Chicago-Kent Law Review

Volume 93
Issue 3 *Comparative and Cross-Border Issues in Bankruptcy and Insolvency Law* | Article 8

9-18-2018

Market Organisations and Institutions in America and England: Valuation in Corporate Bankruptcy

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MARKET ORGANISATIONS AND INSTITUTIONS IN AMERICA AND ENGLAND: VALUATION IN CORPORATE BANKRUPTCY

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I. THE DEBATE

This paper is about the valuation of a financially distressed business for the purpose of determining the allocation of equity in exchange for existing debt claims in a large corporate debt restructuring. In the United States, if a company in chapter 11 is proposing to exchange debt for equity, a body of common law precedent has developed to establish how the enterprise is to be valued in deciding which creditors should receive equity, and in which proportions. Crucially, the Supreme Court has discouraged bankruptcy courts from reaching decisions on value based on exposure to the market.[1] Typically, each group of creditors is mandated to receive equity in exchange for debt, and the existing shareholders appoint professional valuers to value the enterprise based on traditional valuation techniques, of which the most important is probably the discounted cash flow, or DCF, method.[2] Each of the valuation experts puts forward her opinion on value, and the bankruptcy judge ultimately decides between the views expressed.

In England, debt restructuring via a court process to achieve a debt-for-equity swap is, for reasons discussed later in this paper, a more recent phenomenon. To the extent that it has occurred, the English courts have tended to determine whether to approve the allocation of equity in the debt restructuring by reference to the amounts that creditors would have received if no restructuring had been agreed. The company has argued that either the business will be sold by an insolvency practitioner as a going concern, or that it will be broken up and the assets sold separately by an insolvency practitioner. Typically, some evidence of exposure of the business and assets to the market will be submitted to identify the value which would be achieved in the relevant "counterfactual scenario."

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1. Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 425.

2. E.W. (Sandy) Purcell, *Distressed Valuation*, 6 INT'L CORP. RESCUE 17, 18–20 (2009).

The author has already written extensively about the debate surrounding which of these two approaches is to be preferred, considering the theoretical roots of each approach and the influence which each could have on the market for credit for healthy companies in the economy.[3] However, this paper takes a different approach. In an influential piece in 2006, Baird and Bernstein highlighted the way in which the uncertainty posed by valuation litigation in chapter 11 was designed to encourage consensual bargaining between the parties.[4] This paper argues that this was indeed the case in the historical roots of what we might call the "bargaining and litigation" model in the United States and remained the case when chapter 11 was introduced in the 1970s. However, it argues that changes in the institutional environment mean that it is no longer the case, with implications for reform in America and England.

This is particularly relevant at the present time. In England, the Insolvency Service launched a review of the corporate insolvency framework in the United Kingdom in 2016 (and has published many of the responses which it received to the consultation),[5] and the European Commission has published a proposal for a new directive setting minimum harmonisation standards for restructuring law.[6] Both the consultation and the proposal consider the possibility of introducing new tools into the legislative scheme to implement a debt restructuring, and both ponder the question of which approach to valuation should be adopted. In particular, the European Commission proposal seems to contemplate adopting the U.S. approach. At the same time, the American Bankruptcy Institute Commission to Study Reform of Chapter 11 has suggested reforms to the approach to valuation which appear to reinforce the commitment to bargaining and litigation.

The paper proceeds as follows. Part II traces the main contours of significant organisational change in the finance market in America and England, and the impact on debt restructuring. Part III identifies the

3. *See generally* Sarah Paterson, *The Adaptive Capacity of Markets and Convergence in Law: UK High Yield Issuers, US Investors and Insolvency Law*, 78 MOD. L. REV. 431 (2015); Sarah Paterson, *Rethinking Corporate Bankruptcy Law in the Twenty-First Century*, 36 OXFORD J. LEGAL STUD. 697 (2015); Sarah Paterson, *Debt Restructuring and Notions of Fairness*, 80 MOD. L. REV. 600 (2017).

4. Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1968 (2006).

5. THE INSOLVENCY SERVICE, A REVIEW OF THE CORPORATE INSOLVENCY FRAMEWORK: A CONSULTATION ON OPTIONS FOR REFORM, (2016) (U.K.), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525523/A_Review_of_the_Corporate_Insolvency_Framework.pdf [https://perma.cc/R8LM-JNSW].

6. *Commission Proposal for a Directive of the European Parliament and of the Council on Preventative Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU*, at 5–6, COM (2016) 723 final (Nov. 11, 2016) [hereinafter *Commission Proposal*].

consequences for what the paper calls the "institutional order," used here in the sense in which the institutional economists use it as including formal rules (law) and informal norms of behaviour which influence market organisation and affect corporate bankruptcy outcomes.[7] The paper argues that the changes in organisational and institutional structure have fundamentally altered the incentives to bargain which are otherwise provided by the valuation approach in chapter 11, and that as a result there may be both a case for reform in the United States, and a case for adopting a different approach in England and Europe. Part IV puts forward a tentative proposal for a different approach in which bargaining is mandated and evidenced. The paper then concludes.

II. ORGANISATIONAL CHANGE IN THE FINANCE MARKET

Restructuring the debts of large corporates with complex capital structures gets its start in both England and America in the great age of railway construction in the nineteenth century. However, the emerging organisational structure of finance differed markedly between the two jurisdictions, and this was to have significant implications for the evolution of debt restructuring practice. The first crucial difference is the sources of capital and the ways in which they were intermediated. Before the development of regional securities markets in England, so-called railway projectors typically retained local solicitors to connect them with local potential investors.[8] These local solicitors also acted as intermediaries between the railway projectors and the landed classes over whose land the railway needed to be built.[9] As nascent securities markets began to develop in England, lawyers played a crucial role in establishing the railway companies for investment and, later, lent their names to efforts by so-called company promoters to raise capital. Two things are particularly crucial about this early organisation of the market. First, the local solicitor was heavily involved in efforts to raise capital but was not involved in looking after the interests of investors after the capital was invested. Secondly, the capital was raised largely from domestic investors: provincial merchants, farmers and local gentleman who were known to, and approached by, the local solicitor lending his name to the capital raising.

7. DOUGLASS C. NORTH, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE 121, 133, 170 (2005).

8. R.W. KOSTAL, LAW AND ENGLISH RAILWAY CAPITALISM 1825–1875, at 16 (1994).

9. *Id.*

Both the sources of capital, and the way in which capital raising was intermediated, took a very different path in America. In the nineteenth century, America was firmly a debtor nation: raising capital for significant development, including the construction of railway infrastructure, from overseas investors, notably English investors.[10] Nonetheless, raising English capital raised a number of significant challenges: default by American states on their debts somewhat damaged America in the eyes of her potential English investing class,[11] and the appetite of London investors varied with the fortunes of American harvests and war.[12] There was no well-respected, local solicitor in a neighbouring town to lend his name to the promotion effort, but, as in England, financial markets were undeveloped. Into this fray stepped the early American investment bankers, most notably J.P. Morgan. Yet the first crucial difference between the American investment banker and the English local solicitor was that the former did not confine his role to the raising of capital but saw it as a crucial part of his role to monitor the business after investment and, as we shall see, if necessary to step in after default. In the words of Ron Chernow, the American investment banker transitioned from "a passive figure issuing shares for companies to a strong, active force in managing their affairs."[13] And the capital, of course, was raised not from domestic investors but from international ones.

At the same time, the early financial organisation emerged in different political contexts. As Bruce Mann has compellingly demonstrated, early corporate bankruptcy law and organisation emerged in America as the young republic emerged. First, American debtors were in many cases building the new republic with credit raised overseas, or at the very least from out of their state, so that the founding fathers saw local interests vulnerable to the demands of English creditors, and state legislators saw local interests vulnerable to the demands of out-of-state creditors.[14] Secondly, American farmers emerged as a distinct interest group, of concern to the founding farmers, unlike the tenant farmers of the landed, parliamentary class in England. Finally, American debtors were mobile, migrating west as opportunity beckoned or the local economy failed, and labour was, in any event, in short supply.[15]

10. MARTIN MAYER, THE BANKERS 58 (1974).

11. RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 5 (1990).

12. *Id.* at 11.

13. *Id.* at 31.

14. BRUCE H. MANN, REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE 136 (2002).

15. *Id.* at 128–29.

Perhaps for all of these reasons, early American bankruptcy law subordinated the interests of creditors to the court and to court-appointed assignees.[16] In England, in contrast, the political economy of the industrial revolution saw an uneasy alliance between the manufacturing class and the landed class,[17] with a dominant ideology of laissez-faire. Although England's first experiment with a bankruptcy system in the hands of private actors was to be curtailed in 1883,[18] it set a tone of private action on behalf of creditors when a debtor became insolvent which has distinguished English corporate bankruptcy ever since. The initial experience of "privatised" corporate bankruptcy, together with the fact that the English system for raising credit for railroads had not involved an intermediary who saw an ongoing role on behalf of investors, both created an environment in which the newly emerging accountancy profession could find significant and remunerative work in the corporate bankruptcy field.

Thus, when the unstructured and competitive process of building railroads resulted in busts in both America and England, each jurisdiction approached the problem in a distinct way, which, in both cases, was to lay enduring foundations for large corporate debt restructuring a century later. In America, the courts, the investment bankers and the managers of the railroads cooperated together in reorganisation through the equity receivership.[19] In an equity receivership of a distressed railroad, the creditors petitioned the court to place the railroad into receivership and the court would appoint the railroad managers to act as receivers. The objective of the receivership was to persuade the railroad's bondholders to take receivership certificates in exchange for their debt claims. Lawyers at the emerging bankruptcy bar played a crucial part, both being named as the receivers and receiving handsome fees under the auspices of the bankruptcy court.[20] J.P. Morgan, and other investment bankers in his mould, would gain control of the railroad reorganisation committee in order to monitor the case for the purposes of his investors (charging handsome fees in the process). But crucially for current purposes, the court upheld the idea of "upset value" in order to persuade junior bondholders to provide new money. In other words, even

16. ROWENA OLEGARIO, THE ENGINE OF ENTERPRISE: CREDIT IN AMERICA 73 (2016).

17. E.P. THOMPSON, THE MAKING OF THE ENGLISH WORKING CLASS 195 (Penguin Books 1991) (1963).

18. V. MARKHAM LESTER, VICTORIAN INSOLVENCY: BANKRUPTCY, IMPRISONMENT FOR DEBT, AND COMPANY WINDING-UP IN NINETEENTH-CENTURY ENGLAND 170 (1995).

19. OLEGARIO, *supra* note 16, at 112.

20. WILLIAM D. COHAN, MONEY AND POWER: HOW GOLDMAN SACHS CAME TO RULE THE WORLD 41 (2011).

at the end of the nineteenth century, the threat of valuation fights as motivation for bargaining is clearly visible.

In England, on the other hand, early railroad restructurings proceeded voluntarily, using arbitration as the principal method of reaching agreement.[21] In 1862, the Companies Act "empowered a liquidator, with" court sanction, "to enter into compromises with creditors."[22] Various reforms to the procedure followed, but it was only in 1907, following the report of the Loreburn Law Amendment Committee,[23] that the requirement that the company be placed into liquidation was dispensed with. However, this appears to have been more as a matter of procedure and convenience than of substance, and it is perhaps unsurprising that schemes were subsequently to be assessed against the counterfactual of a liquidation. Indeed, that is how they got their start: just as an individual bankrupt could avoid bankruptcy by reaching a compromise with his creditors, so a company could avoid liquidation by agreeing a compromise with its creditors. Furthermore, whereas J.P. Morgan and the great investment bankers of his day dominated large corporate restructuring in America, the newly created accountancy profession was very much involved in large corporate restructuring in England. Thus, the firms of Harding, Pullein, Whinney & Gibbons and Turquand, Youngs, predecessors of the modern-day Ernst & Young, earned particularly lucrative fees from the failures of Overend & Gurney and the European Bank. However, the work of the accountant in England in these large corporate restructurings largely involved realising assets for the benefit of creditors or, later and in the case of so-called industrials such as breweries, in the reconstruction of operations.[24] In contrast, J.P. Morgan lowered the railroad's fixed costs by exchanging bonds into shares, issuing the new equity based on the predicted earnings of the reconstructed railroad.[25] Morgan would subsequently establish a voting trust to run the railroad; as Chernow puts it, "Remote from the scene, the capital providers, the London investors, had ceded much of their power to the banker, Pierpont Morgan."[26]

21. Michael Lobban, *'Cutting the Gordian Knot?' Arbitration and Company Insolvency in the 1870s*, *in* LAW AND LEGAL PROCESS: SUBSTANTIVE LAW AND PROCEDURE IN ENGLISH LEGAL HISTORY 283, 283 (Matthew Dyson & David Ibbetson eds., 2013).

22. JENNIFER PAYNE, SCHEMES OF ARRANGEMENT: THEORY, STRUCTURE AND OPERATION 7 (2014).

23. *See generally* COMPANY LAW AMENDMENT COMMITTEE, REPORT OF THE COMPANY LAW AMENDMENT COMMITTEE, 1906, [Cd. 3052] (U.K.).

24. EDGAR JONES, ACCOUNTANCY AND THE BRITISH ECONOMY 1840–1980: THE EVOLUTION OF ERNST & WHINNEY 98 (1981).

25. ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 183–84 (1993).

26. RON CHERNOW, THE DEATH OF THE BANKER: THE DECLINE AND FALL OF THE GREAT FINANCIAL DYNASTIES AND THE TRIUMPH OF THE SMALL INVESTOR 24 (1997).

American manufacturers relied heavily on retained earnings for development at the start of the twentieth century.[27] In his path finding work, Alfred Chandler analysed the revolutionary changes to American industry at the end of the nineteenth century. He charted the process of growth by forward and backward expansion which produced giants of American industry, adopting mass production and mass distribution techniques which generated impressive cash flows to finance expansion at a time when the new required machinery was inexpensive.[28] The firms relied on cash flow supported by short-term loans from local commercial banks to provide working and fixed capital.[29] However, where firms adopted a merger path towards expansion, it was necessary to go to the capital markets for funds: American Cotton Oil, American Sugar, National Lead, and National Cordage all issued common stock but also preferred stock secured by fixed assets.[30] Moreover, some of the early industrial behemoths demanded costly machinery and intensive use of energy with higher capital costs. The highly centralised and institutionalized capital markets, which had developed in America in the 1850s to raise capital from overseas investors for the construction of the railroads, were now available for the rapidly expanding industries which required them, and bankers, brokers and investors were all looking for new securities to buy and sell.[31] Morgan was standing by to perform his habitual coordination role, able to access significant pools of capital to finance the mergers.[32] By the 1890s, America was enjoying buoyant conditions in its capital markets, but financial failures were to follow. Whilst some firms went into receivership and were subsequently liquidated, investment bankers such as Morgan continued their role as a financial intermediary who would step in to coordinate a complex debt restructuring as circumstances required (or members of the bankruptcy bar would fulfil a similar function).

Thus, in 1907, Milliken Brothers, one of the country's largest steel contractors, was forced into receivership. August Heckscher, one of the receivers, together with Waddill Catchings, a lawyer with Sullivan & Cromwell, successfully proposed a restructuring of the company's debts (which included a $3 million bond), allowing it to emerge from bankruptcy.[33] In other

27. CHANDLER, *supra* note 25, at 298, 373.
28. *Id.* at 238.
29. *Id.* at 311.
30. *Id.* at 330.
31. *Id.* at 332.
32. CHERNOW, *supra* note 26.
33. COHAN, *supra* note 20, at 41.

words, although large industrial failure was relatively rare, where it did occur, complex debt restructuring continued to be visible throughout the early part of twentieth-century America.

Retained earnings were also the principal source of finance for manufacturers in England.[34] Whilst America's capital markets were enjoying buoyant conditions by the 1890s, only a handful of English commercial and industrial companies issued shares and debentures on the London Stock Exchange, notwithstanding its position as the leading stock exchange of the world.[35] Like many American firms, British industrials turned to local banks to provide required capital.[36] It appears that some local banks may have come to rely too heavily on certain local customers and to over-lend to these firms, resulting in a series of mid- and late-nineteenth-century bank failures of which the most significant (and devastating) was the failure of the City of Glasgow Bank in 1878.[37] Britain then experienced an unprecedented wave of bank amalgamations, as publicly organised banks set out to acquire privately owned banking firms.[38] A few large banks emerged who prized stability. As Cheffins puts it, "liquidity crises prompting bank failures in 1847, 1857, 1866 and 1878 heightened awareness among bankers of how vulnerable their businesses were to a loss of public confidence."[39] As a result, these banks had a bias in favour of liquid investments, lending short term loans (which they frequently rolled over) secured over the assets of the borrower. When British manufacturing and industrial companies did access the capital markets, it was more often to issue equities than debt securities.[40] Another important innovation at the end of the nineteenth century was the development of the floating charge in the English courts of Chancery. Although dissenters in the Loreburn Committee in 1906 recommended its abolition,[41] the floating charge emerged unscathed as a vital institutional force in the development of English corporate distress. Thus, when large corporates faced distress in England in the twentieth century, they typically found themselves negotiating with the major bank that had financed their operations pursuant to a debenture granting fixed and floating security over all of their assets and carrying the right to appoint a receiver to realise the business and assets as a

34. WILLIAM P. KENNEDY, INDUSTRIAL STRUCTURE, CAPITAL MARKETS AND THE ORIGINS OF BRITISH ECONOMIC DECLINE 124 (1987); BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 72, 78 (2008).

35. CHEFFINS, *supra* note 34, at 56.

36. KENNEDY, *supra* note 34, at 121.

37. *Id.*

38. CHEFFINS, *supra* note 34, at 70.

39. *Id.* at 90–91.

40. *Id.* at 205.

41. *See generally* COMPANY LAW AMENDMENT COMMITTEE, *supra* note 23.

going concern, or to break-up the business and sell the assets if a restructuring could not be agreed. Just as they had raised finance through private negotiation, so efforts to agree revised terms took place through private negotiation.

Although legal requirements for audit and publication of financial information grew slowly in twentieth-century Britain, banks wishing to convert to limited liability had had an obligation to publish balance sheets since 1879.[42] Banks, with their acute consciousness of the need for public confidence and the knowledge that a loss would limit their ability to make further loans, were constitutionally opposed to taking provisions and writing down debt. At the same time, manufacturers and industrials in Britain simply did not expand to the monolithic size of their American counterparts in the same numbers. As a result, the sorts of large corporate debt restructuring masterminded by the Morgans and other investment bankers in America were not a feature of the English market: bank and borrower would attempt to agree a rescheduling, sale of non-core businesses or assets, increases in interest rate, and the like, and, if that failed, a receiver would be appointed and, usually, the business sold. In the absence of financial intermediaries active throughout the life cycle of the firm, accountants played a crucial role not only as receivers but also assisting in negotiation efforts. After the collapses of insurance companies and railways in the nineteenth century, large corporate debt restructuring of the sort which continued to be practised in America virtually disappeared from the scene in England for almost a century. America, on the other hand, embraced the idea of restructuring a distressed company in order to return it to financial health.

The next significant milestone in organisational and institutional development in America has already been well-charted: the consequences of the New Deal reforms of the Roosevelt government in the 1930s.[43] In the febrile atmosphere of the time, all aspects of American investment banking and its power in the economy were in the line of fire. Most famously, Glass Steagall introduced sweeping reforms to split the business of investment and commercial banking,[44] and the Securities and Exchange Act of 1933 included new and wide-ranging disclosure obligations designed, amongst other things, to reduce the monopoly of information enjoyed by the investment banking community and the power which that information afforded them.

42. CHEFFINS, *supra* note 34, at 233.

43. DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 73–100 (2001).

44. CHRIS O'MALLEY, BONDS WITHOUT BORDERS: A HISTORY OF THE EUROBOND MARKET 11–12 (2015).

Corporate bankruptcy and debt restructuring did not escape the reformers' zeal. Of particular significance, reforms prevented the compromise of debt claims outside court. Outside the immediate field of corporate bankruptcy, other reforms were to have significant implications for the organisational and institutional structure of the American finance market. The first of these was the introduction of Regulation Q, which limited the interest banks could charge on demand deposits. This was intended to reduce competition amongst banks for deposits and increase stability but also enabled competitors outside the regulation to compete for funds, with particular consequences in the 1970s.[45]

Our account is then abruptly punctuated first by war and then by the extraordinary boom years of the 1950s and the 1960s. Large corporate debt restructuring unsurprisingly attracts very little attention in the historical record in any of these three decades. However, significant shifts were continuing to occur in the finance industry which were to have implications. In Cohan's history of Goldman Sachs, Gustave Lehmann Levy, who was in charge of Goldman's arbitrage business, is recorded as becoming "active in arbitraging of railroad reorganisation securities" with the advent of World War II and diminishing opportunities for more traditional forms of arbitrage.[46] Levy appears to have been encouraged by his friend (and competitor) Cy Lewis at Bear Sterns, who began contemplating buying railroad bonds, which were trading at a significant discount after the United States entered World War II, on the assumption that the United States would eventually win the war and there would be an urgent need to rebuild the railroad system.[47] Levy was active in assisting the Murchison brothers, who had bought up bonds of the Missouri Pacific railroad, which filed for bankruptcy in 1933. The reorganisation plan was, in the usual way, for the railroad's bonds to be exchanged into new securities of the reorganised company, but bond prices fluctuated significantly because of the sheer length of the bankruptcy proceeding—twenty-three years![48] The contours of modern distressed debt trading are clearly visible in these accounts of arbitrage business in the 1930s and 1940s.

In the "healthy" finance market, Regulation Q was placing banks under strain in the battle to attract deposits and prompted First National City Bank

45. OLEGARIO, *supra* note 16, at 125; MAYER, *supra* note 10, at 50; O'MALLEY, *supra* note 44, at 13.

46. COHAN, *supra* note 20, at 112.

47. *Id.* at 113.

48. *Id.* at 114–15.

to launch the negotiable certificate of deposit, or CD.[49] The crucial aspect of the CD was that it could be sold in the secondary market, and a rostrum of hungry financial institutions with an eye on trading became active in buying and selling CDs: Discount Corporation of America, Salomon Brothers and First Boston Corporation. Mayer explains how the CD solved the problem of Regulation Q:

> What the CD had going for it on the open market was the chance to get around the Fed's ceiling on interest rates on short-term deposits. Issued at 3 percent per annum, a six-month CD could be bought in a secondary market four months after it was issued; it would then, in effect, be a sixty-day time deposit paying three times the maximum interest rate the Fed allowed banks to offer.[50]

American corporations began to issue commercial paper, borrowing from the emerging institutional investor class—insurance companies, pension funds, university endowments, and the like—largely as a substitute for bank loans, which were suffering as a result of the consequences of Regulation Q. Provided that the paper had a maturity of less than 270 days, it did not require registration under Securities and Exchange Commission regulations. As "disintermediation" began to occur in the finance market, banks turned from focusing on asset management (attracting deposits) to liability management (borrowing in the increasingly deep and liquid markets),[51] supported by the growth of a market for banks to lend money to each other.[52] This interbank market developed in part as dollar deposits built up outside the United States as a result of the cap on interest rates at home and efforts by the U.S. government to prevent the outflow of dollars in the form of the Interest Equalisation Tax, which encouraged anyone who had a dollar deposit outside the United States to keep it there.[53] This played a crucial role in the ongoing expansion of London as a financial centre and, more broadly, globalisation of the finance market.

The end of fixed commissions in 1975 heralded a new era of out-and-out competition.[54] Banks competed vigorously to appear in positions indicating seniority of role in advertisements and issue documents, in order to

49. MAYER, *supra* note 10, at 192; O'MALLEY, *supra* note 44, at 59.

50. MAYER, *supra* note 10, at 193.

51. *Id.* at 376.

52. O'MALLEY, *supra* note 44, at 14.

53. L.J. DAVIS, BAD MONEY 84 (1982); MAYER, *supra* note 10, at 456, 478–80; O'MALLEY, *supra* note 44, at 26.

54. CONNIE BRUCK, THE PREDATORS' BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND RAIDERS 63 (Penguin Books 1989) (1988).

gain coveted league table places. In previous decades, underwriters of securities issues had been listed on tombstones in a preordained hierarchy governed by strict procedural rules.[55] Mandates were no longer won on the back of carefully cultivated relationships, but on price.[56] Crucially, for us, over the next two decades, risk was to develop, as Cohen elegantly puts it, "as a competitive measure."[57] As it became more difficult to make money in traditional banking, attention turned to trading.[58] The rise of the institutional investor also contributed to the rise of the trading house, as the number of workers with company pensions exploded,[59] and mutual funds and investment funds sought to buy and sell large blocks of securities.[60] Trading houses put their capital to work, buying large blocks of securities from clients on the assumption that they would be able to sell the securities on at a higher price. These emerging trading houses had breath-taking capital requirements to carry the federal, municipal, and corporate debt securities in which they made markets, bringing further focus on sources of liquidity and driving further innovation in the finance market. Repurchase agreements, or repos, developed as a vital source of liquidity for the traders. It is during this era of rapid innovation in American finance that many of the cooperative practices of the past were replaced by the competitive practices of the future.

Attitudes to debt were also changing. Academic work played a vital role, notably Modigliani and Millar's theory of capital structure and price and (perhaps more significantly) W. Braddock Hickman's study of the low-grade bond market, in which he argued that a large, well-diversified portfolio of low-grade bonds outperformed a higher-grade portfolio over the long term.[61] Innovators built on this academic work. Towards the end of the 1970s, Michael Milken, an investment banker at Drexel Burnham Lambert, developed subordinated debt as another option for low-rated companies besides borrowing short term money from banks on a senior secured basis with restrictive covenants and diluting existing equity through further equity issues. This was to be the first vital step towards highly complex capital structures.[62] And, as William Cohan points out, Lew Ranieri's innovation at Salomon Brothers in 1977 was ultimately to shift American finance from

55. *Id.* at 30.
56. O'MALLEY, *supra* note 44, at 75.
57. COHAN, *supra* note 20, at 361.
58. BRUCK, *supra* note 54, at 65.
59. SEBASTIAN MALLABY, MORE MONEY THAN GOD: HEDGE FUNDS AND THE MAKING OF A NEW ELITE 52 (2010).
60. COHAN, *supra* note 20, at 146; MALLABY, *supra* note 59, at 53.
61. BRUCK, *supra* note 54, at 28.
62. *Id.* at 45.

knowing the buyer or seller of an investment, to merely focusing on the transaction.[63] Ranieri's idea was that Salomon could buy up mortgage loans from local banks and package them together, selling the resulting securities: what we know today as securitisation. The development of securitisation was absolutely fundamental to a profound shift in the finance market. Before securitisation, a bank lending money to a home owner would hold that loan to maturity. After securitisation, what mattered for the bank was the ability to sell the loan to a securitisation vehicle, which could then fund it by the issue of bonds. Securitisation was followed by other innovations, such as collateralised debt obligations and collateralised loan obligations (CDOs and CLOs) and ultimately synthetic CDOs. This became known as the "originate and distribute" model and is a vital cog in the shift in the institutional order, which has had significant implications for debt restructuring in both America and England.

Government tax reform also did much to incentivise debt over equity capital raising by making interest payments on debt tax-deductible,[64] and in the new world of transactional finance, attitudes to liquidity shifted so that developing new ways in which money could be borrowed was heavily incentivised. And finally, hedging techniques were developed to limit risk,[65] facilitated by publication of Fisher Black and Myron Scholes's options pricing model in 1973 and leading eventually to the development of the International Swaps and Derivatives Association (ISDA) in 1985 to standardise documentation. Whereas mangers in America and England had been highly cautious of debt right up until the end of the 1960s, they now began to embrace it. In 1968, President Johnson announced strict controls on the ability of U.S. corporates to invest overseas, designed to address the growing problem in U.S. Balance of Payments.[66] This provided an immediate fillip to the newly emerging Eurobond markets, as U.S. corporates were forced to borrow overseas. The market rapidly became overwhelmed by the vast paperwork involved in the issues, and this led eventually to the formation of Morgan's pioneering clearing house, Bondclear, in New York. A new European clearing house, followed: Euroclear, modelled on Bondclear and initially owned by Morgan Guaranty,[67] and a separate venture by the Luxembourg banks known as Centrale de Livraison de Valeurs Mobilières, or Cedel. Although the immediate consequences of all of these changes in

63. COHAN, *supra* note 20, at 471.
64. BRUCK, *supra* note 54, at 99.
65. O'MALLEY, *supra* note 44, at 64.
66. *Id.* at 35–36.
67. *Id.* at 38–39; COHAN, *supra* note 20, at 158; BRUCK, *supra* note 54, at 25.

market infrastructure for the institutional order of corporate bankruptcy were perhaps not entirely apparent until later, when they did become visible, it was clear how significant they were.

Penn Central was at the forefront of the new attitude to debt. Formed by the merger of the Pennsylvania and New York Central Railroads, it represented the largest merger in American corporate history at the time and survived for 872 days.[68] The company was financing itself almost entirely in the commercial paper markets, such that it needed to continuously roll over its borrowings in order to stay solvent. Yet losses continued to mount: it lost $101.6 million in the first quarter of 1970.[69] When it could finally no longer roll over its short-term borrowings, it became the largest single bankruptcy in American corporate history at the time. Goldman Sachs was caught up in the maelstrom as Penn Central's broker and dealer in its commercial paper, with many investors (and subsequently the Securities and Exchange Commission) concluding that it had gone on selling the paper long after it should have been aware of the company's financial difficulties, whilst ensuring that the firm had no exposure to Penn Central at the time of its bankruptcy.[70] The incident was to highlight the risks of operating in the new financial environment, but also the new world in which financial intermediaries operated in the American debt securities markets. But it also highlighted a new approach to litigation risk, which will be relevant later in our account: as Cohan puts it, "Goldman allowed an extraordinary amount of dirty laundry to be aired in public, in front of a jury, over a $2.4 million dispute."[71] Importantly, though, Penn Central was subject to a special reorganisation regime for railroads and it was able to survive bankruptcy, reorganise, and emerge from bankruptcy protection. As a result, those who traded in the securities of the distressed firm were to make a handsome profit on the reorganisation, with important implications for the development of distressed trading.[72]

The second milestone did not end so happily. In 1975, W.T. Grant became the largest mercantile bankruptcy in American history.[73] The Grant failure was also a classic tale of mismanagement: a confused business model creating confusion in the mind of the American public, rapid expansion, bad store location, the wrong stock, and exposure to consumer credit. Like Penn Central, Grant financed itself in the commercial paper markets of the 1970s,

68. DAVIS, *supra* note 53, at 19–20.
69. *Id.* at 43.
70. COHAN, *supra* note 20, at 168–85.
71. *Id.* at 180–81.
72. BRUCK, *supra* note 54, at 112; MALLABY, *supra* note 59, at 54.
73. DAVIS, *supra* note 53, at 53.

and by 1974, it had short-term debt of $493.2 million and disastrous inventory control.[74] One hundred and forty-three banks had exposure to Grant as it teetered towards the edge and (possibly with the Fed's insistence) these banks provided a lifeboat loan of $600 million to keep the business afloat.[75] In the end, though, the company filed for chapter 11 bankruptcy protection in October 1975. At the time, the consent of the committee of creditors was required to reorganise in chapter 11 under the protection of the court: the banks refused, and W.T. Grant was shut down.

Further large failures followed. The government rescued the Lockheed Corporation (following a major bribery scandal) with a $200 million guarantee of the manufacturer's debt;[76] and Stirling Homex, Yale Express, and Equity Funding failed or almost failed. Corporate bankruptcy reform was already underway, motivated largely by a dramatic rise in consumer debt in the 1960s and persistent complaints about the costs of bankruptcy administration.[77] But large corporate bankruptcy was on the agenda too, and significant reforms were introduced. First, it was no longer necessary to have a bankruptcy trustee in every case, incentivising management to resort to the procedure as early as possible. Secondly, detailed provisions were included to enable the business of the corporate to be restructured within the protection of the process (for example, the detailed provisions of section 385 which deal with the rejection and assumption of executory contracts). Finally, a cram down mechanism was included in the form with which we are now familiar. As Elizabeth Warren points out in her elegant introductory text *Chapter 11: Reorganizing American Business*, the issues which face a distressed business and the problems which are to be addressed may vary, particularly between restructuring of the debt burden in the manner of the Morgan financial restructurings of the pre-New Deal era, or operational restructuring, where the causes of failure are not merely the debt burden but also mismanagement.[78] Furthermore, the 1978 Bankruptcy Code reforms in the United States were implemented against a backdrop of industrial and manufacturing failure, leading to losses for customers and suppliers. It is perhaps not surprising, therefore, that in determining the allocation of equity in a debt restructuring or the impairment of suppliers or customers in a reorganisation plan, chapter 11 focused on the post-restructuring value of the business. This is a theme which we will return to in Part III.

74. *Id.* at 61.
75. *Id.* at 63.
76. *Id.* at 130.
77. OLEGARIO, *supra* note 16, at 206.
78. *See* ELIZABETH WARREN, CHAPTER 11: REORGANIZING AMERICAN BUSINESS 4–6 (2008).

At the same time that the United States experienced both a growth in debt and in large corporate failure, similar currents of change were stirring in England. Just as in America, English industrials and manufacturing companies were seeking longer term funds in larger amounts. In 1968, Minos Zombanakis, a banker with Manufacturers Hanover Trust Company of New York stationed in Rome and representing the bank in the Middle East, persuaded his New York bosses to provide him with £5 million to start Manufacturers Hanover Limited in London and to develop the idea of the syndicated term loan.[79] His idea was that the interest rate paid by the borrower would be re-fixed every three to six months depending on the participating banks' cost of funds at that time, together with a margin. A group of "reference banks" within the syndicate would report their cost of funds to the agent bank shortly before the interest rate fixing date, which was to develop into the London Inter-Bank Offered Rate, or LIBOR. The syndicated revolving and term loan was to provide the bread-and-butter financing for English corporates for the next twenty or so years. Economically, the 1970s were also the period in which England became reacquainted with large corporate failure. One event was to be particularly significant for debt restructuring: the secondary banking crisis. The secondary banking crisis occurred in Britain in the early 1970s, when unregulated lenders (what would today be known as shadow banks) lent fairly indiscriminately to the commercial property sector. In the bust that followed, it became clear that the regulated banks, who had eschewed commercial property lending themselves, had nonetheless lent to the secondary banks. These banks were forced to provide a lifeboat for companies within the sector by the Governor of the Bank of England, in order to prevent rapid divestment of the property portfolios and a further deterioration in the market.[80] Sir Kenneth Cork, probably the leading insolvency accountant of his day, sought to implement various schemes of reconstruction for one of the major players, the Stern Group, using the Companies Act schemes of arrangement procedure. But he found that legal fees were rapidly mounting, whilst creditors were still resisting signing up. Instead, his firm, Cork Gully, promoted an informal scheme backed by the pressure of the regulator, the Bank of England.[81] This was to prove enormously influential in the next decade.

In 1979, Sir Kenneth Cork reported on the reform of English corporate bankruptcy law. The main innovation suggested by the committee was the

79. O'MALLEY, *supra* note 44, at 47.

80. *See* KENNETH CORK WITH HUGH BARTY-KING, CORK ON CORK: SIR KENNETH CORK TAKES STOCK 93–94 (1988).

81. *Id.* at 195.

introduction of a new procedure of "administration." Amongst other things, administration was intended to incentivise the directors to act earlier to seek corporate bankruptcy protection, and Cork explicitly envisaged the possibility that a company may be restructured and may trade out of its difficulties.[82] Perhaps not surprisingly, however, given that Sir Kenneth Cork was an insolvency accountant, the new procedure held firm to the idea that an insolvency office holder, to be known as the administrator, should be appointed in much the same way that receivers had been appointed for the last half-century in England and Wales. The procedure offered none of the mechanics of a chapter 11 to impose a restructuring and suffered from other significant flaws. In the end, the decision to embed it within the existing institutional order of the day, rather than reimagining the corporate debt restructuring framework in light of the significant institutional change which had occurred in the finance market, may have been fatal to its chances of success (and the company voluntary arrangement procedure, implemented specifically as a debt restructuring procedure, could not affect secured debt which was to severely limit its role in the complex debt restructurings that were to move into view in future decades). Corporate debt restructuring largely continued to be an out-of-court affair. Initially, the English banks were incentivised to bargain out-of-court in part through the soft power of the Bank of England, which laid down principles of restructuring inspired by the Bank's experience of the secondary banking crisis (and which became known as the London Approach).[83] When the Bank stepped away from this role (in part as a result of regulatory changes and in part as a result of a change in policy), the principles continued to hold good in the relatively "clubby" world of the day in which a bank could not afford to upset a peer who wielded the power to exclude it from future syndicates.[84]

In the 1980s, President Reagan, in America, and Margaret Thatcher, in England, launched full-scale deregulation initiatives. In 1979, exchange controls were lifted in the United Kingdom and preparations began for "Big Bang": the wholesale deregulation of the London Stock Exchange. Banks and investment houses began to buy up the old U.K. brokers, and U.S. investment banks arrived in London with gusto. As O'Malley puts it, "the clubby atmosphere of the Square Mile" was replaced by "the rapacious, bonus-grabbing culture of the investment bank,"[85] or as Cohan reports the head

82. *Id.* at 194–95.

83. Sarah Paterson, *Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards*, 14 J. CORP. L. STUD. 333, 335–36 (2014).

84. *Id*. at 336.

85. O'MALLEY, *supra* note 44, at 93.

of Goldman Sachs, Goldman's U.S. style caught on because its bankers were "'younger, seemed brighter, were better informed, had new ideas' [and] 'sometimes were a little brash but didn't waste time talking about their golf game.'"[86] The market was finally diversified and truly global. U.S. competitive practices began to overtake the somewhat more genteel environment in the London market. When Armin Mattle was appointed Managing Director of UBS (Securities), he insisted that underwriters of security issues must honour their commitments if they had failed to place the securities in the market, eschewing the traditional practice of allowing Eurobond underwriters to return unplaced paper to the lead manager, according to O'Malley, stating that "syndication was a business not a charity."[87]

In America, deregulation was to have a number of unforeseen consequences for debt restructuring. First, a significant number of savings and loans associations in the United States went bankrupt, and the ensuing government bailout meant that, for a time, the U.S. government was the biggest holder of distressed debt. As a result, the Garn–St. Germain Depositary Institutions Act of 1982 authorised federally chartered savings and loans associations to make commercial debts and invest in corporate debt securities. At the same time that this deregulatory movement was underway, Michael Milken pioneered junk bond financing of takeovers and he found a ready pool of investment capital in the newly liberated savings and loans associations.[88] Milken's innovation, together with the removal of antitrust regulations as part of Reagan's deregulatory agenda, was to fuel the merger-mania in the 1980s American mergers and acquisitions market, with profound consequences for debt restructuring in the 1990s.[89] A hungry suitor could borrow in the junk bond market and launch a bid for an unsuspecting target, sometimes subsequently stripping assets after purchase in order to fund repayment of the acquisition debt, or simply using the cash from the acquisition target to service the debt. The leveraged buyout, or LBO, had been born. Notwithstanding Milken's fall from grace, charged with insider dealing and securities fraud, and the collapse of the investment bank he worked for, Drexel Burnham Lambert, the LBO was in time to be exported to England. In more immediate terms for corporate bankruptcy, many of the deals of this era (the deal to take Macy's private, for example) were to be the bankruptcies of the next decade.[90]

86. COHAN, *supra* note 20, at 211.
87. O'MALLEY, *supra* note 44, at 61–62.
88. BRUCK, *supra* note 54, at 91.
89. *Id.* at 97.
90. COHAN, *supra* note 20, at 240.

Although Cy Lewis and Levin had famously bought distressed bonds in the 1940s, and Michael Milken got his start buying distressed bonds in the 1970s,[91] towards the end of the 1980s, the business of trading in distressed securities began to be institutionalised: Goldman Sachs started a proprietary $783.5 million distressed fund named Water Street Corporation Recovery Fund, investing in distressed debt securities specifically with the ambition of taking control of the business through the anticipated swap of debt for equity in the reorganization plan—the loan-to-own strategy,[92] or in the expectation that some other solution would be found, causing the price of the bonds to rise (such as Goldman's investment in the troubled toy-truck maker, Tonka, in 1990 in anticipation of a bid from Mattel, Inc. in the event Hasbro was the successful bidder, but the strategy held good).[93] As mentioned, Water Street was a proprietary fund, investing the money of Goldman Sachs's partners. This led to serious questions about conflicts of interest in restructuring negotiations: in the Tonka case itself; in the case of Journal Company, a newspaper company who Goldman had previously advised; and in the case of USG Corp, a gypsum-board manufacturer for whom Goldman had previously acted as underwriter.[94] Water Street was eventually wound up, but the Special Situations Group, or SSG, took its place,[95] and Goldman was to be under the microscope again in the efforts to save Long Term Capital Management in 1998.[96] Multiple, conflicting interests are to be an important feature of our analysis, but so too is what Mallaby calls "[a]n ecosystem of smaller players" with a "rich range of investment styles."[97] The number of specialist funds focused on distressed debt was to prove crucial in the next stage of corporate debt restructuring's development, as was the fact that none of these funds faced the regulatory capital constraints of the banking sector.

Once these organisational changes began to cross the Atlantic to England, the glue which had kept the London Approach in place and supported out-of-court bargaining began to weaken and eventually evaporated almost completely.[98] At the same time, another innovator, Blythe Masters, worked as part of the team at J.P. Morgan in London attempting to develop the idea of a credit default swap to protect against the risk of default on a loan or debt

91. BRUCK, *supra* note 54, at 33–34.
92. COHAN, *supra* note 20, at 296.
93. *Id.* at 298.
94. *Id.* at 298–99.
95. *Id.* at 378.
96. *Id.* at 401.
97. MALLABY, *supra* note 59, at 192.
98. Paterson, *supra* note 83, at 337–52.

security.[99] At first, concern existed amongst investors as to precisely when they would be entitled to trigger payout under the CDS contracts. But in 1999 when ISDA published its Credit Derivatives Definitions, listing the six so-called credit events which could be incorporated into CDS contracts, the market took off.[100] Once again, this was to have perhaps unforeseen consequences for the negotiation of debt restructuring in the decades which followed. Meanwhile, the ever-increasing competition to win mandates steadily eroded creditor protection in debt documentation,[101] and the increasing reliance of English corporates on bond markets resulted in increasingly opaque groups of debt holders, whose identities would not be revealed by the clearing systems through which the bonds were held.

III. IMPLICATIONS FOR THE INSTITUTIONAL ORDER AND BARGAINING AND LITIGATION

We have, then, seen radical and far-reaching structural change in the finance markets in America and England, with consequences for corporate debt restructuring practice in both jurisdictions. This brings us to the first part of the two-part thesis of this paper: the structural change has also resulted in significant changes in the institutional order, and those changes in the institutional order have implications for the utility of the bargaining and litigation model in corporate debt restructuring. "Institution" is used here in the sense of the institutional economists: the values, customs, and norms at work in the market which interact with formal rules such as corporate debt restructuring law and in which those formal rules are embedded.[102] In other words, in assessing our approach to valuation, we need to understand not just formal rules, but also how those formal rules will interact with informal rules, norms, and beliefs.

The first significant shift in the institutional environment was from a generally cooperative to a generally competitive ecosystem. When bargaining and litigation was first developed in the context of the equity receivership and the pre-1930s restructurings of railroads and other politically sensitive firms, J.P. Morgan and his descendants were part of a class of men conscious of what Chernow calls the "Gentleman Banker's Code,"[103] fiercely loyal to

99. O'MALLEY, *supra* note 44, at 149.
100. *Id.* at 152.
101. *Id.* at 180.
102. *See* NORTH, *supra* note 7 and accompanying text.
103. CHERNOW, *supra* note 11, at 197, 235, 257–58.

their investors and genuinely outraged at the business practices of what Josephson was later to name the "robber barons."[104] The investors Morgan represented were entirely in his hands, often even having very little idea of where the railroad operated.[105] As Chernow puts it, he acted as "an enforcer on the ground who could knock sense into railroad chieftains and inculcate a sense of responsibility."[106] His role as trusted arbiter was vital to his business model, hosting negotiations on board his yacht, Corsair, and refusing to allow it back to shore until a deal had been struck. Morgan then took the technology which he had developed for railroads and applied it to the industrial trusts. As we have seen, many of these companies saw the need to merge in order to expand and prosper in the American market, and Morgan stood ready to fulfil his intermediation role throughout the life cycle of the business. Companies agreed virtually exclusive arrangements with their banker,[107] and such competition as there was for business was conducted in a genteel, respectful manner. For much of this period, secure in their sphere of influence, Morgan and other American investment bankers were able to treat relations with the bankruptcy court as something of a partnership. The court would look threateningly at the case, with the potential for a low "upset value," and Morgan would leverage the risk of an unfavourable court decision in private negotiation. In other words, in the cooperative market of the time, bargaining and litigation provided a powerful tool for a powerful intermediary.

The decision to remove the financial intermediary from the decision-making process was a significant element of the 1930s New Deal reforms in America, but, even then, it seems likely that investors for some time would have abided by a more cooperative ethic in bargaining. As we have seen in England, large corporate debt restructuring rather fell away from the picture to be replaced by private negotiation. Yet once again, that private negotiation would have been dominated by the respectful attitude to competition in the English banking market. Kynaston has shown how, after the amalgamation movement at the end of the nineteenth century, British banking operated as something of a cartel, with even more of a club-like atmosphere than the somewhat genteel American banking community.[108] Banks were jealous of their relationships, which they maintained assiduously, respecting each

104. MATTHEW JOSEPHSON, THE ROBBER BARONS: THE GREAT AMERICAN CAPITALISTS 1861–1901, at vii (Transaction Publishers 2011) (1934).

105. CHERNOW, *supra* note 26, at 21.

106. *Id.*

107. *Id.* at 26.

108. 3 DAVID KYNASTON, THE CITY OF LONDON: ILLUSIONS OF GOLD 1914–1945, at 75 (1999).

other's sphere of influence. In this context, negotiating against the backdrop of liquidation may have worked very well indeed.

The first, and most obvious, change in the institutional order, which our brief history in Part II reveals, is the utter decline in this cooperative and respectful milieu to one of almost unbridled competition amongst highly motivated and educated investors. It is difficult to believe that a modern hedge fund, or distressed trading desk, is likely to feel any obligation to respect the sphere of influence of a competitor, or to offer it something in a deal out of obligation, or fairness, or any other social ethic motive. In this environment, neither the threat of unpredictable litigation nor the threat of liquidation (which may seem scarcely credible) may achieve successful bargaining. Collaboration, or cooperation, demands some self-restraint, well-adapted to the process of compromise and bargaining. The requirement to give something away in the bargain, of some sort of emotional exchange in order to reach a settlement, is undermined by the pursuit of the extreme profit motive and, as Richard Sennett describes, the "ethos of giving back to people just, and only, what they 'deserve.'"[109] Sennett suggests that bargaining, in this context, is likely to be "aggressive opinion-pushing rather than real give-and-take discussion."[110]

Indeed, the second change, which our account reveals, is an entirely new attitude to risk. When private individuals were investing wealth in the American or the English railways, it seems unlikely that they were motivated by risk-taking. Indeed, the evidence rather suggests that they had little idea that there was risk in the investment, and that the subsequent busts in railroad investment came as a significant shock. This contrasts with Cohan's account of the rise of "risk as a competitive measure."[111] In other words, risk is to be embraced in modern financial markets because it is the culture of risk-taking which is likely to give rise to an "edge" to the making of money. This is visible in Bruck's story of the rise (and fall) of Michael Milken and in Sebastian Mallaby's account of the rise of hedge fund traders such as Steinhardt and Druckenmiller.[112] The essence of the bargaining and litigation idea is that the uncertainty of the litigation outcome will result in bargaining. But this is poorly adapted to an environment dominated by a high appetite for risk-taking in which the possibility of successful litigation may result in far

109. RICHARD SENNETT, RESPECT: THE FORMATION OF CHARACTER IN AN AGE OF INEQUALITY 220 (2003).

110. RICHARD SENNETT, TOGETHER: THE RITUALS, PLEASURES AND POLITICS OF COOPERATION 26 (Penguin Books 2013) (2012).

111. COHAN, *supra* note 20, at 361.

112. *See* BRUCK, *supra* note 54; MALLABY, *supra* note 59, at 150.

greater rewards than the conservative bargain which might be struck. As Sennett puts it, "the good risk-taker has to dwell in ambiguity and uncertainty."[113]

Equally important to this is the shift from a culture of the firm to the culture of the individual. Although J.P. Morgan and the other great bankers of their day launched American investment banking in a climate of stars and personalities, the maturing investment firms which they founded rapidly prized teamwork, integrity, and placing client interests first. In this environment, there were strong motivations to uphold the brand of the firm and its strong, durable, institutional values in bargaining—integrity, solidity, reliability. As Sennett describes it, "esteem in the iron cage [of corporate life] comes from service to the institution; approval is conferred by an institution upon an individual for belonging."[114] But this culture of teamwork, of company man, has rapidly been replaced by the cult of the individual, reinforced by compensation structures which treat each trader as an individual profit-making centre.[115] In this environment, there is no sense of anything greater than oneself, or of values sustained by the firm which must be maintained, or of being an agent for a client. The market eschews institutionalism in favour of flexibility and what Sennett calls "entrepreneurial virtues."[116] This means that each individual is only as good as their last deal, and that all relationships, management, client, and employment, are seen as temporary. Compensation models reflect this: as Bruck puts it, "[i]t would hardly be like Drexel to place a higher value on respectability than on performance," and "salaries were moderate and all the heavy compensation came in bonuses."[117] This has two immediate consequences for the bargaining and litigation model. First, the individual is likely to embrace risk in the negotiation, rather than to treat the risk of litigation as an incentive to bargain. Secondly, to the extent that the individual does behave aggressively in the negotiation, it is unlikely that it will bring consequences for future deals. In other words, the temporary nature of all of the players makes the market far less willing to practice exclusionary measures, so that a second way in which social norms such as bargaining can be enforced disappears. At the same time, compensation is not just an end in itself, but a route to social status and prestige in what Sennett calls the "natural aristocracy" of the financial markets. Sennett identifies belief in work "as the single most important source of both

113. RICHARD SENNETT, THE CORROSION OF CHARACTER: THE PERSONAL CONSEQUENCES OF WORK IN THE NEW CAPITALISM 85 (1998).

114. SENNETT, *supra* note 109, at 168–69.

115. MALLABY, *supra* note 59, at 69.

116. SENNETT, *supra* note 113, at 47.

117. BRUCK, *supra* note 54, at 163, 247.

mutual respect and self-respect,"[118] evidenced by compensation awarded.[119] If risky litigation is the route to greater reward and strong work identity, so be it: market failure is the source of loss of self-esteem.[120]

The market enforcement point is of greater significance. Bargaining and litigation, as it was originally conceived, reinforced the market's ability to discipline itself. At the time of Morgan, both Morgan's desire to return to the capital markets for future investment and the investors' desire to be invited into future offerings acted to reinforce "good" behaviour in bargaining, whilst the market norms of the day around respect for each other's sphere of influence and a generally cooperative version of capitalism supported the bargaining outcome. Once the players in the market see their position as temporary, this willingness to discipline past behaviour is considerably weakened, so that the threat of exclusion from the market becomes less of a force in the bargaining, putting more strain on the threat of litigation: Sennett calls this the "increasingly short framework of shared time."[121] At the same time, the market will only discipline behaviour which it regards as out of line with the behaviour which it expects. As we have seen in Part II, many of the strategies which were originally advanced by loners, outsiders, or contrarians have become an accepted market strategy: as Bruck puts it, "Milken's gospel had gained such currency that it was no longer the heresy of an outcast but the liturgy of Wall Street."[122] Strategies which were initially regarded as vulgar and had nomenclatures to match—vulture funds, junk bonds—gradually became gentrified with gentrified names to match—distressed debt traders and high-yield bonds. Indeed, as Richard Sennett notes, when Philip Augar chronicled the breakdown of "gentlemanly capitalism" in the City of London, he "[was] struck by how the traditional old-boy network has in fact given way to an equally clubby new-boy network."[123] It is a mistake not to see a distinct consciousness of the group in the new markets, a collective ideology, and to understand how it works. Innovative and aggressive strategies are not only introduced to, but also embraced by, the market.[124] Once this occurs, the market's willingness to discipline aggressive strategies declines, and the support which must be provided by market norms for the bargaining and litigation approach falls away. Indeed, others are likely to imitate

118. SENNETT, *supra* note 109, at 109.
119. SENNETT, *supra* note 113, at 71.
120. SENNETT, *supra* note 109, at 115.
121. *Id.* at 221.
122. BRUCK, *supra* note 54, at 244.
123. SENNETT, *supra* note 109, at 43.
124. MALLABY, *supra* note 59, at 342.

the behaviour they observe,[125] and the aggressive, profit-maximising strategies are the values which bind the group together. Bargaining and litigation is under threat because the core values and behaviour of the market have changed. In this context, "honour" in the group (meaning both codes of conduct within the group and what Sennett calls "a kind of erasure of social boundaries and distance")[126] is affirmed by pursuing economically rational but potentially destructive litigation. Bound up in all of this are complicated ideas that the gentlemanly markets of the past, far from being worthy of admiration, were lazy, unmeritocratic, corrupt. New markets, with their commitment to labour and proving oneself through a competitive work ethic,[127] uphold modern, universal values. Many scholars and commentators have labelled the extremes of behaviour which appear: Piketty calls it "meritocratic extremism";[128] Cohan, "meritocracy gone haywire";[129] Sennett, the "dark side of the doctrine of careers open to talent";[130] and Robert Frank and Philip Cook, the "winner-take-all" society.[131] None of it contributes to the effectiveness of bargaining and litigation as a model.

Furthermore, increasing specialisation in strategy makes it significantly harder for the threat of market exclusion to operate. Indeed, this proved fatal to the functioning of the London Approach in England. A distressed fund trader is unlikely to be moved by threats of exclusion from the primary markets, even if he is persuaded by the credibility of the threat in a market driven primarily by price rather than relationship. Firms compete to find new niches and may move from one niche to another. In other words, the market is in a perpetual state of innovation.[132]

The shift which has occurred in these new ways of doing business from relationships to transactions also has a profound implication for the way in which bargaining occurs. In the days of Morgan, Pierpont was acutely aware of the business below the capital structure. Indeed, his business model demanded that he take an active interest in the business itself, taking seats on boards and exercising influence. This caused Louis Brandeis and others to fear the investment banker as the new monopoly and led to the New Deal

125. SENNETT, *supra* note 109, at 89.

126. *Id.* at 55.

127. *Id.* at 58.

128. THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 416 (Arthur Goldhammer trans., Harvard Univ. Press 2014) (2013).

129. COHAN, *supra* note 20, at 433.

130. SENNETT, *supra* note 109, at 92.

131. ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY 1–22 (1995).

132. SENNETT, *supra* note 113, at 51.

reforms.[133] The British banks, too, maintained close relationships with their borrowers and, although they were frequently accused through the historical record of not understanding their clients' business, were clearly aware of the business which was being financed. The shifts to an "originate and distribute" model briefly traced in Part II have caused the business of finance to become increasingly remote from the businesses being financed. Indeed, Mallaby says of one hedge fund owner, "[h]e wanted people who would approach the markets as a mathematical puzzle, unconnected to the flesh and blood and bricks and mortar of a real economy."[134] This sense of remoteness engendered by the shift towards transactional finance is reinforced by the sheer complexity which has emerged in capital structure, hedging, and investing. What Cohan calls "intellectual and financial jousting"[135] reinforces the sense of a game to be won with superior mathematical ability and instinct. Bargaining and litigation loses its force as the negotiation over the future of a real, living-and-breathing business employing individuals is replaced with a mathematical game to be won by aggressively pursuing the boundaries of the rules. The loss of relationships is also important because the "game" has become depersonalised. Not only J.P. Morgan, but all of the investment bankers of his day and even the workout bankers in Britain in the middle of the twentieth century would have had some sense of personal honour and reputation; that there was an element which was personal in facing off against others round the negotiating table. In modern financial markets, the game is far less personal. Of course, there is much about this which is a good thing: clout and class connections replaced with brainpower and determination and a much-reduced ability to use the club to keep members in and outsiders out. But it also makes debt restructuring about pushing the rules, seeing what it is possible to get away with. There are still redlines, as the treatment of Bear Sterns in the crisis following its refusal to join the lifeboat for Long Term Capital Management, or the treatment of Drexel Burnham Lambert after Michael Milken's fall from grace, demonstrate. But they are far fainter and there are far fewer of them. Bargaining and litigation does not work well in this highly depersonalised environment.

Nonetheless, we are used to thinking of reputation as an important bonding mechanism. When we use reputation in this sense, we tend to mean some vague sense of "behaving properly." But "reputation" is not, as Sennett might put it, a "static quality."[136] Today's financier may want another type

133. CHERNOW, *supra* note 26, at 28.
134. MALLABY, *supra* note 59, at 289.
135. COHAN, *supra* note 20, at 523.
136. SENNETT, *supra* note 109, at 43.

of reputation entirely—a reputation for being tough, for enforcing legal rights, for chasing every, last cent. Indeed, discussing one hedge fund trader, Mallaby comments that "his reputation was also significant. When people saw the wild cowboy coming, they assumed that he would make the market move."[137] Conventional ways of doing things are to be disrupted, and the trader may wish to cultivate a reputation for being creative, aggressive, and visionary. In this context, an uncertain litigation environment may provide grist to the mill. At the same time, the trader is likely to study the legal environment to try to understand where the opportunities lie. Far from being afraid of litigation risk, he will study and assess it for any benefits which it may deliver.

Finally, our story in Part II identified an increasingly opaque market, in which a number of small players have a vast array of different investment strategies,[138] where conflicts of interest may be hard to discern and may lead to unexpected results; where it may be difficult to establish the identity of the investors and where rapid trading will continue throughout the case. This has implications for the relationships necessary for successful bargaining.

IV. A WAY FORWARD?

The first part of the thesis of this paper, then, is that changes in the organisational structure of the finance market in America and England have led to the development of a different institutional order in the finance market. The second part is that this has, in turn, fundamentally altered the incentives to bargain in chapter 11 and has made litigation considerably more likely. As we have seen, the development of the scheme of arrangement against the counterfactual of an insolvency had very different roots in England. Nonetheless, it was also well-adapted to the institutional environment of the time. Railroad capital in England was raised locally from the landed classes, gentleman farmers, and the like. These investors would also have had a strong sense of the ethics of the day and were likely to see merit in behaving well in negotiation. They are also likely to have deferred to the experts who were brought into these situations to advise them, notably the accountants who were beginning to establish themselves as a professional class. Many of these accountants had established reputations as railroad accountants. In 1880, English accountancy gained its Royal Charter, and the various bodies representing accountants united to form the Institute of Chartered Accountants in

137. MALLABY, *supra* note 59, at 145.
138. *Id.* at 192.

England and Wales. [139] It seems likely that, just as Morgan was the trusted arbiter of English investors in U.S. railroad reorganisations, the accountants who advised in railway reconstruction would have been regarded as expert advisers for the middle-class local investors who had put their wealth into railway investment. As we have seen, the scheme of arrangement then largely fades from the picture of corporate debt restructuring for almost a century, but when it reappears, it reasserts its commitment to the counterfactual approach. In previous works, the author has argued that there are merits in this approach: in its greater level of objectivity and in the position of the corporate bankruptcy judge. But it must also be acknowledged that it is a somewhat blunt approach, which may not be well-adapted to some sorts of debt restructuring involving more vulnerable creditors, and which may not inspire market confidence.

Recent debate about reform of chapter 11 in the United States has questioned whether some sort of independent mediator could be appointed to help mediate between the parties and, potentially, to assist the bankruptcy judge in a complex debt restructuring case. The European Commission proposal suggests that member states may require the appointment of a practitioner in the field of restructuring where the restructuring plan needs to be confirmed by a judicial or administrative authority by means of a cross-class cram down.[140] In England there is already a party well-positioned to take this role, in the shape of the insolvency practitioner. In most cases, the company will be arguing in favour of the restructuring on the basis that it produces a better result for creditors as a whole than the best available alternative option, which will often be an administration sale of the business and assets as a going concern. But for this analysis to withstand scrutiny, the administrator-in-waiting must be convinced of the case for moving to a sale transaction if the debt restructuring fails. This is because paragraph 3(1)(a) of Schedule B1 to the Insolvency Act 1986 mandates a rescue of the company as the first purpose of the administration unless the administrator thinks that is not reasonably practicable and he acts in the best interests of creditors, in which case he can move down the hierarchy of purposes to a going concern sale.

There are considerable difficulties with the construction of the hierarchy in paragraph 3 of Schedule B1 to the Insolvency Act 1986, but it cannot be intended to entitle the senior class to hold the administrator to ransom and refuse the debt restructuring plan, where the administrator considers (weigh-

139. JONES, *supra* note 24, at 67, 69.

140. *Commission Proposal*, *supra* note 6, art. 5, at 21.

ing the interests of the different classes and the expected recovery in an administration) that another, fairer scheme is available and the question is the allocation of the debt and equity rather than strategic decisions such as who to sell the business to. There may thus be a role for an insolvency practitioner. Indeed, one solution to mediate between the rather blunt application of a valuation methodology based on the going concern value of the business and assets in what might be a depressed market and the problems inherent in moving towards the valuation approach more commonly adopted in the United States (using professional valuers, adopting valuation techniques such as discounted cash flow, to assess the "intrinsic" value of the business) may be to mandate that the parties must come to court for sanction (what a U.S. lawyer might call confirmation) of the scheme of arrangement with evidence provided by the insolvency practitioner that they have entered into private bargaining, taking into account not only the apparent value in current market conditions but also the forecasts for the business. This could be bolstered by enhanced regulation setting out how the insolvency practitioner should approach the valuation mediation role and new legal rights which creditors could have to make representations to her. Indeed, some inspiration could be taken from the field of takeovers and the role of the independent adviser. The court would then ask the insolvency practitioner to report two things at sanction: first, that the insolvency practitioner is satisfied that the scheme has been arrived at following good faith private bargaining between the parties which took into account the forecasts for the business after the restructuring and, secondly, that if the scheme fails and the administrator is appointed, she will move down the hierarchy to para 3(1)(b) or (c) and no creditor is worse off under the scheme scenario than they would be in the counterfactual. Reform of this type would be limited, however, to large corporate situations, and it would be important for the insolvency practitioner's willingness to take on the role that any challenge to her opinion is dealt with before any final court sign-off on the plan. It is suggested here that a similar approach could be adopted in the United States, with the introduction of mandatory bargaining replacing the hope that the structure of the Code will incentivise voluntary bargaining.

Further inspiration might also be drawn from the Canadian Companies' Creditors Arrangement Act (CCAA) process (and a number of respondents highlighted this in their response to the English Insolvency Service consultation). If a stay is ordered in CCAA proceedings, a monitor is appointed (and the court has discretion to order the appointment of a monitor in other cases). Crucially, the court has discretion to direct the monitor to act as liaison with creditors.[141] Like the English law administrator, the monitor is an officer of the court who can provide a dual function as the court's officer in holding the ring in commercial discussions between the stakeholders and in reporting to the court. But unlike the English law administrator, she does not replace the company's directors, and the company's governance structure continues through the process. Janis Sarra has commented that, "[m]onitors increasingly navigate the debtor company through the complexity of the CCAA process, providing business judgment, negotiation skills and financial advice. The monitor can act as mediator or facilitator, bringing the parties together in an effort to build consensus on a viable going forward business plan."[142] In developing this role for the monitor, the Canadian courts have consistently emphasised the need for the monitor to act independently, and their repeated emphasis on this point appears to have been crucial in the perception of market players and trust in the monitor role.

V. CONCLUSION

At the heart of this Article lies the contention that the efficacy of bargaining and litigation as a tool for determining valuation in a corporate debt restructuring depends on how it interacts with the rest of corporate bankruptcy's institutional structure. The Article has attempted to show how shifts in the organisation of the finance markets have led to significant shifts in informal norms of market behaviour. It argues that bargaining and litigation produces a fundamentally different result when it interacts with these new values, beliefs and informal rules of engagement. The Article tentatively suggests that this has implications for corporate bankruptcy law reform, perhaps suggesting some form of mandated bargaining to replace a legal structure which was designed to incentivise it.

141. JANIS P. SARRA, RESCUE! THE COMPANIES' CREDITORS ARRANGEMENT ACT 32 (2d ed. 2013).
142. *Id.* at 571.