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COMMENTARY ON AGHION, HART, AND MOORE, *IMPROVING BANKRUPTCY PROCEDURE*

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It may be regarded as an act of immoderate temerity—or indeed sheer folly—that a mere black-letter lawyer, and admitted nonimbiber at the Law and Economics fountain, should venture to comment upon this paper.¹ However, in view of the fact that the authors claim—quite accurately—that a previously published version of the proposal advanced in their paper is currently under consideration in the United Kingdom as part of the government-inspired review of insolvency law,² perhaps some remarks are in order, at least from the perspective of U.K. law.

It is true that the authors' earlier paper³ has been actively discussed at various seminars and consultative meetings involving official representatives of the Insolvency Service and its Policy Unit, on whom will fall the burden of preparing and promoting any legislative reform measures which are in due course laid before Parliament. From my personal observations in the context of some of those discussions, however, I would consider it most unlikely that their radical model for determining the fate of insolvent companies will be incorporated into any legislative proposals that emerge from the current review. From the standpoint of most of the interested parties involved in the operation of U.K. insolvency law, Aghion, Hart, and Moore's suggested process of mandatory transubstantiation, whereby debt is converted into equity "on the stroke of midnight," as it were, is likely to prove too daunting both in conceptual and in practical terms. It is one thing, perhaps, for a major creditor—such as a financial institution—to agree to convert a portion of outstanding debt into equity as part of a negotiated solution to the debtor company's financial difficulties. It is quite another thing for all categories of creditor to wake up and discover that they have become overnight the "owners" of their debtor, due to its inability to meet its cumulative liabilities. The further elements of the

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1. Philippe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849 (1994).

2. *Id.* at 850 n.4.

3. Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. & ECON. 523 (1992).

proposal, involving the formulation of bids for the company from various categories of its erstwhile creditors (now designated as its equityholders), seem to hold little promise of operating properly in the real world, where markets are nothing if not imperfect, and the personal affairs and judgments of the parties who find themselves locked into this bidding process—as though engaged in some surreal game of poker—will inevitably generate internal conflicts and tensions, precluding the attainment of the “idealized” or “perfect” solution so beloved by economic theory.

Not only does the proposal encounter objections of a practical nature, as suggested above, but it also attracts the serious charge of threatening injustice through expropriation of those creditors who cannot afford to furnish further value as part of the required bid. According to the authors, such parties, having “had their chance” to participate in the eventual revival of the enterprise, thereby forfeit all further entitlement to recovery of the debt originally due to them, almost like poker players who “fold” when the bidding rises to an uncomfortably high level. The injustice which thereby is done to such parties, if the company’s business is indeed revived to prosperity, is that this will have taken place due in part to the “free ride” gained from the value that those unpaid creditors originally supplied to the company, and for which neither it nor—by extension—its new equity owners have ever had to pay. Of course, the existing law concerning rights of secured creditors and the ranking of priority between different types of unsecured creditors ensures that in many cases the ordinary, unsecured creditors emerge empty-handed from a liquidation. But in a rescue scenario, the interests of these creditors cannot be so cynically ignored, since they are fully entitled to vote on any scheme or proposal prior to confirmation. In some circumstances, therefore, these creditors can exert considerable leverage during the process of negotiating the final terms of the settlement, a prospect they would lack under the authors’ “poker-hand” proposal.

A further matter to be noted is that there are important differences—structural, substantive, and also cultural—between the U.S. Chapter 11 procedure and the U.K. Administration Order. In proffering the same proposal to both legal systems, the authors seem to overlook these differences. Thus, the central role allocated to the judge under their proposal, including the evaluation of bids and the final decision of which to accept, would be distinctly at odds with the U.K. tradition, under which the judge does not “run” the case after the first granting of an administration order has occurred. All the evidence suggests that English judges are less than comfortable when coerced into the role of making commercially

sensitive decisions about the prospects for viability of an ailing company, given that the ultimate consequences of their judgment are borne by the creditors and investors currently encaged by the company's plight. The contrast with the world of Chapter 11, in which virtually every stage *apart from* the initial filing is actively court-driven, could not be more stark. Likewise, the class-based voting on plan confirmation by creditors under Chapter 11—on which the authors' concept of the bidding process appears to be modelled—is conspicuously *unlike* the unified voting by the general meeting of creditors in administration proceedings, and indeed in Company Voluntary Arrangements concluded under Part I of the Insolvency Act 1986. One therefore experiences considerable difficulty in envisaging the proposal in its current form being implanted in the U.K. insolvency system.

To conclude on a more positive note, it must be acknowledged that the authors have successfully pinpointed the many unsatisfactory features of traditionally evolved systems of insolvency law, such as those of the United Kingdom and the United States, wherein the forces of expediency and political response to “hard” and “special” cases have resulted over time in an inconsistent mish-mash of rules generative of numerous, significant exceptions to proclaimed principles (including, above all, the principle of full equality among all creditors). The case for a full and fundamental reappraisal of insolvency law is a compelling one, and this paper is a timely reminder of the need to address this challenge in a way which combines a commitment to properly balanced justice on the one hand, with a regard for what is in tune with the realities of the community of debtors and creditors on the other. No one should underestimate the magnitude of the task confronting us.

