged to become engaged in the rescue or winding-up procedure.890

Secondly, how should one determine the number of additional votes the non-controlling unsecureds receive? And given the fact that this research advocates that it should ultimately be up to directors/office-holders (subject to judicial control) to determine which (group of) unsecured creditor(s) is in a ‘non-controlling’ position891, it would make it very difficult to determine how, when and how many additional votes need to be granted to non-controlling unsecureds. If, however, the class of ‘non-controlling’ creditors would be predetermined and would receive a disproportionate number of votes (i.e. by for example stipulating that consumers always get more votes than the other unsecureds) this could exacerbate already existing agency problems between factions of unsecureds and could, dependent on which (faction of) unsecured creditor(s) would receive additional votes, worsen the agency problems if somehow unsecureds (who happen to be in control of the insolvency procedure) would receive a disproportionate share of the votes.

Thirdly, in both scenarios (i.e. whether the group of non-controlling unsecureds has been predetermined or not), granting additional votes would quite likely make the insolvency procedure overly complicated and burdensome which could lead to negative externalities (such as a lower distribution of dividends to unsecureds). This is because a lengthier and more complex (and costly) procedure could increase the costs of rescuing or liquidating the debtor which would ultimately have a negative impact on the dividend outcome for the whole group of unsecureds (and hence also negatively affect the non-controlling group of unsecureds).

Finally, the idea to give additional votes to non-controlling unsecureds stems from Corporate Governance892, however, the rationale to give loyalty shares to shareholders (which carry more votes) cannot be transplanted to Insolvency Governance. The rationale behind loyalty shares

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890 The Law Commission, Consumer Prepayments on Retailer Insolvency: summary (Law Com No 368 2016) 15.
891 Cf. supra, chapter 5.
is to protect and encourage long-term investment in a company. Unsecureds, on the other hand, do not want to protect their “investment” for they haven’t invested in the company in the first place but rather supplied the debtor with a loan/credit which must be repaid. Hence, these unsecureds are probably more interested in getting their money back. Nonetheless, some repeat trade creditors who trade on a regular basis with the debtor might still be interested in the long-term viability of the company but giving them more voting rights would not necessarily change much for it also depends on who and how many other unsecureds there are before multiple votes could effectively influence the outcome of the rescue or liquidation procedure.

2.2.1.2. Creditors’ committees

i) Notion

If additional voting rights do not seem recommendable, making (more) use of creditors’ committees could, however, be more helpful in order to give unsecureds a better chance of properly monitoring the company’s performance. Such an unsecureds’ committee could be established to ensure that the whole group of unsecureds are adequately protected throughout the insolvency procedure. There is no restriction on the establishment of a creditors’ committee based on the nature of the insolvency procedure. Absent any provision in law for CVAs and IVAs, a creditors’ committee might still be established during every insolvency procedure, including such CVAs or IVAs, if one believes that a committee could facilitate the procedure.

Members of a creditors’ committee occupy a fiduciary position in relation to the group of creditors and other contributories (such as members of the company). They have to act as a ‘representative’ of the creditors who are not a member of the committee. This emanates from the Insolvency Rules 2016. In particular, rule 17.25 determines that a member of the committee should not enter into a transaction that would give him/her payments for services provided in relation to the administration or winding-up of the insolvent estate nor should members of the committee receive profits from the administration of the insolvent estate or any assets that are part of the estate which highlights the relationship of trust (or fiduciary position) of creditors


894 Insolvency Act 1986, s.141 for compulsory liquidations; s.101 for voluntary liquidations; s.26 for administrations; s.49 for receiverships; s.301 for bankruptcy procedures.


896 Re Bulmer [1937] Ch 499 at 502 also referring to Re Geiger [1915] 1 KB 439 at 447 in fine where Lord Cozens-Hardy M.R. held that “the statute is full of provisions recognizing the fiduciary position of members of a committee of inspection and imposing restrictions upon their powers”; S.A. Frieze, ‘Creditors’ committee in a US Chapter 11 case – compared with the UK system’ [2014] Insolvency Intelligence 28, 30.
(being part of the creditors’ committee) vis-à-vis their fellow creditors (who are not part of the committee). 897 Furthermore, rule 17.2 stipulates that the committee ‘should assist the office-holder in discharging the office-holder’s functions’ 898 whereby it should be borne in mind that the liquidator/administrator/bankruptcy trustee stands in a fiduciary relationship towards the company with the company’s creditors being the residual risk-bearers. The fiduciary position of committee members was also acknowledged in Re Bulmer 899 and Re Geiger 900. Both cases still referred to the ‘committee of inspection’ which, under Bankruptcy Acts 901 predating the Insolvency Act 1986, used to be the precursor of today’s ‘liquidation committee’. Particularly, in Re Geiger 902 Lord Cozens-Hardy M.R. clearly stated that “the statute is full of provisions recognizing the fiduciary position of members of a committee of inspection and imposing restrictions upon their powers”. 903 Although in the USA such a duty of a member of the committee is owed to a particular class of unsecureds 904, this is not the case in the UK where the members of a committee have to act in the interests of the insolvent estate for the benefit of the whole group of unsecureds. 905 Furthermore, whilst the creditors’ committees are set up for unsecureds in the USA, secured creditors might still be a member of the creditors’ committees in both the UK and the USA provided that their debt is not fully secured. 906 As indicated above, as a result of the fiduciary position members of the committee occupy, they have to act in the interests of the creditors they ‘represent’. This means that committee members cannot (in principle) advance their own interests at the expense of the creditors they represent if these interests would conflict with the creditors they ought to represent. 907 

ii) Benefits

There are some clear benefits of having such a creditors’ committee during an insolvency procedure.

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897 Insolvency Rules 2016, r. 17.25.
898 Insolvency Rules 2016, r. 17.2.
900 Re Geiger [1915] 1 KB 439 at 447 in fine.
901 See for example: Bankruptcy Act 1914, section 20; Bankruptcy Act 1890 (53 & 54 Vict. c. 71), s. 15, sub-s. 3 . Bankruptcy Act 1883 (46 & 47 Vict. c. 52), s. 22.
902 Re Geiger [1915] 1 KB 439 at 447 in fine.
903 Re Geiger [1915] 1 KB 439 at 447 in fine.
906 For the UK: Insolvency Rules 2016, r.17.4(2); For the US: US Bankruptcy Code, section 1102(a)(1).
907 W. Trower, A. Goodison, M. Abraham and A. Shaw, Corporate Administrations and Rescue Procedures (Bloomsbury 2017) 95.
First, weaker factions of unsecureds would not have to engage in monitoring and controlling the behaviour of the office-holder and the previous management of the company themselves. As a result, these weaker factions could benefit from representation without having to fear that the monitoring/controlling costs would outweigh the dividends they stand to gain from the insolvency procedure.

In addition, it would seem easier for the office-holder to deal more intensively with a smaller (and arguably more engaged) group of unsecureds during an insolvency procedure rather than merely having to rely on a bigger widely dispersed and less-interested group of unsecureds.

From this perspective, both the office-holder and all the creditors would benefit from having a committee which works closely together with the office-holder. This is because the committee would channel the views/thoughts of the creditors to the office-holder it represents which the office-holder might then more easily consider while managing the insolvent estate without unsecureds losing out due to the high transaction costs (such as monitoring costs).

### iii) Concerns

However, despite the positive rationale behind a creditors’ committee, there are quite some pitfalls related to creditors’ committees.

First, the members of the creditors’ committee are creditors themselves and it is quite likely that they may have conflicting interests with at least some of the unsecureds they ought to represent. Although their fiduciary position does not allow them to pursue an agenda different from representing their ‘base’, it is quite hard to see how an institutional investor or debt trader would properly represent the interests of a small trade creditor or employee.\(^{908}\) One can assume that the latter creditors would prefer to continue trading with the debtor-company whereas the former ones might not be interested at all in the continuation of the business.\(^{909}\) The fact that no differentiation is made with regard to different classes of unsecureds by the rules in the UK and the requirement to have a (quite small) membership of minimum three and maximum five members\(^{910}\) might lead to the emergence of a committee which in fact does not represent the interests of weaker factions of unsecureds at all.

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\(^{910}\) Insolvency Rules 2016, r.17.3(1).
Secondly, members of the committee may only get a reimbursement for their travel expenses but aren’t paid for the work they do as part of the committee.\textsuperscript{911} This may not only discourage creditors from becoming a member of the committee (especially as many unsecureds are already reluctant to participate during the insolvency procedure), it may also exacerbate the risk of committee members underperforming or not adequately representing the creditors which are not part of the committee.

Thirdly, members of the committee might not only have a conflict of interests with the unsecureds they ought to represent (i.e. in the external relationship), committee members may also have conflicting views amongst themselves (i.e. in the internal relationship).\textsuperscript{912} Although internal conflicts between committee members may be expected given the fact that different creditors may pursue different goals, it may sometimes be necessary to appoint another committee member if the committee cannot function due to internal ‘fights’.\textsuperscript{913} There is, however, no case-law determining the mechanism how a committee member should be removed. One of the few cases in this regard brought before the court was Re Rubber & Produce Investment Trust in which the court merely decided that they did not have the power to remove a member of the creditors’ committee.\textsuperscript{914} The decision had to be taken by the committee itself without any further guidance by the court what the creditors had to take into consideration when assessing whether another member of the committee should be removed. A similar decision was taken in Re Radford & Bright Ltd (No.1) where the court decided that the court could only direct the office-holder into rearranging or calling a new meeting where the decision about the removal of a member of the committee could be taken by the other committee members.\textsuperscript{915}

Fourthly, an important issue is the enforcement of any action by members of the committee as a result of a conflict between the committee (or a committee member) and the office-holder and/or an intra-committee conflict. The existence of a conflict amongst committee members can not only be expected hard to find out for a committee member, especially given the fact that committee members are acting in a fiduciary role as ‘representative’ of the creditors which are


\textsuperscript{912} Cf. supra chapter 8, pg. 194-195; Insolvency Rules 2016, rule 17.25; Re Bulmer [1937] Ch 499 at 502 also referring to Re Geiger [1915] 1 KB 439 at 447 in fine; S.A. Frieze, ‘Creditors’ committee in a US Chapter 11 case – compared with the UK system’ [2014] Insolvency Intelligence 28, 30.


\textsuperscript{914} Re Rubber & Produce Investment Trust [1915] 1 Ch 382.

\textsuperscript{915} Re Radford & Bright Ltd (No.1) [1901] 1 Ch. 272.
not a member of the committee.\(^{916}\) It may also be difficult to remove a member from the creditors’ committee.\(^{917}\) This is because courts lack the power to do so\(^{918}\), leaving the decision whether a member of the committee should be removed or not open to the creditors of the insolvent company.\(^{919}\) Given the lack of interest amongst (especially the unsecured) creditors to be involved in the insolvency procedure, many creditors might be reluctant in getting engaged in a removal procedure which underscores the accountability issue that might exist.

Consequently, rather than solving the ‘agency conflict’ between unsecureds and the office-holder, the creation of a creditors’ committee might add another ‘agency conflict’ to the already existing agency conflicts, namely the ‘agency conflict’ between controlling committee members/creditors and non-controlling non-committee creditors. As a result, it is questionable whether a creditors’ committee would be an appropriate means to solve any risk of exploitation and/or inefficiency of which weaker factions of unsecureds might suffer due to their non-controlling position.

Nonetheless, the impact of a creditors’ committee should not be overestimated either as its power is relatively restricted given the fact that the committee cannot determine itself what the appropriate actions are that the office-holder should take. In the end, the office-holder will make the decisions himself whilst merely taking into account the views as expressed by the committee members.\(^{920}\)

2.2.1.3. Creditors’ activism: stimulating unsecureds’ engagement?

Having rejected the previous regulatory options to improve creditor control and influence, certain regulatory initiatives might have to be taken to stimulate creditors’ involvement prior to and during an insolvency procedure. This suggestion is based on relatively recent corporate governance mechanisms which aim to enhance shareholder engagement in companies.

For the purposes of this research and given the similarity between shareholders (as residual risk-bearers while the company is solvent) and unsecureds (as residual claimants when the company becomes financially distressed) this research will confine itself to elaborating on the possibility to (i) engage unsecureds during corporate rescue and/or liquidation procedures (which may require directors/office-holders to take action to encourage unsecureds’


\(^{917}\) Insolvency Rules 2016, r.17.12.

\(^{918}\) \textit{Re Rubber & Produce Investment Trust} [1915] 1 Ch 382.

\(^{919}\) Insolvency Rules 2016, r.17.12.

involvement) and (ii) perhaps to impose some (soft-law) duties on unsecureds to take a more active part in the insolvency procedure. However, before examining creditor activism, we will first compare the position of the unsecured creditor to the position of the shareholder and critically examine what ‘shareholder activism’ specifically entails.

i) Shareholders and unsecureds: a comparison

As set out in chapter 1, there is a significant similarity between shareholders and unsecureds. This is because both can be considered to be ‘residual claimants’ albeit at different times.\(^\text{921}\)

As long as a company is solvent, the last ones who would be paid back their investment are the shareholders and so, they are the residual risk-bearers at that time. However, once the debtor-firm can no longer pay off shareholders’ debts, unsecureds take over the position of shareholders because, from now on, it will be the unsecureds that will be the last ones in the ‘payment queue’ and who will then become the ‘residual claimants’.\(^\text{922}\)

In addition, figures for both shareholders and unsecureds indicate that there is a considerable amount of apathy amongst both of them for both are generally not easily inclined to participate in getting involved in overseeing and monitoring (or perhaps even influencing) the debtor’s management.\(^\text{923}\) For shareholders, this is especially so in companies with a dispersed ownership (but might be less when there is a concentrated ownership and where the directors are also the (majority) shareholders). In any case, the main reason why both shareholders and unsecureds are quite reluctant to engage themselves in the operations of the firm is in both cases because economic costs might be high and could exceed the potential benefits.\(^\text{924}\)


\(^{923}\) For shareholders see below part ii) on shareholder activism; For unsecureds see below part iii).

\(^{924}\) This is especially so for unsecureds who have a fixed claim (which, in quite some cases, might be quite low) as opposed to shareholders who have a residual claim (and, hence, are not limited in the same way as creditors).
In this regard, and similar to shareholders monitoring directors, monitoring the incumbent management/office-holder involves a lot of transaction (economic) costs which could outweigh the benefits unsecureds stand to gain from the insolvency procedure. This would be especially so if their claim is relatively small (such as most consumer claims).

Moreover, and allied to the previous point (and again similar to the situation between shareholders), as with shareholders, voting amongst unsecureds is a ‘public good’. This means that, given the costs involved, it is unlikely that one unsecured will start controlling the debtor’s management on his/her own. This illustrates a common pool problem which can manifest itself through the issue of free-riding behaviour by other unsecureds. Therefore, assuming that monitoring by unsecureds would increase the value of the debtor’s estate and could increase distributions to unsecureds, the other unsecureds (who did not monitor the board of directors/office-holder) would still share in the “benefits” this monitoring/investigation of the incumbent management of the debtor and/or the office-holder by one unsecured creditor could have resulted in.

Consequently, given this similarity between both shareholders and unsecureds on the one hand and their (expected) behaviour on the other hand, it can be determined that the regulatory framework for unsecureds (during insolvency governance) and shareholders (as part of corporate governance) is moving in seemingly opposite directions. Although this may not be surprising given the characteristics of large institutional investors/shareholders and the usual characteristics of unsecured creditors, it is contended that, from a policy perspective, this should not mean that insolvency governance cannot (or should not) learn from corporate governance principles, especially when it comes to trying to stimulate unsecured creditors’ engagement. This will later be illustrated in part B.3 below.

ii) Shareholder activism

   a) Definition

Therefore, before embarking on the question whether there might be potential for (unsecured) creditors’ activism akin to shareholder activism, it is deemed important to briefly but critically evaluate (i) what shareholder activism specifically entails, (ii) how the regulatory framework for shareholders has been shaped in order to try to engage them more in the company’s performance and (iii) whether these regulatory changes have had a positive impact on both shareholders and the company.

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926 Ibid.
Although shareholder engagement has been a long-standing discussion (influenced during the 70s and 80s of the previous century by neo-classical scholars), the financial crisis of 2008 put shareholder engagement back into the spotlight.\textsuperscript{928} One of the prominent arguments was that company directors had failed to properly manage the companies \textit{(inter alia due to negligence and/or opportunistic behaviour)} which, so went the argument, would not have happened or could at least have been attenuated if directors would have been subject to more supervision and scrutiny.\textsuperscript{929} Unsurprisingly, in light of the agency problem between shareholders and directors, it was argued that this managerial scrutiny had to be exercised by shareholders of the Company.\textsuperscript{930} This shareholder apathy, however, had contributed (to a certain extent) to the financial crisis.

In terms of the definition, shareholder activism has been \textit{narrowly} described as the actions which shareholders take with the aim of influencing the managerial decisions in a company.\textsuperscript{931} However, more \textit{broadly}, shareholder activism is seen as a mechanism encompassing the continuous activities shareholders undertake as a reaction to the managerial performance of directors in a company (in which they own shares).\textsuperscript{932} The aim of these interventions is to align the interests of directors with those of the shareholder to increase ‘shareholder value’ in the long-run.\textsuperscript{933} The latter (broader) definition does not necessarily mean (unlike the narrow definition) that shareholders have to take certain actions to influence directors’ decisions but which could also involve shareholders convening and/or asking certain questions about certain managerial activities at a shareholders’ meeting.

In this research we will opt for the broader definition. The reason for this is because shareholder engagement is, arguably, grounded in the (economic) agency relationship between shareholders (in economic terms: ‘owners’) and directors (in economic terms: ‘controllers’) and


\textsuperscript{930} Ibid.


the subsequent potential agency conflict which could arise if those in (economic) control of the company (i.e. the directors) would act against the best interests of the company through which they would harm the interests of shareholders. Shareholder engagement such as exercising control (to oversee what managers are doing) is one important tool through which shareholder can be engaged (and is, as argued in the previous chapter, an important accountability tool) which would, arguably, be ignored by opting for the more narrow definition of ‘shareholder activism’.

b) Impact of shareholder activism?

b.1) Increased shareholder engagement?

Having discussed the definition of shareholder activism, we will now examine the actual impact to ascertain whether regulatory measures to engage shareholders could be useful to engage creditors. In this regard and despite the voluntary character of these Corporate Governance and Stewardship codes, empirical studies nonetheless indicate that they were able to enhance shareholder engagement.

For example, the latest Grant Thornton report of 2019 which examines shareholder engagement in the FTSE 350 Companies indicates that shareholder engagement has increased for the first time since 2016 which, Grant Thornton attributes to the adjusted Corporate Governance Code of 2018 based on which (as set out above) the chair (who leads the board of directors) is required to “seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy”. The improvement is quite significant for 43.8% of the FTSE 350 companies give “good or detailed disclosures on shareholder engagement” which is up from 36% in 2016 and 31.3% in 2018. In addition, there is also an improvement in the way boards communicate with shareholders for more face-to-face meetings are rising whilst, in the past, communication merely relied on companies sending reports/information to shareholders in a one-way communication form. Although these results are positive, it would still be a bit too early to immediately infer that “shareholder engagement” cannot be improved anymore.

In this regard, another recent empirical study undertaken by Gomtsian also indicates that asset managers, a particular type of investors, have become more engaged in assessing the

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935 Cf. infra.
937 Corporate Governance Code 2018, provision 3.
938 Ibid (n 808) 34.
939 Ibid 35.
management of portfolio companies and take on a more active monitoring role by voting differently than suggested by the board of directors of these companies. Similarly, a recent study undertaken in the US indicates that investors are more engaged than one might initially have thought, hereby exerting influence over the corporate governance structure of the company in which they hold a certain amount of capital. In this regard, other empirical studies (such as from Activist Insight or Karpoff) also indicate that shareholder activism has increased in both Europe and the USA in recent years indicating that investors are making use of their power to influence board strategies (such as in the area of M&A procedures).

b.2) Impact on firm value?

From a corporate governance perspective, the literature is inconclusive for some scholars indicate that improved monitoring will increase firm value whilst other scholars are more hesitant or completely reject calls for increased shareholder participation. In this regard the Gomtsian study indicated that shareholder activism, although not having a dramatic impact on corporate governance, does exert influence over shareholder meetings and generate some opposition against certain management proposals (such as company policies related to remuneration, M&A or business strategy). The general idea is that shareholder meetings requisitioned by activists will attract more attention and, hence, enhance investor scrutiny. It is expected that this enhanced scrutiny would not only affect the item(s) which might be put on the agenda of the meeting by an (some) activist(s) but could well result in the entire agenda or shareholder meeting becoming subject to increased monitoring by investors. Another empirical study by Gerner-Beuerle and Kirchmaier seems to support aforementioned view for they illustrate that rather than taking into account rational features (such as whether the remuneration package

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540 Portfolio companies are venture capital companies in which investors or institutions such as asset managers hold a certain equity stake.
546 Ibid 18.
547 Ibid.
rewards success instead of failure), say-on-pay votes were largely protest votes indicating that activists could exert influence over a meeting and affect the outcome.948

However, although influencing the meeting, such engagement does not indicate that the firm value would increase. Quite the opposite as votes guided by emotions and cast to protest rather than based on rational well-thought-out plans do not seem to be conducive to actually improving corporate governance standards of the company.

b.3) Diversion between corporate and insolvency governance

Although, in principle, it is believed that enhanced creditor engagement can have a positive impact of board performance, recent regulatory changes indicate that corporate and insolvency governance diverge in different directions with insolvency governance paying less attention to the requirement to engage creditors. This will be set out below whereby we will first ascertain the regulatory tendencies within corporate governance before pointing to the different policies within insolvency governance.

In terms of corporate governance, there is a growing amount of attention to the need for and importance of shareholder engagement. Consequently, following their apathy949 and in order to avoid the creation of stringent hard-law duties on either directors and/or shareholders, a UK Corporate Governance Code and a UK Stewardship Code emerged, respectively in 2010 and 2012 (after the financial crisis which saw a lack of control over the management of companies attributed to the crisis). While the former Code aims to provide guidance to directors, the latter code intends to stimulate shareholder engagement. Recently, both Codes have been updated with the Corporate Governance code of 2018 currently stipulating “in order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties”.950 This clause reflects the Financial Reporting Council’s intention to bridge the gap between shareholders and directors by instructing directors to effectively engage with shareholder so that the latter ones can participate in their monitoring role. On the side of shareholders, the Stewardship Code of 2020 embeds a range of principles certain investors (shareholders) should abide by on a “comply or explain” basis in order to foster higher shareholder engagement.951

951 Financial Reporting Council, The UK Stewardship Code (2020), principle 1-12 for asset owners and 1-6 for service providers available at https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf and, more in particular, principle 9
In terms of insolvency governance, no such reforms or rules which aim to improve unsecureds’ engagement in the insolvency procedure have been enacted. On the contrary, physical meetings as a matter of course for creditors have been abolished by the Small Business Enterprise and Employment Act 2015 and, hence, they are now prohibited unless at least 10% of the creditors (unsecured and secured) or ten creditors requisition a physical meeting.952 Physical meetings had to make way for “deemed consent procedures” whereby, as the name of the procedure suggests, creditors are assumed to consent to intended decisions of the office-holder unless if a qualifying decision procedure is required by the Insolvency Act 1986 or the Insolvency Rules (such as e.g. for the remuneration953 of the office-holder, the extension of a Moratorium954 or the voting on CVAs955), if the court orders that a decision must be made by a qualifying decision procedure956 or when the required threshold has been reached to have a physical meeting.957 With an already very low unsecured creditor engagement958, these reforms will not stimulate their engagement. In fact, it might well be the exact opposite. Another example is the relatively modern usage of pre-pack administrations whereby an agreement between the debtor-company and some stronger (often secured) creditors is concluded leaving ‘weaker’ unsecureds (i.e. often trade creditors and consumers for example) in the dark during the consultation processes and presenting them with a pre-pack which is often nothing more than ‘a fait accompli’959, despite the non-binding SIP 16 requirements to inform unsecureds with the necessary information.960 SIP 16, or Statement of Insolvency Practice 16, is a statement issued
by the Insolvency Service setting out some guidelines how office-holders need to manage a pre-pack administration. These requirements are regulatory and are expected to be adhered to by insolvency practitioners. Furthermore, the recently passed Administration (Restrictions on Disposals etc to Connected Parties) Regulations 2021 also intends to provide greater overview of substantial asset sales to connected parties in an administration within 8 weeks of appointment. Nonetheless, also the recent introduction of a standalone Moratorium by the Corporate Insolvency and Governance Act 2020 which functions as a debtor-in-possession procedure once again shows that creditors’ rights could – at least temporarily – be sacrificed for an insolvent debtor-firm who may never recover without the insolvent debtor being obliged to obtain creditors’ approval.

So, whereas directors need to encourage the residual claimants (i.e. shareholders) to involve and participate in the company as long as it is solvent, the (new) residual claimants (i.e. unsecureds) will receive a managerial treatment which is quite the opposite.

The rationale behind this different treatment (of shareholders and unsecureds) is, arguably, twofold. On the one hand, there is a clear difference between shareholders and unsecureds in the sense that creditors are confined to the limits of their claim (i.e. fixed claim) while shareholders do not have such a fixed claim but rather a residual claim. This means that creditors can only receive what they are owed which is in many cases (e.g. consumer or employee debts) not much. Shareholders, by contrast, are not limited in what they could receive for the more profits their company makes, the higher the amount of dividend payments which could be distributed to them. Consequently, at first sight, it could be assumed that shareholders could be more interested in controlling the company’s affairs than unsecureds (who usually only have a small claim). Secondly, figures indicate that unsecureds (even the HMRC) are largely disinterested and not involved in controlling or monitoring the (insolvent) debtor’s management.

961 The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021, section 3.
Nonetheless, although the former arguments could be attributed to the divergence in regulatory norms which apply to shareholders and unsecureds (despite both being in a residual claimant-position), this still does not give a satisfactory justification for not allowing more creditor engagement. Namely, without rehearsing everything that has been said before, there exist a significant amount of similarities between shareholders and unsecureds too such as, amongst others, the fact that also shareholders/investors may sometimes be disinterested in monitoring the board of directors\(^{965}\) (just as unsecureds may be disinterested at times)\(^{966}\) and also (unsecured) creditors might have a big claim and no matter the size of the claim all unsecureds (especially the more vulnerable ones) would benefit from a properly managed debtor. Furthermore, although corporate governance codes are in principle concerned with public companies, the often-wide number of unsecureds (similar to the dispersed shareholding in public companies) implies that even in private companies, it is likely that issues related to the so-called separation of ‘ownership’ and ‘control’ (e.g. in a solvent (public) company could occur in a private company once it becomes insolvent. This is because unsecureds will be very dispersed and presumably not very engaged which might make the ‘controller’ (e.g. directors/office-holders and/or a controlling unsecured) very powerful. Subsequently, a comparison between shareholder activism as part of corporate governance and creditor activism as part of insolvency governance becomes highly relevant. As a result, the tools used in corporate governance to engage shareholders will be taken into account to stimulate creditor engagement which will be critically examined below.

iii) Viability of unsecured creditor activism?

a) Definition and policy issue

In a similar vein as shareholder activism, (unsecured) creditor activism could be defined as the activities through which unsecureds can monitor, control and evaluate the managerial performance of their debtor both prior to and during an insolvency procedure.\(^{967}\)


\(^{967}\) During the period where, despite not being subject to an insolvency procedure, the debtor is already in financial difficulties and where it is clear that, although rescue might still be possible, unsecureds have taken over the position of ‘residual claimants’ from shareholders.
In spite of the similarity between ‘shareholders’ and ‘unsecureds,’ and despite the diverging regulatory framework, the question whether unsecured creditor activism should be encouraged hinges on the question whether more unsecured creditor engagement, if possible, would contribute to increasing the value of the distressed firm and would increase (i) the likelihood of getting a dividend and/or (ii) the amount which can be distributed amongst unsecureds. For the purposes of this research, this research will only look at this question from an unsecureds’ perspective (which is innovative as it has not been examined before) although in reality the question whether secured creditors should monitor the distressed company’s management more could (and should) also be raised.  

Given the lack of research as to the impact of unsecured creditor monitoring on the distressed firm’s value, this research will compare and contrast with the results of shareholders monitoring the management of solvent companies. As well as relying on such Corporate Governance research, where relevant from the unsecureds’ perspective, we might still draw comparisons from research undertaken about the impact of secured financing on the going-concern or liquidation value of the (distressed) firm/debtor.

b) Arguments against increased creditor engagement

From the perspective of the unsecured creditor in general and its non-controlling factions in particular, there are a lot of concerns which could be raised vis-à-vis any suggestions to increase their engagement.

As said before, the Corporate Governance literature is inconclusive as to whether improved shareholder engagement will increase firm value. Whilst some empirical evidence suggests that increased shareholder activism improves the value of the firm, other studies seem inconsistent with such findings. Consequently, based on empirical Corporate Governance studies, it does not seem possible to absolutely guarantee that increased unsecured creditor activism would increase the likelihood of unsecureds either (i) getting a dividend and/or (ii) increasing the amount of the ‘dividends’ they would be able to get. This is assuming we can compare shareholder and creditors.


970 Ibid 3.

971 Which, in case of unsecureds, is always limited to the full amount of their claim.
Furthermore, although there is a similarity between the often-dispersed nature of the shareholding in a solvent public company and the dispersed character of creditorship in both insolvent public and private companies, it is still questionable to what extent the findings of empirical studies about shareholder activism can be relied upon for the purposes of creditor activism. This is because these studies are always concerned with big public companies whereas creditors are mostly confronted with rather small-medium-sized private firms that become insolvent. However, as seen in various cases, certain insolvencies (sometimes of bigger companies such as Carillion, Debenhams or House of Fraser) might also have a strong controlling unsecured creditor which could, arguably, function as a valid comparator. Furthermore, another comparator could for example be a small-medium sized company with concentrated ownership amongst shareholders. This is the type of ownership often seen in countries on the European continent and, as said before, does not take into account the often dispersed nature of the creditors’ (economic) so-called ‘ownership’.

In addition, unsecureds can be expected to have divergent commercial interests and they probably do not know one another. Especially when there are a lot of unsecureds, their “ownership” (in economic terms) will be akin to the dispersed ownership shareholders have got in typical Anglo-Saxon companies which may lead to free-rider behaviour by unsecureds relying on other creditors (unsecured or secured) to monitor the office-holder and/or the incumbent management of the debtor-company. Related to this is the apparent creditor apathy\textsuperscript{972}, even though some unsecureds, especially at a moment when there are no assets in the insolvent estate, could actually have more appetite for more costly or ‘risky’ activities such as e.g. initiating a claim on behalf of the debtor-company. This is because, when there are no assets left and pressing the office-holder to initiate a claim could potentially increase the asset pool, unsecureds have (apart from their monitoring costs) nothing to lose but they might gain if the procedure that would be initiated by the office-holder would be successful.\textsuperscript{973} The office-holder, on the other hand, would bear the (economic) costs of pursuing such a claim.

Finally, some scholars would also argue that secured creditors are better placed to control the management of the company, something all unsecureds would benefit from, however this has also been widely criticised in the literature, not in the least because secured creditors might only


be interested in the assets over which they have got a security interest and the potential risk of interference in situations where they do become too much involved in (overseeing or strong-arming) the management of debtor-companies.  

**c) Arguments in favour of increased creditor engagement**

However, despite aforementioned concerns, there are several arguments in favour of unsecureds getting more involved in the insolvency procedures of their debtors. Based on the lack of research (empirical, economic and legal) we will again draw comparisons with corporate governance and research with regard to the impact of shareholder activism on the firm value where relevant to unsecureds.

As indicated, despite inconclusive nature of empirical studies as to whether more shareholder engagement increases firm value, these studies do find that there is a growing corporate culture whereby shareholders can influence managerial decisions which, arguably, ‘bridges the gap’ between shareholders and directors and reduces the likelihood of directors behaving poorly (or opportunistically). The latter empirical findings are also consistent with argument put forward earlier by scholars such as Bebchuk who advocate that increased shareholder participation can have a positive influence on corporate governance.

Drawing the parallel with the position of unsecureds (and insolvency governance) one empirical study by Elaine Kempson found that increased monitoring could affect the fees charged by the office-holder. In her study she found that increased control (in her study exercised by secured creditors) led to more critical questions about and a lowering of the office holder’s remuneration during the insolvency procedure.

Consequently, one could argue that following corporate governance studies and the limited empirical findings regarding insolvency governance, having more engagement by (unsecured) creditors would be beneficial for the following reasons.

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[979] However, there will not always be secured creditors who will fulfil this monitoring activity, if there are secured creditors part of the insolvency procedure at all. Hence the need for more engagement by creditors who are unsecured as well.
First, although it cannot be guaranteed that it would \textit{ipso facto} increase the likelihood of distributions (let alone higher distributions) going to unsecureds, unsecured creditor activism would still attenuate a potential agency problem between the unsecureds on the one hand and the incumbent management/office-holders on the other hand.\footnote{K.M. Eisenhardt, ‘Agency Theory: An Assessment and Review’ [1989] 14 The Academy of Management Review 57, 58. This goes against Bainbridge’s ‘Director Primacy Model’ which tends to ignore the potential risk of agency conflicts arising between shareholders (or, in our case, unsecureds) and the management/office-holders. Cf. S.M. Bainbridge, ‘Director Primacy and Shareholder Disempowerment’ [2006] 119 Harv. L. Rev. 1735; S. Bainbridge, ‘Director Primacy: The Means and Ends of Corporate Governance’ [2003] 97 Northwestern University Law Review 547 at 555.} Furthermore, if a potential agency conflict would arise between majority and minority unsecureds a higher engagement level could also be expected to increase the likelihood that (i) non-controlling unsecureds would be aware of the fact their position is being jeopardised whilst (ii) the management/office-holders would then, arguably, be more likely to take action to safeguard the non-controlling unsecureds’ interests.\footnote{Cf. \textit{infra} when discussing the duty of directors to take into account non-controlling unsecureds.}

Secondly, as set out before in this research, as unsecureds take over the shareholders’ position (in being the residual claimants or residual risk-bearers) once the debtor goes into financially dire straits and, in contrast to some empirical findings\footnote{D.L. Dick, ‘Grassroots Shareholder Activism in Large Commercial Bankruptcies’ [2014] 40 J. Corp. L. 1, 41.}, it could be expected that shareholders may no longer be (properly) engaged in monitoring or influencing the management of the debtor-company given the fact that the shareholders know that they will not be able to receive anything anymore. In fact, some shareholders may give up controlling the management and prefer to exit the company rather than spending time trying to influence the board of directors to improve the company’s performance. Hence, given the commercial reality, it seems, arguably, advisable to improve the engagement of unsecureds in a financially distressed company (hereby having regard to those non-controlling factions of unsecureds).\footnote{Cf. \textit{infra} – later in this chapter.}

Thirdly, there is also an argument based on economies of scale. If all (or a larger amount of) unsecureds would be engaged in overseeing the management of their debtors (and would communicate effectively with one another), they could coordinate their efforts in controlling/monitoring the management and, hence, spread these monitoring and coordination costs amongst themselves which would, from an individual perspective, reduce the monitoring costs per unsecured creditor and which could encourage their participation for with a reduced monitoring cost, the chances increase that the controlling costs will no longer be outweighed by the dividends unsecureds expected to gain but coordination is difficult.
Nonetheless, the critical question remains whether increased unsecured creditor engagement would ultimately lead to better managerial performance and, hence, the highest possible dividend payment for both shareholders (but also (unsecured) creditors) might influence the company’s management without actually improving it. In other words: being engaged in the debtor’s management does not necessarily equate improving the management of the debtor’s business. Especially when it comes down to insolvency procedures (and in contrast to overseeing the management of a financially solvent business), some highly specific knowledge is deemed crucial which is the reason why office-holders of insolvent businesses are usually highly qualified insolvency practitioners in whom courts place a substantial amount of trust. The latter aspect leads to the issue of performance by both the board of directors and, in case of an insolvency procedure, the office-holder. These managerial duties and their enforcement will be set out below.

2.2.1.4. Duty to have regard to non-controlling factions of unsecureds

i) Directors’ and office-holders’ duties: current approach

Having examined the possibilities involved in engaging unsecureds more with the management of the company and the insolvency procedures, this research will, as indicated, now turn to ‘what’ exactly creditors ought to examine which is the managerial performance. Or in other words: how should the director or office-holder perform her duties? What can a creditor expect from the director/office-holder?

In this regard, insolvency law takes, in general, a rather collectivist approach. Although distinctions between secured and unsecureds (but, to some extent, also between unsecureds) are undoubtedly made, the current directors’ duties and subsequently the case-law are, nonetheless, designed in the interests of the entire group of secured and/or unsecureds and do not provide any specific guidance as to (i) how vulnerability of certain factions of unsecureds ought to be determined and (ii) directors/office-holders can mitigate the risks vulnerable factions of unsecureds could be exposed to.

This can be illustrated by the Re Pantone 485 case in which Deputy Judge, Mr. Richard Field QC stated that directors have to act in the interests of the general creditors and that if directors do not act in the interests of a particular creditors because this might conflict with the interests of the general body of creditors, directors would not breach their directors’ duties.

986 Re Pantone 485 [2002] 1 BCLC 266 at [72].
A similar approach had been taken in *GHLM Trading Ltd v Maroo*. In this case, it was argued that directors had preferred the interests of some creditors and, therefore, ignored the interests of the *entire/whole* group of creditors. This was because directors of Maroo had repaid their own loan to the company despite the fact such a repayment was not in the interests of the entire class of creditors (but only in their own interests). Mr. Justice Newey stated that, in his view, a director must “*have regard to the interests of the creditors as a class.*” As a result, if a directors advances the interests of one (faction of) creditor(s) above (an)other creditor(s), the director would be breaching her directorial duties.  

Furthermore, creditors of a class should be treated alike by directors and directors should not attempt to treat some creditors preferentially at the expense of other creditors within that same class. The rationale behind these decisions is to protect the *pari passu* principle so that all unsecureds will be treated equally and rateably and to ensure that no creditor’s interests will be advanced to the detriment of other creditors unless such treatment would benefit the *entire* group of creditors.

However, focusing on ‘equal’ treatment risks ignoring the potential problems vulnerable or non-controlling groups of unsecureds could face, especially if unequal parties get treated equally. Therefore, in spite of this laudable rationale, predominantly focusing on relatively large classes (i.e. secured or unsecured) of creditors has the potential to ignore the various agency or opportunistic problems that could arise between factions of different creditors which could jeopardise the interests of non-controlling unsecureds as shown in chapter 4 and 5 (via various cases such as the *Gertner* and *Kapoor* case).

Consequently, this research argues that in acting in the interests of the (insolvent) company for the benefit of creditors, it would be advisable to have regard to the interests of different factions of unsecureds whereby we argue that instead of looking at various stakeholders dependent on the type of their claim (i.e. an employment or consumer claim) the controlling or non-controlling character ought to be the guiding factor for directors. This proposal, however, needs to be distinguished to a certain extent from the aforementioned cases (i.e. *Maroo* and *Re Pantone*) in the sense that this proposal does not advocate a director’s duty to favour one faction of creditors; rather it argues that directors should have regard to the non-controlling character of unsecureds while acting in the interests of the *whole* group of unsecureds.

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987 *GHLM Trading Ltd v Maroo* [2012] EWHC 61 at [168].
989 Whereby this research has consistently focused on the ‘agency conflict’ between controlling and non-controlling unsecureds.
990 *Gertner v CFL Finance Ltd* [2018] EWCA Civ 1781.
ii) Adjusting or refining directors’ duties: transparency (information) requirement

Therefore, in arguing (which this research does) that the director’s duty ought to be refined/adjusted so as to make sure that directors have regard to non-controlling factions of unsecureds (i.e. those unsecureds lacking the power to influence (or alter) the decision-making process prior to or during the insolvency procedure – cf. chapter 5 supra), the approach would not be inconsistent with current case-law but it would depart from a more creditor-friendly (and inclusive) angle and require a director and office-holder to have regard to the interests of particular (non-controlling or more vulnerable) factions of unsecureds in addition to their duty to perform in the interests of the company for the benefit of the whole group of creditors. As explained below, this adjustment would entail the requirement to give unsecureds more information regarding the insolvent debtor and, more in particular, as regards their position within the insolvency procedure.

The arguments in favour of this approach (which will be outlined in more detail below) are as follows:

First, readjusting the director’s duty to the extent set out above would bring insolvency governance more in line with corporate governance by trying to stimulate or encourage creditor’s involvement in requiring directors to have regard to various creditors’ factions and to act in their interests by *inter alia* addressing potential agency conflicts, transparently signalling to non-controlling factions that they might find themselves in a non-controlling or more vulnerable position and detailing what this means for their particular situation. In doing so, unsecureds would be more properly treated during insolvency akin to the way shareholders are treated during the debtor’s period of solvency.

Secondly, by encouraging creditors’ participation in the procedure, it would be expected that more creditors would be encouraged to monitor the directors (or office-holder) which could raise managerial standards. This could provide a windfall for the debtor’s asset pool, not in the least because it could make directors more careful which would, arguably, result in benefits for the whole company. This is certainly very important for companies that can still be rescued but could also be beneficial for companies that will need to be liquidated.\(^{992}\) More in particular, if a particular agency problem would occur (between different creditors potentially jeopardising the interests of one vulnerable group) and directors would be under a *specific* duty to have regard to the interests of this vulnerable group of unsecureds it is presumed that this would incentivise

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\(^{992}\) For example: in the case of an insolvent estate without assets bar a liability claim against the former directors, it could be very useful for unsecureds to control the office-holder in order to push for the pursuit of this claim (or to initiate it derivatively as we argued before).
them to try to anticipate this problem so that it can be addressed before actual harm has been done.\textsuperscript{993} Rather than acting retrospectively (which the current laws are designed for), it would arguably have the potential to anticipate and avoid (at least some of the) problems for which creditors would now have to start unfair harm or material irregularity procedures.

Thirdly, to the extent that a readjustment of this director’s duty would indeed raise managerial standards (and could have the effect of swelling the asset pool of the debtor), it could subsequently also improve consumer and market confidence. This is because it could not only help rescuing businesses, but it could also increase the amount of dividends unsecureds could receive (if rescue is not possible). Both scenarios would, nonetheless, be positive for both the general body of unsecureds and the more vulnerable or non-controlling factions amongst them.

Finally, having such a duty (to have regard to vulnerable factions of unsecureds) would continue to honour the interests of the entire group of creditors whilst at the same time giving appropriate regard to more vulnerable factions of unsecureds in a way which sustains and might even enhance a proper adherence to the \textit{pari passu} principle in a fair, efficient and non-discriminatory way.\textsuperscript{994}

Nonetheless, refining the director’s duty could be open to some criticism.

One of the arguments against this readjusted duty could for example be the fact that it might increase risk-aversion amongst directors and that it could deter them. However, the duty that is proposed in this work is only a refinement (or improvement) of an already existing duty which would not be directly enforceable but only indirectly (through either the office-holder or, as we will argue below, derivatively).

Additionally, another argument against this reformed duty could also be that it would provide directors with too many masters making it increasingly or disproportionately difficult for them to manage the company whilst, at the same time, giving them an escape-route to avoid accountability (allowing them to argue that they intended to benefit a particular faction of vulnerable creditors). These arguments have often been used against both stakeholder and communitarian scholars, however, this research does not believe that similar arguments hold water in our scenario. This is because, as shown below (in the guidelines/scenarios set out in part 3.2.4.3.), we believe that directors should always try to reconcile the interests of both the

\textsuperscript{993} Cf. part iii) on pg. 226 below for a more detailed assessment how this duty would change directorial behaviour (and how it could benefit both vulnerable factions of unsecureds and the entire group of unsecureds).

\textsuperscript{994} How the interests of vulnerable unsecureds ought to be balanced against the interests of the \textit{whole} group of unsecureds and how an improved solution that, in principle, improves our current regulatory framework will be set out below in part 3.2.4.3.
vulnerable factions of unsecureds and the whole group of unsecureds instead of merely acting in the interests of predominantly one faction of vulnerable creditors – unless benefitting this vulnerable faction of creditors would also benefit the whole group of unsecureds.

Finally, it could be argued that such an adjusted duty would be rather vague and that it would unnecessarily complicate the work of directors and office-holders. However, with respect, this argument would also not be valid for the readjusted duty we propose merely refines a duty which directors already have to abide by. What it does is to steer directors into the “right direction” by changing the focus (of this duty) into a more creditor-friendly way by not merely focusing on the entire group of creditors as one homogenous class but, rather, acknowledging the practical realities that directors ought to have regard to non-controlling/more vulnerable factions of unsecureds too (without granting them privileges others unsecureds would not be entitled to). In doing so, it is believed that not only the vulnerable factions of unsecureds will stand to benefit but in fact also the entire group of unsecureds. Determining which unsecureds are particularly vulnerable is a judgment that directors or office-holders will have to make at the time but that depends of the particular facts of the case as set out at the beginning of this chapter. Nonetheless, it can be expected that office-holders will find it easier to ascertain the potential vulnerability of certain unsecureds than directors given their legal and financial expertise.

Therefore, it can be submitted that based on the arguments in favour and against, this research believes that a director’s duty to have regard to (non-controlling) factions of unsecureds (which this research defines as those unsecureds lacking the power to influence (or alter) the decision-making process prior to or during the insolvency procedure) whilst acting in the interests of the company for the benefit of the entire group of creditors would be advisable.

As determined before, this would, in general, impose a transparency requirement on the director/office-holder to give more information as regards the insolvent debtor and, in particular, as regards the position of the unsecured creditor. More specifically, and in line with the criteria of Bovens set out above in chapter 6 part 3.3.1.2., it is suggested that the directors/office-holder should explain clearly which decision (e.g. the decision to curtail the rights of a non-controlling creditor) has been taken and how it would affect the unsecured creditor. The director/office-holder would also have to justify why this decision (e.g. for differential treatment) was taken and if the unsecured would be affected by it, which may be the case if the creditor’s claim would be reduced as part of an IVA or CVA, which alternatives had been examined and why none of the alternatives seemed more worthwhile implementing (according to the business

995 The following section will seek to address this argument by elaborating more extensively how such an adjusted duty could be utilised in practice.
judgment of the director/office-holder). In addition, and without requiring directors or office-holders to give legal advice to unsecureds, it would also be important to determine that unsecureds would have possibilities at their disposal to alter the decision by e.g. proposing a suggestion of their own which would, according to them, improve their position without jeopardising the interests of other creditors and, during a rescue procedure, the chances of the debtor being rescued. Reference can be made hereby by the director/office-holder to the creditors’ meetings which unsecureds can attend and where they can make their voice heard. When the debtor would be subject to an insolvency procedure, it would be important to draw the attention to the unsecureds of the voting power they may have on their own based on the value of their claim in relation to/compared with the value of the claims of the other unsecureds and the legal option to form a coalition of unsecureds, especially if their claim only represents a small portion of the value of the total amount of claims held by unsecureds. Finally (and again without asking directors/office-holders to give legal advice to creditors), it is contended that unsecureds should also be made aware that there might be legal opportunities that they can utilise to object to ‘final’ decisions taken by the director/office-holders.

More specifically, the application of this transparency/information requirement would, of course, be different dependent on whether the debtor would be subject to an insolvency procedure or not and if so, which insolvency procedure it would be.

First, for a company in financial difficulties that is not yet subject to an insolvency procedure or a debtor opting for a part 26A Restructuring Plan which is a debtor in possession procedure, the requirement to inform the unsecureds in accordance with the aforementioned analysis, would, absent an office-holder, fall on the directors and would, if unsecureds believe that there would be non-compliance, be assessed as part of their general directors’ duties. Surely, it would, arguably, not be in line with our efficiency requirement (nor would it be commercially sensible) to provide creditors with information regarding every business decision directors intend to take once a company is entering into financially difficult waters. However, it is contended that directors should, at that point, aim to determine which unsecureds could be more vulnerable (i.e. non-controlling) dependent on the indicative and conclusive factors set out in chapter 5.

For example, this could be if as part of a part 26A Restructuring Plan, one faction of unsecureds would be impaired in contrast to other creditors who may stay unimpaired. If the impaired (faction of) unsecured(s) would not be able to influence the decision-making process because of e.g. the relatively low value of their claims in relation to the value of the claims of other

997 See for the determination of the ‘twilight zone’: BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112 where Richards LJ, however, declined to express a view other than when a company is actually insolvent (cf. chapter 7, part 2.1.1.; BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112 at [222]).
unsecureds and/or because that class may be crammed down, it is contended that the directors should inform that unsecured of the reasons behind the decision to leave them impaired in contrast to others whilst also ensuring that that unsecured is aware of the existence of legal mechanisms to object. Furthermore, it is deemed advisable to allow that unsecured, within a short period of time (which directors and the creditors can agree upon), to try to formulate a potential other rescue solution based on which he would be better off without making anyone worse off so that this alternative could be considered by the debtor.

During a standalone Moratorium\textsuperscript{998} (cf. supra b.3)) which, as said above, is a newly introduced debtor-in-possession procedure whereby the debtor would be monitored by a monitor\textsuperscript{999}, who must be an insolvency practitioner\textsuperscript{1000}, creditors with pre-Moratorium debts face restrictions regarding the enforcement of their claims.\textsuperscript{1001} Also most security interests can no longer be enforced nor can, in general, a legal process be initiated (or continued) against the debtor-company.\textsuperscript{1002} Although the Moratorium lasts for 20 business days initially, it can be extended more than once and may with the consent of creditors (obtained by qualifying decision procedure) be extended for up to one year from the date the Moratorium commenced.\textsuperscript{1003}

Although currently not required by law, it is contended by this research that the debtor/directors should explain and justify to the unsecureds, and especially those non-controlling unsecureds (i.e. those who may not have the ability to influence the decision-making process) why the Moratorium would be initiated and/or extended, how it is expected to affect the chances of the company being rescued and the unsecureds’ getting paid. Again, without giving legal advice to creditors, it is submitted that directors should inform creditors of their ability to challenge the directors’ or monitor’s actions\textsuperscript{1004} if they disagree and believe/allege to be disenfranchised by the directors’ decision. During a Moratorium, directors can continue to manage the company in the ordinary course of business\textsuperscript{1005} with major decisions, however, being subject to consent of the court\textsuperscript{1006} or the monitor.\textsuperscript{1007} Subsequently, it is submitted that while managing the company (during a Moratorium) and subject to the oversight of the monitor, directors must have regard to

\textsuperscript{998} Insolvency Act 1986, section A1.
\textsuperscript{999} The monitor monitors the company’s affairs to oversee whether rescue is (and remains) possible/viable.
\textsuperscript{1000} Insolvency Act 1986, section A35.
\textsuperscript{1001} Insolvency Act 1986, section A21(2) (which is defined as the so-called ‘payment holiday’).
\textsuperscript{1002} Insolvency Act 1986, section A21(1).
\textsuperscript{1003} Insolvency Act 1986, section A11 and A12.
\textsuperscript{1004} Insolvency Act 1986, section A42 and 43 (regarding the challenging of the monitor’s action) and section A44 regarding the challenging of directors’ actions. Cf. Insolvency Act 1986, section A38.
\textsuperscript{1006} Insolvency Act 1986, section A29 (regarding disposals of company property not in the ordinary course of business).
\textsuperscript{1007} Insolvency Act 1986, section A26 (regarding the granting of security interests to creditors during the Moratorium).
the interests of non-controlling factions of unsecureds in a similar way as to how this research advocates that directors should act whilst the debtor-company is not subject to any insolvency procedure (cf. infra next paragraph). Furthermore, if directors intend to use the Moratorium to devise a rescue strategy such as a CVA/IVA, Scheme of Arrangement or part 26A Restructuring Plan or if they want to proceed to an administration or liquidation procedure, it would be advised to inform, disclose and justify to unsecureds why this specific procedure is contemplated, why the directors (and the monitor) believe that this would be the most optimal strategy for the company and the general group of creditors (including the non-controlling factions) and how it would (or could) affect the dividend rights of the unsecureds. Given the fact that the company will move from the Moratorium to a different procedure, it may, however, not be possible yet to accurately describe how this procedure will affect the unsecureds involved. Nonetheless, as advocated below in light of CVA/IVA procedures, it is submitted that consideration should hereby be given to potentially valuable suggestions given by unsecureds if these suggestions would not only enhance the position of the (faction of) unsecured(s) itself but also of the debtor-company and the general group of creditors. Finally, once the debtor has moved to a different procedure and the Moratorium has terminated \(^{1009}\), it is submitted that the transparency and information requirements set out above and/or below for each specific procedure should be considered by the directors/office-holders.

If the debtor would not be subject to any procedure (such as a part 26A Restructuring Plan or a Moratorium \(^{1009}\)), it is still important to reflect as to which unsecureds may be most likely to become vulnerable. In that regard, directors determined in the Kayford-case that a specific trust-account had to be set up for the consumers. Therefore, as set out above (cf. part 2.1.2.2. ii)), if directors reasonably believe that the company is in financial difficulties and if they fear the debtor could soon be subject to an insolvency procedure, it is submitted that they should consider which unsecureds would most likely (e.g. because of the ‘low’ value of their claim or their unimportance for the immediate survival of the company) end up in a non-controlling position. Directors are, hereby, advised to start taking contingency plans (such as e.g. setting up a trust account) to mitigate the losses for such non-controlling creditors (e.g. consumer or tort creditors) and, to the extent possible, inform them of their position and the mitigating measures that have been taken so they would be made aware of their position and the implications for them of the company’s ailing financial position \(^{1010}\) (including thus how the directors have attempted to

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\(^{1010}\) As set out above in chapter 5, part 3.1.3., there may, however, be situations – for example during a pre-pack administration (see below) – whereby a director/office-holder may not want to disclose the upcoming decision *ex ante* (i.e. prior to the commencement of an insolvency procedure) to the creditors. This is because directors may fear that it could jeopardise the chances of keeping the going-concern value of the company’s business intact and, thus, enabling the company to be rescued. Also, other legal
mitigate the losses for them whilst ensuring that the chances of business recovery would be maximised). For example, this could apply to a company who has decided to carve-out one line of business that was deemed too costly and negatively affecting the company’s overall financial position.\textsuperscript{1011} In such occasion and if this occurs at a moment when the company is in financial difficulties (a moment when directors must, arguably, have regard to the interests of creditors\textsuperscript{1012}), it is proposed that it would be incumbent on directors to differentiate in their communication to creditors between those creditors would be confronted with a new debtor (after the carve-out of the business line) and those who remain creditor of the same debtor and justify the reasons behind the decision to carve-out one business line, why any alternatives were deemed unsatisfactory and what this means for the non-controlling unsecureds involved.

Secondly, similar principles that apply to directors at the moment when the company is in financial difficulties would also apply to IVAs or CVAs where directors are, however prior to the approval of the CVA\textsuperscript{1013}, under the supervision of a nominee. At the moment no detailed information requirement exists. Only a progress report on the progress and prospects for the full implementation of the arrangement during the CVA/IVA\textsuperscript{1014} and a final report at end of the CVA/IVA\textsuperscript{1015} need to be produced by the supervisor. From a regulatory perspective, SIP 3.1 and 3.2. only refer to the need for the insolvency practitioners to provide “sufficient” information in a report to creditors after the debtor has formulated a CVA or IVA-proposal to allow the creditors to make an informed decision.\textsuperscript{1016} However, no information or clarity has been given as to what this entails. Subsequently, when the debtor is an individual subject to an IVA procedure this research argues that during the process of drafting the proposal, the transparency requirement would apply to the debtor under supervision of the nominee. It would hereby be important for the nominee to monitor if the debtor (a company or an individual) complies with the transparency requirement. It is submitted that directors may want to reach out to those unsecureds who are most impacted by the CVA and who may lack the required influence to alter the decision-making process through the ordinary decision-making process. Namely, by informing them of their non-controlling position and, for example, allowing them to provide a potential alternative (which

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\textsuperscript{1012} Companies Act 2006, s172(3); \textit{BTI 2014 LLC v Sequana SA} [2019] EWCA Civ 112.
\textsuperscript{1013} After the CVA is approved, the nominee usually becomes the supervisor (cf. A.R. Keay and P. Walton, \textit{Insolvency Law Corporate and Personal} (Jordan Publishing Limited 2020) 158), however, the information requirements set out before would predominantly apply in the pre-approval stage during which directors under the supervision of the nominee would have to act in a transparent way together with the (unsecured) creditors to get the CVA approved.
\textsuperscript{1014} Insolvency Rules 2016, rules 2.41(4) for a CVA and 8.28(4) for an IVA.
\textsuperscript{1015} Insolvency Rules 2016, rules 2.44 for a CVA and 8.31 for an IVA.
\textsuperscript{1016} For a CVA: Statement of Insolvency Practice 3.2., principle 8; For IVAs: Statement of Insolvency Practice 3.1., principle 6.
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would be better off for anyone), they may be able to make their voice heard in a more substantial way. Once the proposal has been drafted, it is contended that the supervisor should explain to the unsecureds which decisions have been taken and why. More in particular, it must be explained to those unsecureds that are deemed non-controlling why they have been subject to differential treatment, what the reasons were behind this differential treatment, why all alternatives were held worse and that the affected creditors may object to the CVA/IVA-proposal if they do not agree with the justifications given by the debtor.

Once the company is subject to a liquidation, bankruptcy or administration procedure, the information requirement would be different and would no longer apply to the directors but to the office-holder (i.e. the liquidator, bankruptcy trustees or administrator). Whilst during a CVA/IVA differential treatment (e.g. in terms of dividends) may sometimes be justified between unsecureds to secure the continuity of the debtor’s business, the pari passu principle applies, as set out in chapter 2, to unsecureds during a winding-up/liquidation or bankruptcy procedure. Although the liquidator/bankruptcy trustee is required to produce a progress report (such as the supervisor in the CVA/IVA), the information that should be included in the report is rather general such as details of the progress which has been made, information regarding the remuneration, a summary of the payments and receipts and what still needs to be done. According to this research, the information provided should be more detailed in order to benefit the unsecureds and particularly the non-controlling unsecureds. It is, therefore, contended that it should be incumbent on the liquidator/bankruptcy trustee to determine and disclose to the unsecureds whether some (controlling) unsecureds (or other creditors) may have been preferred by the debtor prior to the onset of the liquidation/bankruptcy procedure and whether, according to the office-holder, the previous management had complied with their directors’ duties or not. The liquidator/bankruptcy trustee should, so goes the argument of this research, explain to the unsecureds how she pursued her investigation, which conclusions she drew from this investigation and which decisions she has taken such as e.g. as regards the commencement of insolvency claims. She should hereby justify her decisions such as to commence (or refrain from commencing) an insolvency claim and inform the unsecureds of the legal options at their disposal to (i) pursue an insolvency claim themselves (through e.g. an assignment of the cause of action) and (ii) their legal right to hold the liquidator/bankruptcy trustee accountable by raising potential objections they may have against the liquidator for decisions they do not agree with if they believe that this would be a breach of her duties.

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1018 This also applies to other decisions the liquidator would take such as continuing certain existing contracts and ending others etc.
During an administration procedure, the position of the administrator could resemble the one of the liquidator if the administration is used to wind-up the company. However, if the administration intends to rescue the debtor which is still the primary purpose of an administration, it would be incumbent on the administrator to explain and justify the decisions taken during the rescue procedure, how she determined that the course of action she has taken (e.g. selling the company’s business) will be the best option for the general group of creditors (including the non-controlling factions of unsecureds), which other options had been considered and why the non-controlling factions of unsecureds are not worse-off (or perhaps even better off) compared to the other rescue options she considered. Important in this regard will also be the information provided in relation to the investigation of the previous management of the company and why it would be justified to commence (or not to commence) insolvency claims against the previous management. Again, and similar to liquidation procedures and without acting as a legal advisor to the unsecureds, it would be useful to inform the unsecureds of the potential objections they may raise and their ability to pursue insolvency claims themselves (e.g. through a misfeasance procedure if the company will be wound-up or after an assignment of a cause of action to the creditor).

Nonetheless, this heightened transparency requirement should not make pre-pack administrations impossible. A pre-pack is a low-cost and speedy process in which creditors and the debtor who experiences financial difficulties conclude an agreement before the initiation of any statutory administration procedures after which the appointed administrator concludes the administration in line with the pre-pack arrangement. Such pre-packs are, thus, often concluded in secrecy between the debtor and the acquirer of (some of) the debtor’s liabilities and this secrecy may allow the protection of the going-concern value of the company’s business which increases the chances of repayment for creditors and the preservation of jobs. Nonetheless, without going into too much detail for this would be beyond the scope of this research, several problems remain in spite of recent regulations. Although the administrator

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1019 Also the administrator (as well the liquidator) should provide a progress report, however, it is submitted that more information should be provided to unsecureds along the lines described above.
1020 Insolvency Act 1986, Schedule B1, section 3(1)(a).
1021 Company Directors Disqualification Act 1986, section 7A. This duty also applies to liquidators and administrative receivers.
1022 Insolvency Act 1986, section 212.
1023 Small Business Enterprise and Employment Act 2015, section 118; In re London & Westcountry Estates Ltd Hockin and others v Marsden and another [2014] EWHC 763 (Ch).
1027 The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 which have been enacted in the wake of the UK government report in relation to pre-pack sales. Cf. The Insolvency Service Corporate Report, Pre-pack sales in administration report (08 October 2020) available
is required to justify, through a SIP 16 statement, why a pre-pack was undertaken and which alternatives had been considered. The administrator must also demonstrate he or she has acted with due regard for the creditors' interests and the disclosure must be provided with the first notification to creditors and, according to SIP 16, in any event within 7 calendar days of the transaction. According to SIP 16, it is a core principle that the administrator provides creditors with sufficient information. Surely, these information requirements are highly relevant, especially given the secrecy surrounding a pre-pack, nonetheless, according to this research this heightened transparency should not be confined to pre-packs but should also apply to directors as of when the company is in financial difficulties and to the office-holders appointed in any other insolvency procedure (as set out above). Specifically, regarding pre-packs, it has been contended that the disclosure requirements imposed by SIP 16 are not sufficient and might have to be increased so that the administrator would also have to explain to the creditors why certain liabilities of the debtor-seller were transferred and why others were left behind in the debtor. Also, the evaluator who has recently been introduced by the Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 and who should draft a report of which creditors must be notified in case of a substantial disposal of the debtor-company's business to a connected person does not have to consider the latter issue. According to this research, the lack of any obligation to inform creditors of the reasons and the justifications behind the sale of some but not of their liabilities was rightly criticised. Furthermore, if such a sale of a substantial part of a company’s business occurs outside the scope of a pre-pack, this research contends that the administrator should nonetheless adhere to the information requirements set out above. Nonetheless, given the fact that pre-packs are more ‘secret’ compared to other insolvency procedures, it is deemed that such transparency requirement should not be enshrined in hard-law but should be part of regulatory soft-law measures as explained below.


1028 Statement of Insolvency Practice 16, statement 16.
1029 Ibid.
1030 Statement of Insolvency Practice 16, statement 17.
1031 Statement of Insolvency Practice 16, principle 6.
1032 See for the information requirement on liquidators: Statement of Insolvency Practice 2, statement 16 and 17 which remain very broad and open. It is submitted that these information requirements are expanded in line with our analysis set out in this research.
1034 The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021, section 3(1)(b) and 7(h).
1035 The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021, section 6(3) and 9(5)(b).
The aforementioned information requirements and heightened transparency are also in line with demands already expressed by creditors\textsuperscript{1037} and following our analysis, it would enhance fairness because, in conformity with our guidelines\textsuperscript{1038}, it is intended to improve the position of both vulnerable unsecureds and the entire group of creditors.\textsuperscript{1039} Furthermore, it would also be in accordance with our efficiency-requirement. For it would merely be a readjustment of an already existing duty without introducing or proposing new complex and economically costly rules while potentially even improving market confidence. Finally, it would also improve the power of accountability for it could have the potential of improving creditors’ engagement (and monitoring) whilst the duty would continue to be enforceable through the regular legal and judicial means (on top of our argument to allow derivative actions).

As set out before, although this research advocates a heightened transparency requirement, it would, with the exception of pre-pack administrations because of their ‘secrecy’ (cf. supra), not advocate for hard-law but merely soft-law rules that would impose this increased transparency requirement. Without repeating what has been discussed in chapter 7, this is, in summary, for the following reasons.

First, there is, arguably, no need to impose another hard-law rule on either directors or office-holders to abide by this information/disclosure requirement for this can already be assessed as part of already existing directors’/office-holders’ duties which are enshrined in law. In this way, soft law rules would complement hard-law duties\textsuperscript{1040} when assessing whether the directors/office-holders had complied with their duties.

Secondly, there is a wide variety of businesses, different business sectors and every insolvency is different too making it, arguably, impossible (or at least hard) to specifically determine in hard-law at which stage and how the directors/office-holders must comply with such information requirements. This also avoids the creation of laws that would inevitably end up being vague which could lead to business uncertainty and potential over-deterrence for some more risk-averse directors/office-holders.

\textsuperscript{1037} Lazari Properties 2 Ltd v New Look Retailers Ltd [2021] EWHC 1209 (Ch) at [309]; Discovery (Northampton) Ltd v Debenhams Retail Ltd [2019] EWHC 2441 (Ch) at [102]-[111]; Prudential Assurance Co Ltd v PRG Powerhouse Ltd [2007] EWHC 1002 (Ch) at [84]-[90].

\textsuperscript{1038} Cf. infra part iii) on pg. 204.

\textsuperscript{1039} In a situation whereby a certain business decision would only benefit the non-controlling faction of unsecureds without also making benefitting the whole group of unsecureds, it is submitted that directors should refrain from taking any such action.

Thirdly, soft-law rules give some more liberty to directors/office-holders to determine themselves when, how and to what extent they are making the proposed disclosures to creditors and, more in particular, how it would affect the non-controlling factions of unsecureds (i.e. those unsecureds lacking the power to influence (or alter) the decision-making process prior to or during the insolvency procedure) without being constrained by hard-law legislation which could be enforced by office-holders and creditors through section 212 of the Insolvency Act 1986 (or after an assignment of the cause of action). In this regard, it would reduce the risk of some creditors trying to cause disruption (similar to hold-out shareholders) by attempting to put undue pressure on directors/office-holders (and for example constantly threatening to hold directors/office-holders to account for allegedly not having provided sufficient information or not having altered a CVA despite alternatives put forward by the creditor). Instead, these soft-law guidelines should enable the debtor to focus on restructuring/winding-up the company whilst being able to come up with tailor-made solutions. Subsequently, it is submitted that this environment (without hard-law constraints) might be more conducive to directors/office-holders including and engaging with unsecureds (and particularly the more vulnerable/ non-controlling factions of unsecureds).

In this regard, it could be contended that an *insolvency governance code* may have to be created in order to attempt to align the duties of the directors/office-holders with the creditors, and more in particular, the non-controlling factions of unsecureds. Such a code would also give some more guidance to both directors/office-holders and unsecureds as to what they may expect from one another and how, when and to what extent the director or the relevant office-holder would inform the creditors prior to or during the rescue or winding-up procedure. Such an *insolvency governance* code, albeit differently, has already been proposed by Wessels for creditors’ committees but according to this research, a more comprehensive code (rather than a code solely focused on creditors’ committees) seems more useful and underscores the importance of insolvency governance for creditors, debtors, directors, office-holders and, arguably, the wider public interest.

### iii) Practical usage for company directors: arguments pro/contra and situations.

Having argued that directors/office-holders ought to have regard to (factions of) unsecureds which are deemed more vulnerable in order to have proper regard to their interests, this research submits that, once a company is in the twilight zone, it is a duty of the directors (and office-holders) to act in the interests of the debtor for the benefit of the general group of creditors whilst having regard to non-controlling factions of unsecureds. This extra focus on more

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vulnerable factions of unsecureds differs to some extent from the present duty for it would entail that some additional reporting requirements would, arguably, have to be adhered to as regards unsecureds which are deemed non-controlling by the directors/office-holders and that directors/office-holders would aim to engage these unsecureds more in the insolvency process.

Nonetheless and despite the analysis as regards the suggested information/transparency requirements applicable to directors and office-holders extensively elaborated on above, it is key to address the potential counter-argument that such a duty to act in the interests of the debtor for the benefit of the general group of creditors whilst having regard to non-controlling factions of unsecureds might be vague. Therefore and without rehearsing what has been said above, the following part will give some more guidance/structure as to how directors/office-holders are expected to adhere to this rule. In this regard, we believe that – in line with our key insolvency values – the following guidelines could be useful for directors in adhering to this readjusted duty.

First, it can be argued that being more transparent and, thus, signalling to certain factions of unsecureds that they may be non-controlling or more vulnerable could mitigate the information-asymmetry that exists between the management and the unsecureds. In doing so directors/office-holders could be advised to provide them with information regarding their legal position (i.e. the unsecured character of their claim), their (assumed) controlling/non-controlling position, the proportionate size of their claim and the potential of building coalitions with other creditors, potentially sharing similar interests. For example, the office-holder or director could signal to a consumer that her claim is unsecured, that her individual claim makes up 1% of the total amount of claims and that all consumer claims together would be 55% (potentially granting them more power as a unified coalition during a creditors’ meeting). Such a strategy could not only mitigate the information-asymmetry, but it would also aim to include unsecureds more actively in the management of the insolvent company or the insolvency procedure. Nonetheless, solely providing unsecureds with more information would not nearly be sufficient for many of them might not be prepared to get actively engaged in the rescue or winding-up of the debtor-company (e.g. if they fear that the monitoring and investigatory costs are economically too high).

Secondly, allied to the previous requirement to enhance transparency, it could be argued that directors should consider the implications of their (business) decisions on the vulnerable factions of unsecureds. For example, if managers/office-holders see that one group could be particularly vulnerable (e.g. such as the landlords in the House of Fraser case), it seems highly

\footnote{Or some non-controlling unsecureds may have signalled to directors/office-holders themselves that they believe to be more vulnerable in which case the increased transparency requirement set out below would have to be complied with by directors/office-holders as well.}
recommendable for office-holders and managers to document and disclose why certain business decisions have been taken and, more in particular, how the interests of non-controlling factions have been balanced against the interests of the controlling unsecureds and the potential rescue possibilities for the company. Once again, such decisions and the reasons why the decisions have been taken ought to be reported to the unsecureds with, preferably, a reminder of their legal and financial position and, more in particular, legal avenues they can use to object (ex post) to certain decisions. The suggested reporting requirements would thus be signalling the unsecureds’ non-controlling position to the unsecured, the business/rescue decisions which have been taken, the rationale and justification behind these decisions and the implications of them on the non-controlling unsecured in addition to legal options to object (as set out in detail above: cf. part ii)). Nonetheless, in order to avoid potential over-deterrence of directors, this research submits that soft-law guidance as regards the reporting requirements could be drafted which directors can consider when managing the debtor-firm and which can be taken into account by courts when assessing whether the directors/office-holders have potentially violated their directorial duties. Such enhanced transparency whereby, as a minimum minimorum, differential treatment between unsecureds needs to be justified and explained in clear terms is also consistent with demands that have already been raised by non-controlling unsecureds at present, as part of unfair prejudice procedures.\footnote{Ex post in order to avoid that a small minority of unsecureds tries to block decisions that could ultimately benefit most (if not all) unsecureds and/or the firm.}

Consequently, looking a bit more in detail into the directors’/office holders’ proposed duty to have regard to vulnerable factions of unsecureds and, more in particular, my suggested guideline to consider the consequences/implications of business decisions for vulnerable groups and the general group of unsecureds, it seems that, generally, four different situations could occur.

First, a certain business decision could have negative implications for the general group of unsecureds and the non-controlling faction(s) of unsecureds. In such case, it would be reckless and ill-advised to pursue such a business decision.

Secondly, a certain business decision could be beneficial to (a) certain group(s) of unsecureds whilst not being in the interests of the general group of unsecureds (i.e. by favouring one particular creditor at the expense of the whole group of unsecureds). The Gertner and Kapoor-cases are, arguably, a good example of such decisions. Again, as in the previous situation, directors should refrain from taking such a business decision and it would be recommended

\footnote{Lazari Properties 2 Ltd v New Look Retailers Ltd [2021] EWHC 1209 (Ch) at [309]; Discovery (Northampton) Ltd v Debenhams Retail Ltd [2019] EWHC 2441 (Ch) at [102]-[111]; Prudential Assurance Co Ltd v PRG Powerhouse Ltd [2007] EWHC 1002 (Ch) at [84]-[90].}
that directors and office-holders should argue and provide evidence why they did not decide to pursue this decision although it would have been beneficial to one (or some) groups of unsecureds. As said before, this critical reflection should then, in line with transparency demands and in order to include unsecureds in the (run-up to the) insolvency process, be disclosed to all unsecureds.

Thirdly, a certain decision could be beneficial to the whole group of unsecureds but could adversely effect a (or some) faction(s) of unsecureds. An example of this would be the recent Debenhams\textsuperscript{1045} and House of Fraser\textsuperscript{1046} cases whereby landlords alleged to be in a worse position compared to the other unsecureds since the proposed CVAs applied a much larger discount to their claims in comparison with the other unsecureds. In such a situation whereby a particular business decision might not be beneficial to certain groups but would, overall, benefit the entire group of unsecureds, this research argues that directors should be able to pursue the decision but it will be key for directors/office-holders then to properly argue, document and indicate (i) which arguments convinced them to make the particular decision and (ii) to show how, according to them, this business decision will benefit the general group of unsecureds. Surely, directors and office-holders should also try to mitigate the adverse/negative consequences some of the more vulnerable unsecureds could face (and to report and disclose this). As indicated above, it would be particularly\textsuperscript{1047} important here to engage with these unsecureds and allow those unsecureds who are in a non-controlling position (i.e. when they lack the ability to alter the decision-making process during an insolvency procedure such as a CVA/IVA because of e.g. their lack of votes, market reasons such as the greater importance of critical creditors that ensure business continuity etc..) to offer, within a short period of time (determined by the debtor and non-controlling unsecureds), the opportunity to present an alternative restructuring method that would not only be beneficial for the non-controlling unsecured but also the general group of unsecureds.

Finally, a certain decision could be beneficial to the whole group of unsecureds and to the vulnerable factions of unsecureds. If such a business decision is possible, it is strongly advised to take this decision and report to the entire group of unsecureds why the decision was in all their interests.

\textsuperscript{1045} Discovery (Northampton) Ltd v Debenhams Retail Ltd [2019] EWHC 2441 (Ch).
\textsuperscript{1046} Re House of Fraser [2018] EWHC 1906 (Ch).
\textsuperscript{1047} Of course, engagement with creditors should, according to this research, not be confined to situations whereby the business decision would be positive for the general group of creditors and negative for one faction of non-unsecureds, however, especially, because one faction of unsecureds, who may lack the ability to influence the decision-making process, would be negatively affected here, it appears highly important to engage with this group as set out \textit{supra} under ii).
<table>
<thead>
<tr>
<th>Implications of business decision.</th>
<th>Negative for non-controlling (vulnerable) factions of unsecureds</th>
<th>Positive for non-controlling (vulnerable) factions of unsecureds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Negative</strong> for general group of unsecureds</td>
<td>Refrain from taking this decision. Report, disclose and justify why.</td>
<td>Refrain from taking this business decision. Report, disclose and justify why.</td>
</tr>
<tr>
<td><strong>Positive</strong> for general group of unsecureds</td>
<td>Advisable to take the business decision but crucial to (i) report and disclose how this decision was made and why and (ii), if possible, indicate how negative consequences for vulnerable unsecureds have been mitigated and (iii) seek engagement from unsecureds (esp. affected non-controlling factions).</td>
<td>Pursue the business decision and report to unsecureds (with an explanation of the reasons behind the decision taken).</td>
</tr>
</tbody>
</table>

**Table 3: Suggested behaviour of directors during the company’s insolvency**

This research believes that such a strategy would be in line with our insolvency values for it would improve unsecureds’ ability to hold directors/office-holders to account (by mitigating/reducing the information-asymmetry) and would enhance fairness by properly and carefully having regard to both the entire group of unsecureds and, also, the more vulnerable factions. More importantly, it would also be in line with our requirement to have an efficient regulatory framework.

In spite of criticisms regarding the Pareto approach, this research believes that aforementioned suggestions would, arguably, constitute a Pareto improvement for unsecureds as they would arguably make (i) unsecureds as a group, in general, better off through a more active inclusion in the insolvency process and the attempt to reduce the information asymmetry between unsecureds and the management of the firm and (ii) it would also enshrine a duty to have proper regard to non-controlling factions which grants them some additional protection. In this case, both the entire group of unsecureds and the more vulnerable factions of unsecureds would be better off without making any unsecured creditor worse off. Bringing directors and office-holders into the equation, however, would probably scupper the argument that the suggested reforms constitute a Pareto-improvement for the suggested reforms would most likely increase

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their workload to some extent (and, thus, the economic costs of managing the company). This is why we argued in chapter 6 that the Pareto approach might not be satisfactory for a Pareto-optimal outcome might, nonetheless, be suboptimal from the perspective of unsecureds, in particular the more vulnerable groups of unsecureds. The suggested reforms would, however, be Kaldor-Hicks efficient\textsuperscript{1049} since they would, arguably, lead to a societal net-gain since both the entire group and vulnerable factions of unsecureds would be better protected even though directors might still have to bear some of the ‘economic costs’ by an increased workload. In protecting increasing the protection of unsecureds, it can be expected that this could have a positive effect on the rescue chances of a company which, in turn, could improve market trust. This approach to generate an efficient outcome is also consistent with the philosophy behind the part 26A Restructuring Plans recently introduced by the Corporate Insolvency and Governance Act (‘CIGA’) 2020. Pursuant to CIGA 2020, a part 26A Restructuring Plan can be sanctioned by the court if “none of the members of the dissenting class would be any worse off than they would be in the event of the relevant alternative”.\textsuperscript{1050} This ‘no worse off’-test requires the court to examine a hypothetical counterfactual in order to determine whether in such hypothetical circumstances it could be expected that members of the dissenting class would be better off or at least no worse off.\textsuperscript{1051} However, the law only narrowly refers to ‘members of the dissenting class’ and suggests that a part 26A plan can also be sanctioned if the hypothetical alternative would be expected to result in an equal outcome for these creditors. Although this ‘no worse off’-test is therefore different from and wider than a Pareto or Kaldor-Hicks-efficient improvement, it appears that courts come close to interpreting this provision in a Pareto-optimal way by assessing whether the Part 26A Restructuring Plan can be expected to have at least improved the position of creditors.\textsuperscript{1052} Nonetheless, although this approach can be applauded, it does not take into account the impact that reaching such an ‘optimal’ part 26A Plan may have on the directors. Dependent on how directors are impacted by attempting to reach the most optimal Restructuring Plan, the efficiency could be rather Kaldor-Hicks than Pareto.\textsuperscript{1053}

To conclude the section on directors’/office-holders’ duties and the increased transparency requirement, this research submits that by giving more information to unsecureds and, in particular, having regard to those factions of unsecureds who are, in principle, lacking the power to influence (or alter) the decision-making process prior to or during the insolvency procedure (i.e. the non-controlling unsecureds), might give those more vulnerable unsecureds more


\textsuperscript{1050} Companies Act 2006, section 901G(3).

\textsuperscript{1051} Re Virgin Active Holdings Ltd [2021] EWHC 1246 (Ch).

\textsuperscript{1052} Ibid at [224]. Also, Re DeepOcean 1 UK Ltd [2021] EWHC 138 (Ch).

\textsuperscript{1053} Or, due to the wider/broader ‘worse off’-test neither of them.
certainty and could stimulate their involvement in and engagement with the debtor. This is especially so given the suggestion of this research to differentiate between controlling (i.e. stronger) and non-controlling (i.e. more vulnerable) unsecureds in terms of their legal and commercial position and how the decisions taken by the director/office-holder would affect them and mandating the debtor to provide non-controlling factions of unsecureds with the opportunity to provide a possible alternative restructuring solution during a CVA/IVA or the ability to initiate an insolvency claim (e.g. a recovery procedure against a former director) during administrations/liquidations which may be solutions they might not have been aware of otherwise. By tailoring the information to the specific faction of unsecureds, giving them the opportunities that they have at their disposal to be more involved and to possibly alter (or contest) the decision, it is submitted that the circle might be squared between (i) examining those unsecureds who may be non-controlling and, thus, lacking influence, (ii) mandating engagement with the latter ones and (iii) stimulating/encouraging (non-controlling) unsecureds’ participation in the decision-making process of the debtor-company when it is in financial difficulties.

Nonetheless, although this increased information/transparency requirement is strongly advised, the ability of the unsecured to be engaged and, if deemed necessary, to contest the decisions taken by directors/office-holders requires an appropriate\textsuperscript{1054} private enforcement framework.

Consequently, having discussed the duty of the office-holders and directors, it is now, thus, key to elaborate on the enforcement mechanisms unsecureds have got at their disposal in case either the director and/or the office-holder do not adhere to their duties. This will be critically examined below. First, private enforcement mechanisms (i.e. a direct and a derivative claim) will be examined before examining the potential need for a public enforcement mechanism.

\textbf{2.2.1.5. Private enforcement mechanisms}

\textit{i) Direct actions?}

The first enforcement mechanism for creditors would be to sue directors/office-holders in case of an alleged breach of their duties. However, if creditors would have a direct action against directors/office-holders, this would mean that directors/office-holders would be directly liable to creditors. In such situation, the duties of the director/office-holders would not (only) be owed to the company but that they would (also) be owed \textit{directly} to the creditors.

\textsuperscript{1054} With ‘appropriate’, this research means that the framework must be efficient, fair and ensuring that those actors that need to be held accountable (e.g. for breach of their duties) can be held to account.
Although after the *Credit Lyonnais* case there was, initially, some belief in the US that directors’ duties would be owed in such a direct way to creditors\(^{1055}\), this view was changed by the *Gheewalla* case.\(^{1056}\) Also there is no such direct action existing in the UK and other Commonwealth countries. This is because the duties of the director are owed to the company and the company (rather than creditors) is the proper claimant in case of a breach of directors’ duties.\(^{1057}\) Once a company enters into financial difficulties, this duty shifts in being for the benefit of the shareholders to being for the benefit of the creditors, but it nonetheless remains a duty owed to the company. As a consequence, there is no direct cause of action vested in the creditors for a(n alleged) breach of directors’ duties.

A similar reasoning can be employed as regards the office-holders’ duties. Although creditors are entitled to sue office-holders for an alleged breach of their duties pursuant to section 212 of the *Insolvency Act 1986* (i.e. misfeasance claims), this is not a direct action for the office-holder will not be directly liable to the creditor but, as the aforementioned statutory provision makes clear, any indemnification or restitution must be made to the company\(^{1058}\) and must thus be for the benefit of the entire group of creditors.

A direct action or a direct directorial liability towards creditors would also not be recommendable for it would, arguably, give directors too many masters with too many diverging (and conflicting) interests so that it would be economically more costly and burdensome to manage the company. Furthermore, for some directors, this could lead to more risk-aversion whilst it might give a handy route to escape liability for other directors at the same time as the latter ones would always be able to argue that they were acting in the best interests of at least some faction of creditors which would almost always give them a justification for almost any contested business decision.

Therefore, in light of the aforementioned arguments and the fact that the duty of the director/office-holder is owed to the company (but not directly to the creditors) means that, in case of a violation of such duty, the cause of action is vested in the company and not in the creditors. For creditors – unsecured or not – to be able to pursue any such claim vested in the company, they would have to be able sue derivatively, on behalf of the company. The sections below will investigate whether such enforcement mechanism already exists and, if not, whether

\(\text{\(^{1055}\) Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp (1991) Del Ch WL 277613; LEXIS 215.}\)

\(\text{\(^{1056}\) North American Catholic Education Programming Foundation Inc v Gheewalla 930 A. 2d 92 (Del, 2007).}\)

\(\text{\(^{1057}\) Foss v Harbottle (1843) 67 ER 189.}\)

\(\text{\(^{1058}\) Insolvency Act 1986, section 212(3).}\)
creditors – and more in particular, unsecureds – should be entitled to pursue a claim on behalf of the company against the office-holder or the director(s) for an alleged breach of their duties.

ii) Derivative actions for non-controlling unsecureds
   a) Definition and description

If a direct action for a potential breach of directors’/office-holders’ duties would not be recommendable, it might perhaps be justified to grant creditors the right to sue derivatively or, thus, on behalf of the company if the directors/office-holders are presumed to be breaching their duties owed towards the company.

Such a derivative action is presently an action initiated and pursued by members of the company on behalf of the company.\(^\text{1059}\) It is an action which is vested in the company for a(n) (alleged) breach of directors’ duties\(^\text{1060}\) but rather than being pursued by the board of directors which is supposed to be the principal actor (for breaches of company’s rights)\(^\text{1061}\), it is (one or some of) the members of the company who institute the action on behalf of the company.\(^\text{1062}\) For a derivative claim to be successful it is required that there is an underlying breach of the directors’/office-holders’ duties.

The primary reason why members of the company institute the proceedings rather than the board of directors is because the directors do not initiate the action themselves.\(^\text{1063}\) This is usually in a situation where the interests of the directors are either very much aligned with the controlling shareholders and/or whereby the directors are the controlling shareholders themselves (and, thus, engaged in directorial misconduct). The position we are envisaging is one where the controlling shareholders have orchestrated a breach of directors’ duties.\(^\text{1064}\) Economically speaking, in such a situation, there arises an ‘agency conflict’ between the non-controlling shareholders and the controlling shareholders with the board of directors merely acting in the interests of the controlling shareholders rather than the company.\(^\text{1065}\)

\(^{1059}\) Companies Act 2006, section 260-263.
\(^{1060}\) Companies Act 2006, section 260 (1)(a).
\(^{1064}\) However, shareholders do not owe any duty to the company or other shareholders.
\(^{1065}\) Although they owe a duty towards the company and not towards the members of the company; Cf. Companies Act 2006, section 172.
b) Analogy between unsecureds’ and shareholders’ derivative action.

As established before, given the similarity between shareholders (as residual risk-bearers while the company is still solvent) and unsecureds (practically and economically taking over the position of shareholders once a debtor/company approaches insolvency) and, hence, the similarity between the controlling (or non-controlling) position both shareholders and unsecureds can hold, it is deemed important to examine whether at the moment when a debtor-company is near insolvency unsecureds (rather than shareholders) should be able to file a derivative action.

Although statutory law does not specifically prohibit a derivative action instigated by members of the company at a time when the company is insolvent, it does not specifically permit members to do so either and case-law in England and Wales suggests that once a company has become subject to an insolvency procedure, members should no longer be allowed to start derivative actions. In any event, they are not likely to do so save where they are also creditors or the action will help make the company solvent again (but given the fact that legal proceedings are drawn out it is not likely that judgment would occur before the company collapsed). One of the leading cases in this regard is Fargro v Godfroy. In this case, the company went into liquidation, however, the minority shareholder still commenced a derivative action because of an alleged conflict of interest by the directors (and shareholder) (i.e. a diversion of a corporate opportunity to their own favour). The judge, Walton J., did not grant leave to pursue the action because, according to him, the company’s situation had entirely changed since the company had gone into liquidation. Because of the liquidation procedure (and the appointment of a liquidator), the minority shareholder was no longer ‘at the mercy’ of directors allegedly engaged in wrongdoings. On the contrary, the claim had now been vested in the liquidator’s hands and, possibly in contrast to the incumbent board of directors, it is clear that the learned judge believed that the minority shareholder should have (more) trust in the liquidator’s decision whether or not to start an action to swell the asset pool against the former directors. This point of view has recently been reiterated in the Pagden v Fry case whereby Jeremy Cousins QC, the deputy judge, also referred to the argument put forward in the Cinematic Finance case that a derivative claim could possibly “circumvent the insolvency regime”. Mr. Cousins, the deputy judge in Pagden endorsed that view by stating that “the Companies are now in liquidation, and the Liquidators are in place. Proportionality and the balance of convenience firmly favour

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1068 Pagden v Fry [2019] EWHC 540 (Ch).
1069 Cinematic Finance Ltd v Ryder [2012] BCC 797 at [22].
allowing them to get on with their work, and not disturbing the current arrangements."\textsuperscript{1070} Additionally, courts have the power to allow a derivative action to continue or not.\textsuperscript{1071} The existence of few derivative cases, however, suggests that courts are quite reluctant to sanction derivative proceedings, even in situations when the company is still solvent.\textsuperscript{1072}

Looking at creditors (rather than shareholders of the company), while case-law seems to go against the institution of derivative claims by shareholders when the company has become insolvent, creditors have no standing at all to institute derivative proceedings\textsuperscript{1073} despite the fact that exactly at that moment (when the company approaches insolvency) the unsecureds take over the shareholders’ position as residual risk-bearers.\textsuperscript{1074}

Although the argument that an insolvency procedure should not be obstructed by a possibly vexatious claim (instituted by the members of a company), at a time when the company is in dire financial straits, is understandable, case-law in England and Wales seems to steer insolvency governance into a more “management-centric”-way by (i) not allowing creditors to file a derivative action and (ii) placing the authority to file an action firmly in the hands of the office-holder.\textsuperscript{1075} As illustrated above, this is once again an example of how insolvency governance appears to move into a different direction than corporate governance for rather than aiming to encourage creditor engagement, the occurrence of ‘insolvency’ is used as an argument to place more authority on the management (which is exercised by an office-holder from then).

Nonetheless, (unsecured) creditors are not completely deprived of any rights for they can still apply in an insolvent regime to have the conduct of the office-holder reviewed\textsuperscript{1076} with the office-holder’s power being subject to the control of the court\textsuperscript{1077} and, in a worst case scenario, they can even request the removal of the office-holder which can be achieved via a creditors’

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\textsuperscript{1070} Pagden v Fry [2019] EWHC 540 (Ch) at [116].
\textsuperscript{1071} Companies Act 2006, section 262.
\textsuperscript{1073} Pagden v Fry [2019] EWHC 540 (Ch) at [114].
\textsuperscript{1075} Admittedly, the underlying principle within corporate governance is also that corporate actions must be commenced by directors of the company. Cf. The Companies (Tables A-F) Regulations 1985 SI 1985/805, Table A art 70 and The Companies (Model Articles) Regulations 2008 SI 2008/3229 reg 2 and sch 1 art 5 (private companies); Reg 4 and Sch 3 art 5 (public companies) as also cited by A.R. Keay, “Can Derivative Proceedings Be Commenced When a Company is in Liquidation?” (2008) 21 Insolvency Intelligence 49.
\textsuperscript{1076} Insolvency Act 1986, section 212(3).
\textsuperscript{1077} Insolvency Act 1986, section 167(3).
decision made by a qualifying decision procedure or by a court order.\textsuperscript{1078} Admittedly, it is unlikely for courts to second-guess decisions taken by office-holders and will usually refrain from interfering with the office holder’s commercial judgments\textsuperscript{1079}, however, as we will discuss later, this could be harmful/worrisome from a governance and accountability perspective. In addition, and as discussed in chapter 4, unsecureds do also have the ability to file a claim based on unfair prejudice for CVAs/IVAs\textsuperscript{1080} or unfair harm for liquidations and administrations\textsuperscript{1081} and they are also entitled to file a misfeasance claim against (former) directors and/or the office-holders or seek a review of an office-holder’s decision, which, arguably, grants creditors similar rights akin to the ones they would have received through the institution of a derivative action.

Nonetheless, although creditors do have several remedies and procedural options at their disposal, the fact that they are not entitled to sue derivatively on behalf of the company for breach of directors’/office-holders’ duties even though unsecureds (of an (almost) insolvent company) and shareholders (of a solvent company) are in a similar economic position seems inconsistent and begs the question whether it would be useful for creditors to file a derivative actions as well.

c) Creditors’ derivative action: concerns and arguments in favour

Therefore, moving on to the question whether creditors should also get the opportunity to file a derivative claim, it is worthwhile reiterating, as outlined before, that the more the company’s assets diminish, the more important the interests of unsecureds (should) become for directors. This is because unsecureds find themselves in a comparable/analogous position as shareholders (in a solvent company) once the company approaches insolvency.

However, allowing creditors to initiate a derivative action akin to the one members of the company can make use of would not be without some considerable drawbacks.

First, unsecureds are usually not really actively engaged in the insolvency process of a debtor-company.\textsuperscript{1082} This is arguably exacerbated by the fact that the corporate (solvency) and

\textsuperscript{1078} Insolvency Act 1986, section 172(2); Insolvency Act 171(2)(b); Insolvency Rules 2016, rules 6.26, 6.27.
\textsuperscript{1079} A.R. Keay, “Can Derivative Proceedings Be Commenced When a Company is in Liquidation?” (2008) 21 Insolvency Intelligence 49, 54.
\textsuperscript{1080} As regards unfair prejudice procedures: For IVAs: Insolvency Act 1986, s. 262; For CVAs: IA 1986, s. 6. As discussed above, disgruntled creditors bound by a CVA or IVA can also file a claim based on material irregularity. As regards unfair prejudice procedures: Insolvency Act 1986, s.262(1)(b). Specifically regarding IVAs, a creditor may also petition for the bankruptcy of the debtor (which is an option not available to creditors bound by a CVA): cf. Insolvency Act 1986, section 264(1)(c) and 276.
\textsuperscript{1081} For administrations: Insolvency Act 1986, Schedule B1, para. 74(1) or for liquidations: Insolvency Act 1986, s.112 (voluntary liquidation) and s.168 (5) (compulsory liquidation).
insolvency governance frameworks appear to diverge with shareholders being engaged and included more while encouraging unsecureds to be more engaged (as part of insolvency governance) does seem to be discouraged to a certain extent.

Secondly, because a derivative claim is a claim instituted on behalf of the company, any indemnification will go to the company and not to the individual creditors-applicants. This could be an even bigger stumbling block for unsecureds than it is for shareholders for a lot of unsecureds will only have a reasonably small claim and the transaction costs of pursuing a derivative claim might be deemed too high for many, especially if the indemnification is merely swelling the asset pool (i.e. the insolvent estate) and the unsecured creditor in the end only receiving (a proportion of) its own (small) claim. However, there could be discretion in the court to order that the company pay the costs\textsuperscript{1083}, although it is rarely employed with shareholders\textsuperscript{1084} and it remains questionable to what extent the company would be able to repay these costs anyway given its financially dire situation. Although a derivative claim could increase the chances of receiving a (higher) dividend (by swelling the asset pool), there is a clear risk that the economic costs (are perceived to) outweigh the dividends unsecureds will be able to obtain (given the size of their claim and the percentage recoverable ultimately). Surely, there is also the case that there must be an underlying actionable cause of action that can be the subject of a claim.

Thirdly and allied to the previous argument, a free-rider problem could easily arise for unsecureds who do not institute a derivative procedure will not have to bear any economic costs whilst still participating in the benefits if the derivative action swells the asset pool.\textsuperscript{1085} So, unsecureds who are not involved in a derivative proceeding would enjoy the fruits of a successful derivative action whilst not having to bear any (economic) costs if the case gets dismissed or rejected. However, the costs of instituting a claim might outweigh the benefits and it can be assumed that unsecureds will be cautious given that the claims might fail and/or lead to insufficient recoveries (e.g. if the directors do not have any money themselves).

Finally, a critical issue is funding. Leaving aside the economic costs to monitor whether an action can be filed against the former management of the company, by pursuing a claim the unsecured will also incur a considerable amount of litigation costs. This begs the question: who should pay for these costs? The unsecureds themselves? If unsecureds would be personally liable to fund


\textsuperscript{1084} B. Hannigan, Company Law (Oxford University Press 2018) 560 at [20.33].

\textsuperscript{1085} This is also the case for shareholders: E. Iacobucci and K.E. Davis, “Reconciling Derivative Claims and the Oppression Remedy” (2000) 12 Supreme Court Law Review 87, 92.
a derivative claim, the chances that they would want to institute such a proceeding would be very slim (unless it would be very clear *ex ante* that the procedure would be successful undoubtedly allowing the asset fund to swell). The funding problem is an issue which has plagued office-holders for quite a while too. However, alongside other practical solutions, the recent legislative reform allowing the assignment of a range of insolvency claims (including the fruits of these claims) and litigation funding companies have addressed the issue to some extent. The office-holder’s ability to assign a claim does, however, not solve the question how an unsecured creditor could be rewarded for the institution of a derivative claim if this were to become an option. A potential solution to solve this in favour of the unsecured creditor instituting a claim could be the creation of a preferential position via the provision of ‘winding-up costs’. Granting creditors that fund an insolvency claim a preferential position is something which already exists in Australia. Although section 564 of the Australian Corporations Acts 2001 creates the possibility of a preferential position for creditors who fund a claim pursued by the office-holder, it could be argued that a creditor who initiates a derivative claim which receives permission from the court should be able to be rewarded as well. This is because the rationale for granting a preferential position to creditors who fund a claim pursued by an office-holder is the same as the creditor who, in the absence of a claim instituted by the office-holder, pursues (and funds) such a claim derivatively, namely, to advance the public interest by encouraging creditors to help collecting assets to (re)build the insolvent estate and, in doing so, to maximise the amount of distributions to unsecureds. The higher share the creditor is able to recover depends on the recovery which was made and must reflect the risk taken by the funder-creditor. This means that if the claim is unsuccessful, the creditor will have lost the amount of money used to fund the claim on top of the economic costs (such as e.g. the time spent on investigating and monitoring the claim).

In spite of these flaws and concerns outlined above, there are, however, a considerable amount of arguments that would support the introduction of a creditors’ derivative action.

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1086 Obviously, this could depend on the size of a creditor’s claim.
1088 Such as conditional fee arrangements for example. Cf. V. Finch and D. Milman, *Corporate Insolvency Law* (Cambridge University Press 2017) 479-481.
1089 Small Business Enterprise and Employment Act 2015, section 118; *In re London & Westcountry Estates Ltd Hockin and others v Marsden and another* [2014] EWHC 763 (Ch).
1090 V. Finch and D. Milman, *Corporate Insolvency Law* (Cambridge University Press 2017) 479; However, litigation funding companies might be willing to fund a good case but there might be problems in them getting paid. Any sum awarded would go to the company and so the funder could not get anything although judges have the power to award costs to the funder.
1091 Corporations Act 2001 (Australia) section 564.
First, it is illogical that members of the company, as residual risk-bearers while the company is solvent, can file a derivative claim while unsecureds, at a moment when they become the residual risk-bearers economically are not allowed to file similar derivative actions despite the fact that their interests have become paramount now.\textsuperscript{1094} In contrast to the UK’s position, both Singapore\textsuperscript{1095} and Canada\textsuperscript{1096} allow creditors to file a derivative action for this reason. This was clearly set out in the Canadian case, Peoples Department Stores Inc. (Trustee of) v. Wise, whereby Major and Deschamps JJ both stipulated that “the fact that creditors’ interests increase in relevancy as a corporation’s finances deteriorate is apt to be relevant to, inter alia, the exercise of discretion by a court in granting standing to a party as a “complainant” under s. 238(d) of the CBCA as a “proper person” to bring a derivative action in the name of the corporation under ss. 239 and 240 of the CBCA”.\textsuperscript{1097} (my own emphasis)

However, acknowledging the similarity in the legal and economic position between shareholders and unsecureds might be a necessary argument to allow creditors to file derivative actions but it is therefore not necessarily sufficient. This is because one could argue that there is no need for creditors to be able to file a derivative claim given the fact that the power to pursue such litigation has been vested in the office-holders and creditors have several accountability mechanisms at their disposal in case office-holders would not act appropriately (such as e.g. by refusing to initiate a procedure against the former directors despite the chances of this procedure being able to attract assets to the insolvent estate).\textsuperscript{1098} Nonetheless, such arguments would not apply to a pre-liquidation situation when the company is near insolvency. In such cases, it could be beneficial to allow a derivative action, especially if no office-holder has been appointed, in order to swell the company’s asset pool. In this regard, in Canada, creditors can file for oppression (which is similar to the unfair prejudice provision in England and Wales), however, such claims are personal claims and if creditors would get money for themselves, this would deplete the (insolvent) firm’s estate which would be negatively impact the other unsecureds and would be akin to giving preferential treatment to one unsecured creditor. Giving preferential treatment to one unsecured creditor is something this research has consistently


\textsuperscript{1095} Singapore Companies Act 1967, section 216A(1)(c); Although not directly including ‘creditors’ the section stipulates that “any other person who, in the discretion of the Court, is a proper person” can file a derivative claim which opens up the possibility to include creditors at a time when the company approaches insolvency.

\textsuperscript{1096} Canada Business Corporations Act 1985, section 238.

\textsuperscript{1097} Peoples Department Stores Inc. (Trustee of) v. Wise [2004] SCC 68.

\textsuperscript{1098} Nonetheless, there could always be an assignment of the action to a third party such as a creditor.
argued against, hence, the reason why allowing creditors to pursue such an individual oppression action will be rejected.\(^{1099}\)

Nonetheless, several additional arguments can be put forward in support of a derivative claim by creditors.

Therefore, a second argument would be that derivative actions could increase the asset pool at a time when the company’s finances have deteriorated to such an extent that there is nothing left for shareholders. Given the fact that shareholders are often considered to be poor monitors\(^{1100}\), it seems defensible that creditors should step in when their money is at stake. However, the question would then arise whether (unsecured) creditors should be allowed to file an action for as long as no office-holder has been appointed (i.e. during a debtor-in-possession situation) or whether, even after the appointment of an office-holder, creditors should be allowed to file a derivative lawsuit. Allowing creditors to file a derivative action after an office-holder has been appointed creates the risk that there might be an overlap of the same procedures if an office-holder would consider starting a lawsuit against the former directors/management herself.

In such scenario, it can be expected that the court would have to intervene. According to rule 19.9F of The Civil Procedure Rules the court may rule that the [derivative] action cannot be “discontinued, settled or compromised” without its permission\(^{1101}\) which points to the court’s ability (and, perhaps, willingness) to continue to oversee the procedure. Furthermore, by allowing the derivative action to proceed, the court has established that the action is in the interests of the company and that directors instituting such claim would not breach their duties.\(^{1102}\) Hence, if creditors would be allowed to start a derivative action, it could be expected that both the directors but also the office-holder would (want to) cooperate with such a procedure as the court has established that the derivative action is in the interests of the company by allowing it to go forward.\(^{1103}\) If an office-holder has already been appointed but fails to start a claim against the former management and creditors believe that that would be an important avenue to increase the asset pool, a move towards the American regime would be positive. This would mean that before allowing creditors to initiate a derivative claim they should have to prove cumulatively that their claim could be successful\(^{1104}\) and, if so, would swell the asset pool and

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\(^{1099}\) A similar argument has been made in W. Trower, A. Goodison, M. Abraham, A. Shaw, *Corporate Administrations and Rescue Procedures* (Bloomsbury Professional Ltd 2017) 292.


\(^{1101}\) The Civil Procedure Rules, section 19.9F.


\(^{1104}\) Which will have to be done by providing the court with clear facts/evidence. Creditors will have to build their case which could be difficult given the existence of an information asymmetry between them.
that the office-holders are unwilling to initiate a claim (which could for example happen if they fail to obtain funding and the insolvent estate is empty). Nonetheless, it can be assumed that creditors might not want their action to be taken over by an office-holder if the office-holder used to be reluctant or, perhaps, even hostile towards the pursuit of any actions against the previous management. In such case, creditors could seek an assignment of the cause of action from the insolvency practitioner.

Thirdly, giving an opportunity to creditors to pursue derivative actions would also provide additional checks and balances to control the management of the insolvent debtor (performed by the company’s directors or the office-holder) for they would be able to pursue actions immediately themselves when office-holders are found to be negligent in not initiating or suggesting such a claim. In this regard, derivative actions could improve accountability. Although courts already have the power to review an IP’s actions (or inactions), it would, nonetheless, allow creditors to act more quickly as it would remove the burdensome layer of having to go to court to remove the office-holder first or to request the court to appoint an additional liquidator before being able to initiate a legal action or to be compelled to request an assignment of the cause of action. In other words, allowing unsecureds to instigate a derivative claim themselves would transform insolvency framework from a very “board-centric” to a more “creditor-friendly” framework.

Fourthly, there is a significant statutory omission to hold the office-holder (or director) to account during a CVA, IVA, a Part 26A Restructuring Plan and a Moratorium. Although misfeasance claims can be initiated by creditors against directors and officers of the company (including liquidators, administrators etc..) pursuant to section 212 of the Insolvency Act 1986 which reduces to some extent the need for a derivative claim, especially as any proceeds would be to the benefit of the company (and not the individual applicant-creditor), such misfeasance claims can only be instigated at the time when a winding-up order has been made in relation to the insolvent debtor-company. Consequently, in the aforementioned situations (i.e. a CVA, IVA, Moratorium or Part 26A Restructuring Plan) whereby unsecureds would be deprived of the option to hold the office-holder (or director) to account, the availability of a derivative action would be a useful tool to (i) ex ante attempt to ensure that the office-holder will perform his

and the company. Nonetheless, in order to be successful, creditors would have to show that a derivative action will benefit the insolvent estate. This could for example be achieved by showing facts that suggest directorial misconduct (e.g. a fraudulent transaction, an illegal transfer of money etc.).

duties in the interests of all unsecureds without potentially advancing some creditors’ interests above other creditors’ interests and (ii) in case of an alleged violation of the office-holder’s duties to be able to hold the office-holder to account.

Finally, allowing creditors to file a derivative claim would benefit non-controlling factions of unsecureds in two ways. On the one hand, it would allow them to benefit (and share in) the proceeds if the derivative procedure was instituted by other creditors (unsecured or not). On the other hand, it would also allow the non-controlling unsecured creditor to file a claim herself if the other creditors would be reluctant to do so. As will be argued below, allowing them to file a claim individually but also as a class seems important for in the latter event (when they start a claim as a class/faction), they are able to share the economic costs amongst themselves which could incentivise them to become involved for it would reduce the costs each creditor would have to bear individually. This, however, raises the potentially difficult issue of arranging creditor coalitions.

In conclusion, based on the arguments pro and contra set out above, this research argues that derivative actions should be introduced to improve the position of non-controlling unsecureds.

Having examined the private enforcement mechanisms and various ways to enhance (the functioning of) private enforcement (i.e. trust schemes, stimulating creditors’ activism, derivative actions etc.), there continue to be drawbacks which, from a policy perspective, would limit the success of private enforcement. This is because there is no guarantee that unsecureds would actually be more engaged, especially given their often rather apathetic attitude at the moment. Furthermore, even if some unsecured creditors might be more engaged if the aforementioned proposals would be enacted, there may still be other unsecureds who refrain from being involved in the insolvency procedure (in terms of monitoring the directors/office-holders, asking questions, pressing to pursue insolvency litigation etc.) and who may thus, for example, not initiate insolvency claims although there would be an opportunity for them to do so. This could be because there remains an information-asymmetry between the debtor and the unsecureds and/or because the creditor may fear that the benefits of a potentially successful claim would be outweighed by the economic transaction costs it would involve (even if there would be a public trust to help finance insolvency litigation). The latter is very likely if the claim of the individual creditor is rather low. As a result, some directors (or office-holders) may fall ‘through the cracks’ and would not be held to account in cases where they might need to be

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held accountable. Subsequently, solely relying on private enforcement would not be advisable. Therefore, and as indicated in chapter 4, this research will examine if and to what extent public enforcement measures could complement private enforcement in order to enhance accountability of the debtor’s management/office-holder, market trust and thus the regulatory protection of unsecureds.

2.2.1.6. Public enforcement

i) Directors’ duties

As indicated, the aforementioned legal actions and remedies (with the exception of the compensation orders for disqualification that can be pursued by the Secretary of State as set out in chapter 4)\textsuperscript{1109} all lie in the private sphere. However, the pitfalls that these enforcement mechanisms contained (as explained above), arguably, necessitate an examination as to whether directors’ duties may need to be monitored and enforced via a public regulator in order to improve accountability. This is because such a public regulator would not only monitor the director’s performance but would also be bestowed with the ability to enforce directors’ duties in case the director would violate her duties.\textsuperscript{1110} A regulatory example where a public regulator can enforce directors’ duties in such a way can be found in Australia where the Australian Securities and Investments Commission (ASIC) can issue directors with a civil penalty for a breach of their directors’ duties.\textsuperscript{1111}

Enforcing directors’ duties through a public regulator is, however, not uncontested for several arguments have already been put forward against the usage of a public regulator. Some of the key objections against a public regulator are as follows:

First, a public regulator could reduce managerial risk-taking and may make directors more risk-averse.\textsuperscript{1112} This argument is, however, open to criticism for this same argument has also been put forward as regards judicial enforcement of directors’ duties. Nonetheless, from a litigation point of view, courts have often shown to avoid hindsight bias whilst refraining from second-guessing the business judgment of the directors.\textsuperscript{1113} In a similar vein, it can be submitted that a public regulator would also only intervene when it is clear that a director has seriously breached his/her directors’ duties.\textsuperscript{1114}

\begin{flushleft}
\textsuperscript{1109} Company Directors Disqualification Act 1986, section 15A and 15B; Cf. supra chapter 4 for a more extensive discussion.
\textsuperscript{1111} Corporations Act 2001, section 1317G.
\textsuperscript{1113} Re Idessa (UK) Ltd [2011] EWHC 804 (Ch).
\textsuperscript{1114} This is also the case in Australia: M. Welsh, ‘Civil Penalties and Responsive Regulation: The Gap between Theory and Practice’ [2009] 33 Melbourne University Law Review 908, 928.
\end{flushleft}
Secondly, it could be argued that relying on a public regulator could reduce shareholder and creditor engagement and may, thus, discourage them from intervening.\textsuperscript{1115} This argument is based on the economic free-rider problem. It, however, fails to take into account that the viewpoint of shareholder may differ from that of the regulator and so, it may occur that the shareholder may be fearful of a claim potentially instigated by the regulator whilst in other scenario the public regulator may determine no civil penalty ought to be issued whilst shareholder may believe that a lawsuit against the directors would be warranted. Also, a public regulator is not meant to take over the position of shareholders/creditors and may not always have sufficient resources to enforce every single breach. Instead, although a regulator is deemed to enforce directors’ duties, based on their own self-interest, shareholders and creditors are still encouraged and expected to continue monitoring the directorial performance. Nonetheless, one of the reasons why a public regulator is deemed useful is because shareholder and creditor engagement is minimal.\textsuperscript{1116}

Thirdly, a further objection against public regulators is the costs it would involve and, in this regard, the burden it could be for the public purse for funding for a public regulator will be coming from the taxpayers. Nonetheless, this argument does not convince for improved accountability and higher directorial standards could avoid debtors becoming insolvent which would protect a wide number of stakeholders (including non-controlling unsecureds)\textsuperscript{1117} and which could, as a consequence, enhance market trust.

Fourthly, it has been argued that a public regulator would lack motivation and that, as a result, it would not be useful. This argument emanates from the assumption that public servants would, in contrast to shareholders and creditors, lack the incentives to properly exercise their investigatory and enforcement role. Nonetheless, also this argument fails to convince for several reasons. This is because the assumption that public servants would \textit{ipso facto} lack incentives is not only not evidenced, it also fails to take into account that doing a good job might enhance these servants’ promotional prospects and that more funding may be granted to the regulator by the government if their performance is good.

Fifthly, a more theoretical viewpoint, it has been argued by contractarians that company is private law and that there should be no public intervention. Nonetheless, this argument is woeful for the evidence shows, as indicated above, that private actors (shareholders and creditors)

\textsuperscript{1116} Ibid.
often do not engage in controlling directors, let alone instigating a procedure against them. Furthermore, especially when concerned with small private companies, it would be quite schizophrenic if shareholders (who are often also directors of the company) started a (derivative) claim against themselves, leaving the enforcement of directors’ duties effectively to the office-holder once the company has become (almost) insolvent. As argued above, a public regulator by being able to intervene sooner could avoid a (private) debtor-firm getting to this stage of insolvency or at least to hopeless insolvency. This could also reduce the workload of insolvency practitioners.

Finally, it could be argued that there is a certain information-asymmetry between the regulator and the directors, however, this can be overcome by requiring directors to cooperate with the public regulator’s investigation and to provide the regulator with the requested amount of information in order to facilitate their monitoring and reduce the investigatory costs.

Nonetheless, despite these criticisms, it seems, on balance, still defensible to create a public regulatory body that would enforce directors’ duties for this would enhance accountability and protect creditors’ position (incl. the non-controlling unsecureds) for the following reasons. First, a public authority – such as an ombudsman – is expected to be more financially skilled and experienced than the average director to control whether the directors of a certain company are performing their duties to the standard required.  

Secondly, whilst there could likely exist a free-rider problem at the level of unsecureds are regards monitoring the directors, no such problem would exist if a public authority would be (legally) required to supervise, monitor and, if necessary, enforce directors’ duties. However, as indicated above, it could still be argued that the existence of a public authority could disincentivise unsecureds even more from monitoring the board of directors. Nonetheless, although the aforementioned criticism may not be entirely without merit, the existence of a public agency whereby complaints could be raised may perhaps even have a positive effect on unsecureds’ involvement for their economic/transaction costs would now be reduced due to the fact that the public authority would engage in the supervision (and enforcement) of directors (and their duties) whilst, absent such a regulator, unsecureds need to supervise, investigate and initiate claims themselves which, undoubtedly, increases the transaction costs and may well discourage them from appropriately monitoring the directors.  

Thirdly, a public authority could issue fines and enforce directors’ duties in situations where private enforcement would not be possible. This could be when the company has authorised or

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1119 Ibid 89.
ratified a violation of directors’ duties and in which case a derivative claim could no longer be initiated. A public regulator would not be bound by any such authorisation or ratification by the company and, in any case, such ratification would be of no effect if the company were insolvent or near to it.\textsuperscript{1120}

Fourthly, the existence of a public authority (and their ability to supervise the board and to enforce directors’ duties) may also stimulate directors to perform better. Although critics would allege that public enforcement may unduly deter directors by making them more risk-averse, such argument would not hold water for directors are \textit{currently} already under required to abide by the regulatory framework (which include the directors’ duties set out in ss.171-177 Companies Act 2006).\textsuperscript{1121}

Consequently, taking into account the aforementioned arguments, a public authority will certainly have the effect of improving weaker parties, such as non-controlling unsecureds’ position. This is because a knowledgeable and experienced public institution would ensure that directors are being supervised and, if necessary, ‘forced’ to abide by the statutory and common law provisions regarding directors’ duties. in addition, such a regulator would create a place where such vulnerable creditors could go to if they assume that one (or some) of the directors are disenfranchising their interests. This could, in turn, have a positive effect on market trust for improved accountability standards illustrate that directors ought to perform well or risk being held to account.

\textbf{ii) Office-holders}

Whilst currently no public enforcement regime exists for directors’ duties, the regulatory framework as regards office-holders is quite different. This is not only because office-holders are usually more legally and financially skilled containing more relevant expertise than the average director to manage the company but also, and crucially, because several regulators, in the form of Recognised Professional Bodies (R PBs)\textsuperscript{1122}, exist in order to monitor and, if deemed necessary, to sanction the insolvency practitioners. In addition, oversight over aforementioned RPBs has been exercised by the Insolvency Service on behalf of the Secretary of State.\textsuperscript{1123}

Furthermore, in addition to aforementioned control and as discussed in chapter 5 and above, creditors have been bestowed with several other legal options to hold the office-holder to

\textsuperscript{1120} Ibid 89.
\textsuperscript{1123} Insolvency Act 1986, section 391(4).
account such as *inter alia* their ability to request the court or, even vote, for the removal of the office-holder\(^\text{1124}\) and their ability to start a misfeasance claim.\(^\text{1125}\)

### a. Pitfalls

Nonetheless, despite these regulatory measures, significant pitfalls still occur in relation to the office-holder from an accountability-perspective. This is, *inter alia*, for the following reasons:

First, unsecureds tend to be rather passive\(^\text{1126}\) and figures from the OFT indicate that unsecureds only attended a creditors’ meeting (pre-changes to decision-making processes) in around 5 percent of the cases.\(^\text{1127}\) The lack of engagement by unsecureds, often due to a lack of legal/financial knowledge and a fear that the monitoring costs would outweigh the benefits of getting their claim fully/partially repaid\(^\text{1128}\) gives more power to office-holders which could harm the unsecureds’ position if the office-holder would not diligently perform his duties in the interests of all unsecureds.

Secondly, the screening of office-holders undertaken by courts prior to their appointment with the aim of ensuring that they will act impartially and independently does not take place vis-à-vis office-holders who are, ahead of the restructuring of the insolvent debtor, appointed out-of-court. On such occasion, the creditors of such a debtor will not benefit from the pre-appointment control courts usually exercise.\(^\text{1129}\) This allegedly gives more power to stronger creditors such as banks to influence who will become the office-holder and inevitably risks that office-holders are, in practice, predominantly accountable to those major creditors who (have) appoint(ed) them.\(^\text{1130}\)

Thirdly, although courts may be able to give some protection (through screening) as to the office-holder’s impartiality and independence prior to their appointment, case-law shows that courts tend to be very reluctant in challenging the business decisions taken by the office-holder afterwards.\(^\text{1131}\) This is based on courts generally trying to avoid second-guessing business decisions.

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\(^{1124}\) Insolvency Act 1986, section 172(2).

\(^{1125}\) Insolvency Act 1986, section 212; If such a misfeasance claim would be successful, office-holders may be required to pay damages to the (insolvent) company.


\(^{1128}\) Ibid at [1.15].

\(^{1129}\) S. Paterson, ‘Debt Restructuring and Notions of Fairness’ (2017) 80(4) MLR 600, 609.


\(^{1131}\) Brake and others v Lowes and others [2020] EWCA Civ 1491; *Four Private Investment Funds v Lomas* [2009] BCLC 161; *DKLL Solicitors v HM Revenue & Customs* [2007] B.C.C. 908 Ch D; *Re CE*
decisions by the office-holders. Nonetheless, this wide discretion granted to office-holders removes a critical aspect of accountability and makes it incredibly hard for generally already passive unsecureds to challenge the office-holder’s attitude (if they would wish to do so).

Fourthly, accountability of office-holders is still largely based on a rather self-regulatory approach whereby RPBs monitor and, if deemed necessary, sanction the office-holder. Although such a self-regulatory approach has got its merits as it avoids overregulation and enhances flexibility in commercial markets, it remains a matter of concern as, in spite of some improvements by the SBEEA 2015, the system remains very complex with currently 4 different RPBs monitoring IPs. In this regard, the existence of so many different RPBs reduces consistency in the approach undertaken as regards to monitoring and sanctioning office-holders and, arguably, makes it even more difficult for unsecureds to hold them to account due to increased transaction costs to go through this (self-)regulatory web. In addition, it has been submitted that due to the arguably rather ‘niche’-area of insolvency law and the fact that members of RPBs may be practising insolvency practitioners themselves, there is a risk that RPBs may not provide the necessary safeguards as regards independence and impartiality, unsecureds (especially weaker unsecureds) may have expected. Although, any such potential lack of independence by RPBs might seem a strong accusation due to control over the RPBs being exercised by the Insolvency Service on behalf of the Secretary of State, it, nonetheless, adds an argument to the list of concerns with the current regime applicable to office-holders. Finally, RPBs arguably also only take a rather narrow view by predominantly focusing on the behaviour of a certain member hereby potentially not sufficiently taking into account the wider insolvency process (e.g. previous directorial behaviour) whilst some RPBs


INSOL International, ‘Corporate insolvency practitioners, ethics and remuneration: Not a case of moral bankruptcy?’ (INSOL Special Report, August 2020) 49-50 at [6.4].

Insolvency Act 1986, s.391(4).
lack the availability of independent assessors determining the outcome of a complaint or being able to review the complaint.  

Consequently, in spite of several regulatory measures that aim to provide an appropriate accountability mechanism for office-holders, the aforementioned issues still require an improvement of the current insolvency framework to enhance accountability and fairness. Therefore, this research suggests the creation of one single regulator (rather than 4 separate RPBs) and the usage of an ombudsman.

**b. A single regulator**

In terms of having just one single regulator which, under the current rules, the Secretary of State has the power to create until 2022, critics may submit that such centralisation could negatively impact competition amongst IPs within the market hereby reducing quality standards and increasing prices. Furthermore, it could be contended that establishing a single regulator would not be a drastic change and would not move away from the rather self-regulatory approach.

Nonetheless, the self-regulatory approach whereby the industry, subject to control by the Insolvency Service, controls its ‘own’ insolvency practitioners allows the insolvency industry to quickly respond to market needs and, arguably, avoids insolvency practitioners being emmshedd in burdensome rules that it is feared that a single independent regulator could impose top-down on IPs.

However, although keeping the self-regulatory approach, centralising the powers of the 4 RPBs into one single regulator is, nonetheless contended for the following reasons.

First, it would enhance consistency in terms of the regulatory approach and complaints procedures undertaken and would, therefore, provide more clarity to unsecureds. This would undoubtedly enhance the position of weaker factions of unsecureds as it would reduce the currently existing economic search costs unsecureds would have to undertake to investigate how (and where) to file a complaint and would, arguably, provide more streamlined process as regards compliance.

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1139 Small Business Enterprise and Employment Act 2015, section 144.
1140 J. Wood, ‘One ring to rule them all: has the call for a single regulator been answered?’ [2020] 33(2) Insolv. Int. 55, 61.
1141 Ibid.
1143 Ibid (n 954).
Secondly, enhancing consistency would arguably also stimulate creditor engagement and could therefore enhance accountability of the office-holder which, in turn, could have a positive impact on the trust placed on the insolvency profession.

Nonetheless, one single regulator would take away the possibility to compare best practices between RPBs and it could be alleged that there is insufficient evidence showing that one or some RPBs do not exercise their powers to the standard required. Furthermore, having one single regulator, although still an improvement, would also not address the issue that the scope of their activities remains relatively narrow as opposed to an ombudsman who would be able to take a broader view. This is why, in addition to the creation of one single RPB, this research defends the establishment of an ombudsman.

c. An ombudsman

An ombudsman is found in other regulatory fields such as in insurance, banking, Legal Services and, in terms of insolvency, would provide an additional body that would monitor and, if necessary, sanction office-holders. Creditors would be able to lodge a complaint against an office-holder with such an ombudsman.

Although an ombudsman would need big enough support from the public and sufficient funds which could both be an issue and whilst an ombudsman in addition to a single RPB (regulator) could also seem costly, inefficient, bureaucratic and unnecessary due to the recent regulatory reforms in order to improve oversight of RPBs\textsuperscript{1144}, it is, nonetheless, defensible to have such an ombudsman in conjunction with the aforementioned single regulator that would replace all RPBs. This is for the following reasons.

First, the scope of the activities that the ombudsman could monitor and investigate would be broader than that of the RPB(s) as the latter body/bodies predominantly focus on the managerial behaviour of one of their members.\textsuperscript{1145} Instead, an ombudsman would also be able to take into account the wider insolvency process\textsuperscript{1146} and, as contended in this research, could also function as a public enforcement body holding directors (and not only office-holders or insolvency practitioners) to account at a time when the debtor-firm is in financial difficulties. In this regard, it is worthwhile to mention that whilst an RPB makes up part of a self-regulatory framework, an ombudsman would create a more official \textit{public enforcement} body that would not be part of the insolvency framework itself but would act and function as a public regulator.

\textsuperscript{1144} In this regard, a complaints gateway has been created and the Insolvency Service annually publishes a report on RPB performance in addition to the information it now releases as regards sanctions imposed on IPs. See: V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 177.

\textsuperscript{1145} V. Finch and D. Milman, \textit{Corporate Insolvency Law} (Cambridge University Press 2017) 176-177.

\textsuperscript{1146} Ibid.
Secondly, following our argument to centralise all RPBs into one single regulator removes the ability to compare the best practices of each RPB1147 and an ombudsman would then be able to ensure that the RPB’s practices would be properly monitored in order to ensure that maladministration would not occur or could quickly be penalised. Against this argument it could, however, be submitted that the RPB is already supervised by the Insolvency Service on behalf of the Secretary of State. Nonetheless, the ombudsman would only consider individual cases (after a complaints procedure at the RPB would have been exhausted) whilst the Insolvency Service is more concerned with the general issues as regards the RPB’s functioning and policy.

Thirdly, an ombudsman would provide unsecureds and especially weaker groups of unsecureds with a very speedy and cheap way to lodge a complaint against the office-holder and, dependent on the scope of its activities, potentially also managers/directors. This would, arguably, not only enhance fairness and accountability (as directors and office-holders could be held to account more swiftly) but also efficiency as the currently available routes to hold directors/office-holders to account are often very complex and costly to creditors.1148 As a result, if weaker factions of unsecureds would allege that their position has been disenfranchised by the office-holder, they would then be able make their voice heard more cost-efficiently which, in turn, could also force office-holders (and directors) to have more regard to the voices of such weaker parties and to ensure that, for example, weaker factions of creditors are also appropriately informed of the implications of certain commercial decisions so that they can make an informed decision at a creditors’ meeting.1149

Fourthly, in enhancing accountability and providing a fairer and more easily accessible (i.e. cost-efficient) framework for vulnerable groups of creditors, the insolvency profession might gain more market trust which would not only be positive from a national but also from an international perspective as a reliable, trustworthy, fair(er) and, arguably, more efficient insolvency framework could convince international businesses to choose England and Wales as the appropriate legal forum for the restructuring and/or winding-up of their firm.

Consequently, taking into account the aforementioned arguments and despite some challenges and potential pitfalls, it seems, nonetheless, worthwhile to reform the current regulatory framework through the merging of all RPBs into one single RPB and to create a public

1147 J. Wood, ‘One ring to rule them all: has the call for a single regulator been answered?’ [2020] 33(2) Insolv. Int. 55, 61.
1148 V. Finch and D. Milman, Corporate Insolvency Law (Cambridge University Press 2017) 177.
1149 The latter issue was at stake in Re Virgin Active Holdings Ltd [2021] EWHC 814 (Ch) at [128] whereby the court as part of a Restructuring Plan ex Companies Act 2006, part 26A ordered the ailing company to issue more information to certain landlords who under the companies’ Restructuring Plans would be crammed down.
enforcement body (ombudsman) that would provide an arguably more cost-efficient route to creditors to hold directors and office-holders to account than the procedures creditors can make use of through private enforcement.

III. Conclusion

Having elaborated on the insolvency values that should underpin the regulatory framework and how these values need to be balanced against one another in chapters 6 and 7, this chapter examined the regulatory measures which could improve the position of non-controlling unsecureds. A distinction between non-governance and governance-related recommendations was made in that regard.

*In terms of non-governance measures,* it was submitted that granting preferential treatment to non-controlling unsecureds and/or requiring them to mandatorily insure themselves or debtors ought to be rejected because such solutions would, arguably, make insolvency procedures more complicated and would thus breach the efficiency-value whilst potentially even granting certain unsecureds extra protection without them needing it as a result of not properly taking into account the actual non-controlling/vulnerable character of unsecureds. Nonetheless, some benefits could be drawn from the usage of trusts/trust accounts. Although in a limited way, this research advocated that this could be helpful to improve the position of non-controlling unsecureds. This is because such trust accounts would guarantee the application of the *pari passu* principle. Therefore, this research argued that the debtor’s management as part of their fiduciary duty to act in the interests of the company while having regard to creditors should consider whether a trust account could be set up to protect weaker unsecureds. In addition, a trust funded by the taxpayer and/or through fines levied on directors who have breached their directors’ duties could help improving the position of weaker unsecureds by ensuring that the *pari passu* principle would be upheld amongst them. This could be critical during corporate rescue procedures as recent cases have shown that certain creditors which may, at first sight, not be deemed vulnerable (e.g. landlords) risk ending up in a disenfranchised position. In doing so, such recommendation would contribute to ensuring that “unequal” (weaker) creditors are not treated “equally” and would thus be in line with our efficiency and fairness criteria. Nonetheless, despite the importance of the non-governance measures, it was advocated that more emphasis had to be placed on improving governance rights for good governance would not only reduce the risk of the debtor becoming insolvent, it would also increase the chances of rescue procedures succeeding and unsecureds receiving a higher or the appropriate returns without having to bear too many economic transaction (e.g. monitoring) costs.

*In terms of governance-related recommendations,* this research made a distinction between private and public enforcement suggestions. -Regarding the private enforcement suggestions,
it was submitted that derivative actions for creditors should be introduced which would usually be most beneficial for those creditors that are, allegedly, in a non-controlling position and that directors should reflect and communicate more transparently to unsecureds about the actions that they consider important. Imposing new duties on directors/office-holders was, however, rejected for it would make procedures too burdensome, costly, complex and would risk increasing economic transaction costs, likely breaching the efficiency and fairness values. Nonetheless, despite the merits of private enforcement and enhanced creditor participation, it was submitted that this would not be sufficient due to, inter alia, the unsecureds’ passivity and the many challenges with existing insolvency procedures. This research therefore argued for the creation of a public ombudsman who would be able to monitor directors when a debtor would be failing and who could sanction them, if necessary (e.g. when not sufficiently having regard to the interests of all the unsecureds including the non-controlling factions). Such an ombudsman would act in conjunction with a centralised RPB overseeing officeholders.

In the following chapter I will move on to the conclusion by giving a detailed overview of the recommendations that have been critically assessed as part of this chapter and which will be placed against the current regulatory framework and the risks that the currently existing framework creates for non-controlling factions of unsecureds.
I. **Introduction**

Having arrived at the end of this research, the final chapter will, without rehearsing the discussions elaborated on in earlier chapters, attempt to give a concise overview of the vulnerable position certain non-controlling factions of unsecureds currently still face and to answer the questions formulated at the commencement of this research.

These research questions were as follows:

Who are minority (non-controlling) unsecured creditors and what are the problems they could face when a company is insolvent?

Should there be better protection of minority (non-controlling) unsecured creditors in insolvencies in terms of (i) their monitoring rights and their rights to influence the insolvency procedure, (ii) their recovery/dividend rights and (iii) their rights to hold the office-holder accountable?

In giving an overview of the answers to these research questions, I will, hereby, first summarise the current regulatory framework with its key principles and, crucially, the pitfalls for these weaker factions of unsecureds before summarising (i) how the non-controlling unsecured can be identified and (ii) how the regulatory framework could be improved and which solutions might be employed in order to enhance the regulatory protection for these weaker/non-controlling factions of unsecured creditors.

II. **Underlying insolvency principles**

Starting with the general framework, two fundamental principles, namely the *pari passu* and anti-deprivation principle, underscore the current regulatory framework which aim to ensure that as much as possible from the asset pool of the debtor will be divided amongst unsecureds in an equal and rateable way.

Most critical is the *pari passu* principle which attempts to eradicate or, at least, mitigate the competition between creditors, hereby trying to avoid a “run on the debtor” and a subsequent "survival of the fittest" whereby the first creditors might be able to receive some dividends based on a ‘first come first served’ basis whilst those who arrive later (or last) would only be able to recover less or potentially nothing at all.

However, although the *pari passu* principle forms the cornerstone of the English insolvency framework, several exceptions have been created which allow a certain differentiation amongst
creditors enabling certain groups of creditors to recover more of their claim prior to other creditors who rank lower.

Nonetheless, despite the existence of these legal exceptions to the *pari passu* principle, this research showed that even between those unsecureds who are not subject to any aforementioned legal priority which would allow them to trump the *pari passu* principle, differentiation between such creditors exists. Although the existence of different groups of unsecureds should not necessarily give rise to legal issues (such as if there are merely different commercial interests between unsecureds), there could arise problems if one (faction of) unsecured creditor(s) is to act, willingly or not, to the detriment of other factions of unsecureds.

In order to answer the first research question, namely which unsecureds could be weaker (i.e. non-controlling) and, arguably, more at risk, the research started from the analogy between corporate governance and insolvency governance as regards the economic actors involved in dealing with the (insolvent) debtor and in terms of the subsequent economic relations these economic players have with one another.

III. Similarity between corporate (solvency) and insolvency governance: key actors and economic relations

In terms of the key economic actors, this research argued that shareholders, directors/managers and (other) third parties (such as e.g. consumers) can be described as the key economic players during the solvency of the debtor-company. If the company becomes insolvent or is on the brink of insolvency, the crucial actors (replacing the aforementioned ones) were stated to be the unsecured creditors, the office-holders and, again, third parties (such as the community or employees). These economic actors – although being in a different legal position – are economically in a very similar position (albeit at different times). More in particular, while the shareholders are considered the residual risk-bearers as long as the debtor-firm remains solvent, unsecureds “take over” this role once the company enters into financial difficulties as at that moment there will not be sufficient money to pay off all the creditors by virtue of being insolvent or on the brink of insolvency. When it comes to the management of the company, office-holders take over from the incumbent management unless the previous directors/managers are able to continue managing the debtor-firm themselves (such as during a CVA or IVA). And both solvent but also insolvent companies enter into contracts with third parties, creating a wide variety of both voluntary and involuntary relationships between the debtor and, often, “outsiders”

Having established the similarity between economic actors, it follows that the economic relations which manifest themselves between these actors within and/or with company are relatively similar too. Whilst the relations between the company and other stakeholders (often, outsiders)
can be compared, the most important relations focused on as part of this research are the ones between shareholders and directors on the one hand and, certainly, between majority/controlling and minority/non-controlling shareholders on the other hand. Namely, while shareholders are argued to have an economic (but no legal) relation with directors, the same could be said about the relation between unsecured creditors and either the office-holder or the incumbent management. Likewise, the relation between shareholders – and more in particular controlling and non-controlling shareholders is analogous with the relation between controlling and non-controlling unsecured creditors.

This analogy between corporate and insolvency governance gave new insight into insolvency governance and allowed this research to provide a more accurate determination of the (non-)controlling position of an unsecured creditor and which allowed this research to formulate an answer to the first research question (cf. infra part IV). This, in turn, significantly contributed to suggesting regulatory reforms that would enhance the protection of those unsecureds who are actually in need of additional protection (cf. infra part V). In doing so, this research argued that any reform would have to be compliant with three crucial insolvency values – efficiency, fairness and accountability.

IV. Determination of unsecured creditor’s non-controlling position

As stated above, the innovative determination that there is an analogy between shareholders of a solvent company on the one hand and the unsecureds of an (almost) insolvent debtor-company on the other hand enabled this research to define a controlling unsecured as an unsecured who has got the ability to influence the outcome of the insolvency procedure. A non-controlling unsecured would thus lack this ability and would arguably be in a more vulnerable position vis-à-vis the controlling unsecured(s) and the debtor.

Whilst previous research has merely focused on general factors such as the nature of a creditor’s claim (e.g. consumer claim) or the lack of an unsecured’s financial resources to determine vulnerability, the more concrete/practical factors (e.g. the ability to form a coalition of unsecureds) have only been given scant attention.

Merely focusing on the abstract factors and thus failing to take into account the more concrete factors when assessing an unsecured’s vulnerability creates the risk that certain vulnerable creditors do not get the protection they deserve whilst other creditors could end up receiving protection which they may not need. Henceforth, it was submitted that a more practical/concrete approach ought to be taken to determine the unsecureds’ vulnerability. This

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1150 For example, if the nature of their claim (e.g. a small trade creditor) would ipso facto determine that such a creditor should get additional protection, even though they could be in a controlling position if concrete factors (e.g. exercising of voting rights) would be taken into account.
research, therefore, argued that it was important to have regard to these abstract/general indicators in conjunction with the more concrete/practical situation.

Ascertaining which unsecured is non-controlling and, thus, arguably weaker is critical because cases (such as Kapoor) illustrate that control could be exploited or at least used inefficiently in which case the non-controlling unsecureds’ position could be jeopardised. In case of exploitation there would be a deliberate attempt to bypass the pari passu principles by the controlling unsecured whilst inefficiency would merely result from an inadequate usage or, perhaps, lack of appropriately utilising the control to the extent possible and needed by the controlling creditor. Nonetheless, in both inefficiency and exploitation situations a certain transfer of wealth from non-controlling unsecureds to controlling unsecureds would occur.

Consequently, this ability to accurately determine the non-controlling position of an unsecured is critical for those involved in the insolvency procedure, not in the least the incumbent management or the office-holder who should have regard to the creditors' interests when managing the debtor-firm. However, and more importantly perhaps, knowing that the vulnerability of a creditor does not solely hinge on some pre-existent general/abstract factors also allows us to suggest regulatory reforms which are more flexible and tailor-made aiming to provide protection for any faction of unsecureds that is non-controlling and in need of more protection.

This observation thus leads to the analysis of the second research question, namely whether the regulatory protection of non-controlling unsecureds ought to be enhanced and if so, how. To be able to answer this question, this research first examined what the current regulatory challenges were for non-controlling unsecureds before critically assessing how they could be overcome or, at least mitigated by enhancing the non-controlling unsecureds’ regulatory protection from both a governance and non-governance perspective.

V. Contemporary challenges and regulatory suggestions

Starting with these currently still existing challenges for non-controlling unsecureds, this research showed that there are still various legal and economic concerns which have not been appropriately addressed and which particularly affect the non-controlling unsecureds.

First, as indicated above, it is often difficult to determine which unsecureds are more vulnerable. Vulnerability is often determined based on abstract factors such as the nature of a creditor’s claim (i.e. government or consumer claim etc..) rather than the actual non-controlling position an unsecured creditor may find him-/herself in. This is a problem that not only occurs in statutory legislation (i.e. by giving a preferential position to a certain creditor such as the HMRC) but also
in the insolvency literature whereby the nature of the creditor’s claim is very often used by legal scholars to argue that certain vulnerable creditors need further protection. By focusing on the nature of the creditor’s claim this scholarly debate, however, errs and creates an inaccurate duality between those scholars in favour of the creditors’ bargain theory who argue that almost no additional protection would be needed for allegedly weaker creditors and those in favour of other insolvency theories such as, inter alia, stakeholderism and communitarianism whereby the distinguishing factor between the latter theories merely lies in the question how many creditors ought to receive further protection but where the nature of the claim (e.g. consumer claim, employment claim etc..) is usually still seen as the critical factor in order to assess whether additional protection ought to be granted or not. This research, however, innovatively argued that such an inaccurate assessment of the potential vulnerability of unsecureds risks advancing/improving some creditors’ interests when this may not be appropriate or necessary whilst other unsecured creditors, in an equally or more vulnerable, could risk losing such additional protection.

Second, the statutory procedures with regard to ex ante control and ex post remedies such as inter alia liability, claw-back and unfair prejudice procedures often require various conditions (incl. thresholds) to be met. This is commonly quite difficult to achieve, especially for small and rather vulnerable unsecureds.

Thirdly, in contrast to corporate governance where a lot of attention has been given to shareholder empowerment/engagement, no similar attention has been given to creditors’ activism as part of insolvency governance. Consequently, often high thresholds have to be satisfied for creditors to requisition (and participate in) a creditors’ meeting which makes creditor involvement especially difficult for weaker/non-controlling unsecureds.

Fourthly, this research also showed that information-asymmetry causes significant problems for weaker unsecureds. The latter unsecureds often require further financial/legal information and explanation about both the actions taken by the management/office-holder on the one hand and the options (such as forming a coalition of creditors or remedies) they have at their disposal during the insolvency procedure.

Finally, the aforementioned concern is exacerbated by the economic costs of getting involved in the insolvency process by e.g. monitoring the performance of the management/office-holder and, if needed, the attitude of other unsecureds. These costs may very easily outweigh the benefits these unsecureds stand to gain from their involvement, especially if their claim is relatively small.
These are some of the major issues that highlight the precarious position of non-controlling unsecureds but also indicate the need for tailor-made reforms. This is especially so because of the difficulty or, perhaps, impossibility in ex ante covering all potential situations where an unsecured could be non-controlling.

Considering the need to have a flexible and tailor-made insolvency framework which would also be grounded in the insolvency values (i.e. efficiency, accountability and fairness), this research advocated for a mixture of regulatory reforms in response to the second research question.

In contrast to previous literature in which governance rights were only given scant attention, this research submitted that governance rights play an important role in enhancing the position of non-controlling unsecureds. These governance rights intend to align the interests of the unsecureds, and in particular, the non-controlling unsecureds with the interests of the management/office-holder. This alignment ought to improve managerial performance by enhancing accountability which should positively impact the dividend outcomes for weaker unsecureds. As part of these governance-related reforms, this research examined the directors’/office-holders’ duty on the one hand and the rights of unsecureds on the other hand. As regards the directorial duty, it was advocated that the information-asymmetry between unsecureds and the management/office-holders ought to be bridged by enhancing transparency and, more in particular, providing an accurate explanation as regards the managerial decisions taken, the reasons behind them and how it would affect the particular unsecureds. From the unsecured creditors' perspective, more creditor involvement to monitor both the management and/or the attitude of controlling unsecureds was argued to be important. Analogous to corporate governance, it was submitted that unsecureds should have easier access to creditors’ meetings through lower thresholds. Similar to shareholders it was also contended that derivative actions should be open to them once their debtor is on the brink of insolvency.

Nonetheless, although these reforms would be beneficial, solely relying on private enforcement would, arguably, not be sufficient due to high economic monitoring/controlling costs and the expected continued inertia of non-controlling unsecureds. Hence, more reforms seemed to be required to appropriately enhance accountability and fairness. Therefore, this research submitted that there was also a need for a public enforcement regime. This would mean that a public regulator/ombudsman would also oversee the performance of directors which should relieve creditors to some extent. As regards office-holders, this research also defended the creation of an ombudsman which would act in cooperation and co-existence with the control exercised by the RPBs whereby it was suggested to centralise all RPBs into one single RPB.
Arguably, such public enforcement would stimulate directors to perform well, grant an additional avenue for creditors to complain if they do not agree with such directorial performance and would complement the other measures suggested above to enhance the protection of unsecureds. Especially, non-controlling unsecureds would benefit from public enforcement for there would be effective control and oversight as regards the office-holders’ and managers’ performance whilst the vulnerable groups of creditors would not (or only to a lesser extent) bear the risks of having insufficient information, financial resources, knowledge, time, voting rights, bargaining powers etc..

Although these governance-solutions which up until now have not been properly examined from an insolvency perspective are important to strengthen the position of weaker unsecureds and to increase the chances of them receiving a dividend as high as possible\textsuperscript{1151}, several challenges still remain. Consequently, despite the importance, solely relying on governance-solutions would not be an iron-clad solution. For example, whilst governance-related solutions may enhance managerial performance, it may sometimes still be required to curtail the dividend rights of some unsecureds (e.g. landlords) and not of others in order for a CVA, for example, to succeed and for the debtor-company to be restructured. Therefore, other non-governance solutions seem still required to improve the position of vulnerable unsecureds beyond improved governance-solutions.

Although a significant amount of literature has focused on examining whether the preferential (dividend) position of certain vulnerable unsecureds should be expanded to more vulnerable groups or whether insurance would have to be made mandatory for directors, this research only argued, to some extent, in favour of the usage of trusts and trust accounts. Despite the existence of several drawbacks as regards such trusts/trust-accounts, this research contended that they could still provide some solace to weaker unsecureds. In this regard, an insolvency trust funded by charging a levy on every company at the moment of incorporation and/or every individual who has been convicted\textsuperscript{1152}, could be set up to try to ensure that the current drawbacks regarding insolvency litigation would be mitigated by enhancing the opportunities for unsecureds to file a claim (e.g. against the former management for alleged breaches of their duties). This would \textit{inter alia} be important from both an accountability and fairness perspective. In this regard, it was also submitted that the creation of a trust-account for the non-controlling group of unsecureds could be subsumed under the general fiduciary duty of directors to act in the interests of the company for the benefit of creditors. This would take into account the difficulties directors may face to determine \textit{ex ante} whether creditors are non-controlling and,

\textsuperscript{1151} Of course, confined to the limits of their claim.
thus, in need of more protection whilst at the same time mitigating the risks to which vulnerable unsecureds could be exposed to. Again, it would not be the aim to repay the entire creditor’s claim but rather to ensure that the pari passu principle would be upheld and that every unsecured would have her claim reduced to the same extent.

VI. Conclusion

To conclude, it remains a sad fact of life that when a debtor becomes insolvent, there are insufficient assets to cover all creditors’ claims. Nonetheless, Insolvency Law aims to ensure that all unsecureds obtain at least the highest pro rata portion of their claim possible. Severable principles have been introduced in that regard such as the anti-deprivation rule and the various procedures to swell the asset pool.

Nonetheless, by examining the position of the unsecured from a governance-perspective, this research showed that significant challenges continued to exist for all the unsecureds with some weaker unsecureds being subject to even more risks than their fellow unsecureds.

In order to ensure that all unsecureds are treated equally and that those who are non-controlling or more vulnerable are made ‘less vulnerable’ or, thus, ‘equal’ to the other unsecureds a certain ‘leg up’ had to be provided. This research argued, in this regard, for several governance-related measures (e.g., enhancing creditors’ activism, refining the directorial duty, derivative actions for creditors and public enforcement through an independent insolvency governance-regulator) which ought to improve the position of the non-controlling unsecured without unnecessarily burdening the management/office-holder of the debtor-company. The latter is in line with both the efficiency and accountability value. In addition, as a non-governance suggestion, the creation of a public trust (to fund insolvency litigation) and the usage (such as in the Kayford case) of trust accounts by directors could be helpful although to guarantee that creditors see their entire claim repaid but merely to restore the pari passu-principle and uphold the fairness principle..

Consequently, in having put forward these governance-related suggestions which were innovatively examined from an insolvency governance-perspective, this research has attempted to drive forward the debate as regards protection of unsecureds by providing suggestions that are deemed efficient and fair whilst enhancing managerial accountability. Nonetheless, the debate ought to continue and further research would still be advised. In particular, whilst this research focused on the laws of England and Wales, the potential vulnerable/non-controlling position of international creditors of insolvent debtors under Private International Law has not been examined as part of this research. Nonetheless, it would be worthwhile examining if and to what extent international creditors could be non-controlling and whether additional protection
ought to be advocated given their international position. Furthermore, more research regarding the accountability of office-holders and public enforcement should, arguably, be undertaken and an analysis into the similarities and differences between concentrated/dispersed ‘ownership’ at shareholder and unsecured creditor level and particularly the implications of such concentrated/dispersed creditor governance would also be very useful to get an even more detailed understanding of insolvency governance.
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