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An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives, and the Creditors' Bargain

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AN AGENCY COST ANALYSIS OF THE WRONGFUL TRADING PROVISIONS: REDISTRIBUTION, PERVERSE INCENTIVES AND THE CREDITORS' BARGAIN

by Rizwaan Jameel Mokal*

Previous work on the wrongful trading provisions of the Insolvency Act 1986 (s. 214) has been content with description, or with statutory construction. This paper employs the tools of agency theory and the creditors' bargain heuristic to analyse the need for these provisions, their structure, role, and effect. It examines why those interested in the company's undertaking would demand and accept a s. 214-type duty. The analysis reveals that the duty would not be equally relevant for all types of companies, and that the influence of the market for managerial labour ensures most s. 214 actions are likely to be brought against directors of closely-held companies, and against shadow directors. The analysis, by pointing out that security plays a role similar to s. 214 itself, also justifies a recent Court of Appeal decision which precludes secured creditors from any recoveries under that section. Finally, the incentives created by the provisions for the managers of both healthy and distressed companies are examined. It is suggested that these incentives are generally socially efficient.

I. INTRODUCTION

The law of corporate insolvency is coercive, and that coercion needs to be justified. When a firm is solvent, the law is happy enough to allow individual creditors to pursue their own strategies in recovering what is owed to them. An unsecured creditor is free to obtain a judgment against the firm and to enforce it, without having to worry about the rest of the debtor firm's affairs. The secured creditor can, in appropriate circumstances, seek possession of the collateral. All the parties are left to do what they consider to be in their own best interest, and claims are satisfied (roughly) in the order in which they are brought.

But once it appears the firm is no longer able to pay its debts as they become due,[1] the situation changes. While secured creditors are in general still free to pursue individual remedies,[2]

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[1] Insolvency Act 1986 (hereafter, IA), s. 123.

[2] The question whether this is commensurate with the aims of insolvency law is seldom asked in this jurisdiction. When asked, it is shrugged aside with the observation that security holders are merely seeking

numerous constraints are imposed on general creditors. Attempts to extract individual advantage are liable to be struck down if the debtor is motivated by the desire to prefer the particular creditor over others.[3] And once the firm goes into the formal liquidation procedure, all unsecured creditors are bound. A winding-up order operates in favour of all those with interests in the company's undertaking,[4] and the dedicated insolvency forum enjoys a monopoly over the collection of the debtor's assets and disposal of unsecured claims against it.[5] So, why should the law restrict creditors' freedom of action when their debtor becomes insolvent?

It is current orthodoxy that one of the main reasons insolvency law exists is to maximise the pool of assets available to all the company's creditors.[6] As the company approaches insolvency, the existence of multiple claims leads to a type of Prisoner's Dilemma: many self-interested and rational individual actors pursuing identical ends in ignorance of each other's activities. When the firm is insolvent, it is unlikely to have enough assets to pay off all its creditors, almost as a matter of definition. So in the absence of a collective and mandatory insolvency procedure, the earlier each creditor can put in his claim, the greater the likelihood of him being paid in full (or at all). Such individual action is aggressive and wasteful, imposing costs on all the actors viewed collectively.[7] Insolvency law steps in to enforce a single compulsory procedure for the proof of debts. The race no longer goes to the swiftest. The debtor's business need not be broken up and sold piecemeal, for example, to satisfy individual creditors as and when they make their claims. Rather, a more socially efficient decision might be made, based perhaps on the disposal of the business as a going concern, which might bring better returns. Secured creditors already having taken the first bite, the residue can be distributed pari passu (like claims to be treated alike) among all the unsecured creditors. Insolvency law is paternalistic, then, curtailing the creditors' freedom of action in their own collective best interest.

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access to what in fact belongs to them. See e.g. James L.J. in Re David Lloyd & Co. (1887) 6 Ch.D. 339, 344-5. But as more thoughtful commentators have pointed out, this answer is far from satisfactory. See e.g.. Clarke, "Security interests as property: relocating security interests within the property framework", in Harris (ed.), Property Problems from Genes to Pension Funds (London 1997).

[3] IA, s. 239; see Re MC Bacon [1990] B.C.L.C. 325, per Millet J. (as he then was).

[4] IA, s. 130(4).

[5] IA, ss. 127, 128, 130(2).

[6] Commentators accept that it might have other goals as well, for example, attempting to rescue the firm, and to penalise the management for acts or omissions harmful to the company and its creditors. See, e.g., Finch, "The measures of insolvency law" (1997) 17 OJLS 227 for an overview of different visions of insolvency law, and Goode, Principles of Corporate Insolvency Law (London 1997), 25-9.

[7] As to the nature of these costs, see below.

The theoretical justification is said to lie in the notional bargain rational self-interested creditors would strike ex ante about the treatment of their claims in case their debtor becomes insolvent.[8] If all those who would eventually line up to prove in the company's winding-up could come together before anyone had lent anything, runs the argument, they would accept a curtailment of their individual rights, should insolvency occur. They would accept the need to preserve going concern value, and would bargain to restrict their ability to undertake independent aggressive action, so long as all other creditors with similar claims would also be under identical constraints.[9]

The hypothetical creditors' bargain, then, justifies the coercion inherent in corporate insolvency law by appealing to the virtue of autonomy. Creditors themselves would freely accept limits on their freedom of action in the debtor firm's insolvency if they could come together ex ante to enter into an agreement binding on all.[10] The law merely steps in to provide an off-the-shelf system, and the parties no longer have to waste resources in identifying each other and coming up with a new agreement for each transaction.

The creditors' bargain justification of insolvency law is of course not cost free. If the coercive insolvency rules are best viewed as a reflection of the hypothetical ex ante agreement, then the coercion must necessarily be limited to what would be regarded by the parties themselves as acceptable at the negotiation stage. Further, the collective nature of the mandatory forum entails the existence of special rules for the proof of debts and the distribution of the insolvent's assets. Given that the hypothetical bargain would be concluded to overcome the common pool problem mentioned above, it has been argued that special insolvency rules should not disturb the *relative* value of parties' pre-insolvency rights.[11] Not only would such a redistribution -- being unrelated to the solution of any common pool problem -- not form any

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[8] The locus classicus is Jackson, "Bankruptcy, nonbankruptcy entitlements, and the creditors' bargain", (1982) 91 Yale L.J. 857. See also, by the same author, The Logic and Limits of Bankruptcy Law (London 1986); Baird and Jackson, Cases, Problems and Materials on Bankruptcy (Boston 1985); Baird and Jackson, "Corporate reorganizations and the treatment of diverse ownership interests" (1984) 51 Univ. Chicago L.R. 97.

[9] Jackson, Bankruptcy, 16.

[10] Note that involuntary creditors, e.g. victims of torts committed directly or vicariously by the insolvent, have little say in the voluntary ex ante bargain. Still, even they would presumably agree to an arrangement which maximised the value of the firm for all the claimants; see below.

[11] One way that the relative value of pre-insolvency rights could be upset would be for the special insolvency law regime to create rights in some parties which did not exist under the general law; see Jackson, Bankruptcy, 22 and 93. But Jackson also cautions, in the first sentence of chapter 3 of Bankruptcy, 68, that "Bankruptcy law... should focus primarily on values, not rights."

part of the hypothetical bargain, it would also create perverse incentives. For example, the parties in whose favour insolvency rules redistribute would have an incentive to rush the company into the dedicated insolvency forum to take advantage of those rules, even if the debtor firm's business is viable and it could be brought back to profitable trading if given the chance. So while the mandatory forum exists to counter the adverse effects of selfish individual behaviour, any redistribution of rights would in fact end up encouraging parties selfishly to invoke the special (redistributive) rules in a way detrimental to the collective interests of all the parties affected.[12]

Opponents of redistribution point out that having in the insolvency forum an alternative method of vindicating claims[13] is expensive, and this expense must be justified by having reference to the reason for which that additional method exists. That reason is to be found, *via* the notional creditors' bargain, in the need to preserve the going concern and to minimise transaction costs.[14] That reason is undermined if insolvency law creates new rights which do not exist under the general (non-insolvency) law. The only way to avoid this result seems clear: "[I]n its role as a collective debt-collection device, bankruptcy law should not create rights. Instead, it should act to ensure that the rights that exist are vindicated to the extent possible. Only in this way can bankruptcy law minimize the conversion costs of transferring an insolvent debtor's assets to its creditors."[15]

This, then, is the basic argument against insolvency law carrying out any redistribution, and the discussion also fleshes out the notion of redistribution. In this context, a rule of insolvency law is redistributive if it confers a right on a group of claimants which they would not have as a matter of non-insolvency law. Crucial, for the purposes of this paper, is the question of how to determine what is available to the insolvent's creditors. In answering it, the proper perspective is said to be that of "an unsecured creditor attempting to execute on a particular asset or to assert a security interest in it".[16] If the general law denies him access to something, insolvency law should promise him no more: "If unsecured creditors cannot execute against an asset as a matter of nonbankruptcy law, then that property has no value to them and should not be considered to be... property of the [insolvent firm's] estate."[17]

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[12] Jackson, Bankruptcy, 21.

[13] In addition to non-insolvency debt-collection mechanisms.

[14] See above.

[15] Jackson, Bankruptcy, 22; see also, Baird, "Loss distribution, forum shopping, and bankruptcy" (1987) 54 Univ. Chicago L.R. 815, 825-6.

[16] Jackson, Bankruptcy, 93.

[17] Ibid.

This paper uses the wrongful trading provisions of the Insolvency Act 1986[18] to argue that parties bargaining ex ante would in fact agree to a change in the relative values of their claims at the time of the company's insolvency. So a form of the notional bargain, extended to include not just creditors but also shareholders and managers could itself provide for -- and therefore justify -- some types of insolvency redistribution.[19] It is also argued here that far from creating perverse incentives, some types of redistribution might actually have effects conducive to the common good.[20] It is to be noted that both these propositions contradict the views of most law and economics theorists writing on insolvency issues.[21]

A word about terminology. The terms "manager" and "director" are used interchangeably in this paper to refer to the top decision-makers in the firm's hierarchy. It has rightly been noted that "Directors, despite what company articles say, do not manage listed companies. Instead, the board, in accordance with the articles of association, delegates its managerial powers to full time executives."[22] A couple of points should be noted here as relevant to the argument which follows. First, whatever the case with listed companies, the analysis below suggests the s. 214 duty is most relevant to companies whose directors themselves own a substantial chunk of the firm's equity. In such companies, there is unlikely to be any clear-cut distinction between directors who sit on the board, and managers who are entrusted in reality with the day to day running of the business. Further, even when a director has justifiably delegated some of his managerial functions, he retains a residual duty of supervision and control, and has a continuing obligation, individually and along with the rest of the board, to maintain a sufficient knowledge and understanding of the company's business.[23] A failure on his part to do so will cause him to be liable for any wrongful trading which might take place.[24] Finally, in a firm where there is a clear distinction between directors and lower-level managers, if the directors "delegate" their decision-making powers to a manager to such an extent that they could be regarded as being accustomed to act in accordance with the latter's instructions, then the latter

[18] Section 214.

[19] See Section III, below.

[20] See Section V, below.

[21] To take a specific example, Cheffins, Company Law (Oxford 1997), 537-548, argues that a s. 214-type duty would not be offered and accepted by the interested parties in a hypothetical bargain.

[22] Cheffins, 603-4.

[23] See e.g. Re Barings plc and others (No 5); Secretary of State for Trade and Industry v Baker and others (No 5) [1999] 1 B.C.L.C. 433.

[24] IA, s. 214(5); see e.g. Re Brian D Pierson (Contractors) Ltd. [1999] B.C.C. 26.

renders himself a shadow director,[25] and thereafter is directly subject to the strictures of the wrongful trading provisions.[26]

II. ARE THE WRONGFUL TRADING PROVISIONS REDISTRIBUTIVE?

Section 214 of the Insolvency Act 1986 arose out of frustration at the perceived failure of the rules against fraudulent trading. The Cork Committee reported[27] that the existing law did not provide sufficient incentives to directors of insolvent companies to take steps to prevent further loss to their company's creditors. Not only was the drafting of the rules infelicitous,[28] but the requirement to show dishonesty on part of the debtor's managers to the criminal standard proved unduly onerous.[29] The Cork Committee recommended that any person involved with the management of the company be made personally liable for the company's debts if he allowed such debts to be incurred, there being no reasonable prospect of repaying them. The directors would be under a duty to place their company under receivership, administration or liquidation if at any time they considered it to be insolvent, on pain of being liable for wrongful trading. A claim for wrongful trading would be available to the company's creditors or members, its liquidator, administrator or receiver, if the company was in a formal insolvency proceeding (administration, receivership or liquidation).[30]

These strong proposals were watered down by the Department of Trade and Industry[31] before being enacted as what is now s. 214 of the Insolvency Act 1986.[32] The action is available only to the liquidator when the company is in insolvent liquidation, and only directors[33] can be made subject to it. If, at some time before the commencement of the company's winding up, a

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[25] IA, s. 251.

[26] As to shadows, see Section IV, below.

[27] Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982), hereafter, the Cork Report, Ch. 44.

[28] See Oditah, "Wrongful Trading" [1990] LMCLQ 205, 206.

[29] Ibid.; see Re Patrick & Lyon Ltd. [1933] Ch. 786. But as Prentice points out, the courts shifted their position after the publication of the Cork Report, rejecting the so-called "sunshine doctrine" and making it somewhat easier to prove fraud; see "Creditor's interests and director's duties" (1990) 10 OJLS 265, 265 fn 5.

[30] Cork Report, paras. 1781 - 1806.

[31] A Revised Framework for Insolvency Law (Cmnd 9175, 1984).

[32] This weakening of the proposals has been criticised; see, e.g., Williams and McGee, "Curbing unfit directors", Insolvency Lawyer, Feb 1993, 5.

[33] Including shadow directors; see IA, s. 251.

director knew or ought to have concluded that there was no "reasonable prospect" of avoiding insolvent liquidation, he would be liable for wrongful trading,[34] unless from then on, he took "every step" he ought to have taken to minimise loss to the company's creditors. The standard by which he is to be judged is defined by reference both to his actual knowledge, skill and experience, and to the expertise reasonably to be expected of a person carrying out the same functions as him in relation to the company.

To determine whether s. 214 is redistributive, a comparison must be made between the positions of the beneficiaries of these provisions before and after the debtor firm becomes subject to the distinct insolvency regime. The provisions are redistributive if they gives to those whose interests they serve a claim against assets they would not have under the general law.[35]

It is clear, after the Court of Appeal's judgment in Re Oasis Merchandising Services Ltd.[36] that it is the firm's general body of creditors together which stands to benefit from any recoveries under s. 214. The reasoning which led to this conclusion is very relevant. In this case, the liquidator had purported to assign the fruits of a s. 214 action to a specialist litigation support company, the assignees promising in return to fund the action. This was challenged. It was common ground that the agreement was champertous, and the dispute centred around whether the power conferred on the insolvent company's liquidator[37] "to sell any of the company's property" applied to validate it.[38] The Court held that it did not, since a distinction was to be drawn:

> between assets which are the property of the company at the time of the commencement of the liquidation... including rights of action which arose and might have been pursued by the company itself prior to the liquidation, and assets which only arise after the liquidation of the company and are recoverable only by the liquidator pursuant to statutory powers conferred on him.[39]

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34 The term appears, not in the section itself, but only in the marginal notes. It is in this potentially significant way that the section is wider than Cork's proposals; the debtor need not be trading for its directors to be rendered liable under s. 214.

35 See text accompanying fns. 15-17, above.

36 Sub nom Ward v Aitken & Others [1997] 2 W.L.R. 764; pet diss [1997] 1 W.L.R. 1197 (HL).

37 By IA, Sch. 4, para. 6.

38 Re Oasis, above, 770-B.

39 Ibid., 773D, E.

Only the former category of asset was covered by the statutory exception. But recoveries under s. 214 fell within the latter category. Not only was it the case that the assets recovered as a result of a successful s. 214 action did not form part of the debtor's estate at the point where the special insolvency regime took over. In fact, the very right of action under s. 214 did not exist till that moment. The company never itself had that right while solvent (and governed by the general law). This explains why it could not have created a charge over any recoveries.[40] It followed that anything squeezed out of directors would go to augment the pool of assets available for distribution to preferential and unsecured creditors. That did not mean of course that any of the company's creditors could have proceeded directly against the company's directors at any time. The right of action created by s. 214 inhered exclusively in the liquidator, arising only under the rules creating the distinct insolvency forum. The Court of Appeal highlighted the contrast by noting that recoveries under s. 212 of the Insolvency Act 1986 for misfeasance in the company's affairs could be charged by debenture, since the section provided a summary method of vindicating rights available to the company before the winding up.[41] It is clear, then, that under s. 214, the insolvent firm's general creditors are being given benefit of a right, held and exercised in their favour by the liquidator, which does not exist under non-insolvency law, and they gain access under that right to the personal assets of the debtor company's directors, which assets were immune to their claims before the debtor entered the special insolvency forum.

That is not quite the end of the matter. As pointed out above, s. 214 creates a duty on directors, once there remains no reasonable prospect their company would avoid insolvent liquidation, to take steps to minimise loss to the company's creditors. The duty could be owed either to the insolvent company itself, or it could be owed to the creditors and mediated through the company. In either case, the question arises whether this duty, though nominally a new one available for vindication only once the company is in insolvent liquidation, is merely a recast of a duty under general non-insolvency law owed by the directors to the company itself, or to its shareholders. If that were the case, then s. 214 would not be substantively redistributive.

The argument might look something like this. It is trite law that the directors of a healthy company are under a duty to protect and uphold the interests of the company, and that of course includes having regard to the interests of the company's shareholders. The general law imposes obligations on directors to manage the company's affairs in the interests of shareholders

[40] Ibid., 773G.

[41] Ibid., 773F.

as a whole.[42] The directors are required to protect the collective interests of both current and prospective shareholders and to this end they must positively direct their efforts.[43] But "[the directors'] loyalty needs to change when there is a change in the residual owner, the person who gains or loses from any change in the fortune of the firm."[44] Now when insolvency threatens, legal doctrine recognises that the company's creditors replace its shareholders as the "owners" of the company, and therefore, it is to them, *via* the company, that directors' duties are owed.[45]

It might therefore be argued that s. 214 merely reconfirms the switch of loyalty required of the directors of a troubled company, crystallising the content of the duty. The obligation to act in the collective interest of the shareholders metamorphosises into a duty to take every step to minimise harm to the company's creditors as a group. The directors pay from their own pocket for loss done in breach of the fiduciary obligations imposed by the general law to shareholders *via* the company, and they pay similarly for breach of the duty to creditors imposed by s. 214. The latter provision is not redistributive since it imposes no new obligations, and makes available nothing not already at risk. All this section does is to confirm the change in identity of the recipients of the benefit of directors' duties.[46]

This argument is superficially attractive but ultimately unpersuasive. First, it is difficult to reconcile with the Court of Appeal's decision in Re Oasis,[47] and the clear distinction drawn between the vindication of a pre-existing right under s. 212, the fruits of which are capable of being charged by the company, and the creation of a wholly new cause of action which does not exist till the company enters insolvent liquidation, and which therefore the company can not deal with at all. [48]

But second, it is difficult to see the duty imposed by s. 214 as analogous or equivalent to any duty which could exist outside of insolvency. Remember that the section imposes what

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[42] Piercy v S Mills & Co. [1920] Ch. 77; Hogg v Ltd. [1967] Ch. 254. The statement in the text must be qualified; section 309 of the Companies Act 1985 imposes a subsidiary obligation on directors to have regard to the interests of the company's employees.

[43] For examples, see Rackham v Peek Foods Ltd. [1990] B.C.L.C. 895.

[44] Baird, "The initiation problem in bankruptcy" (1991) 11 International Review of Law and Economics 223, 228-9.

[45] Kinsela v Russell Kinsela Property Ltd. (in liq.) (1986) 4 N.S.W.L.R. 722, 730, per Street C.J.; quoted with approval by Dillon L.J. in West Mercia Safetywear Ltd. (in liq.) v Dodd and another [1988] B.C.L.C. 250, 252-3.

[46] Oditah considers a similar argument in "Wrongful trading" [1990] LMCLQ 205, 217-8.

[47] [1997] 2 W.L.R. 764, above.

[48] See also Re Howard Holdings Inc. [1998] B.C.C. 549, 554G.

could be called terminal obligations. These arise only when there are no reasonable prospects of the company avoiding insolvent liquidation, and they disappear into the ether if perchance the company does recover. The very background against which they operate is that of the company having died while incapable of satisfying all outstanding debts. Most of the deceased's creditors would have to suffer some loss. It is in this context that the directors are required to take every step they ought to take to minimise this loss. In many, if not most cases, this would effectively require the directors to relinquish control, either by asking a court for an administration or winding-up order, or by inviting a secured creditor to appoint a receiver.[49] It is obvious this would seldom be appropriate (or even possible) while the company is solvent.

In any case, directors of healthy companies are not always concerned to maximise the gains in the short run, and valid strategies might entail a levelling of returns on the company's investments or even some losses while it battles for market share, say:

> So long, at least, as the company seems likely to continue as an independent entity, there would seem to be no reason in principle why the directors, in adopting their business policies, should be required by law to favour those shareholders who wish to sell their shares now or in the short term, as against those who see themselves as long-term holders.[50]

Under s. 214, on the other hand, the only concern would generally be with short-term performance, the only aim would be to increase the immediate value of the company's assets or to halt a fall in that value, and all decisions would be judged with reference to that. The contrast could hardly be greater. The point is not only that the obligations imposed by s. 214 exist only in insolvency, but that, because of their terminal nature, they are incapable of existing except when the company is on its deathbed. It can safely be concluded, then, that s. 214 is redistributive in the sense outlined above.[51]

Finally, it is difficult to argue that the section seeks to preserve the relative values of the rights of various claimants. Most importantly, by creating a potential liability in directors which did not exist before, s. 214 actually upsets relative values as between them and the firm's

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[49] See e.g. Framework, above, para. 12; Goode, Insolvency, 472-3.

[50] Davies, "Directors' fiduciary duties and individual shareholders", in McKendrick (ed.), Commercial Aspects of Trusts and Fiduciary Obligations (Oxford 1992), 87.

[51] See also the decision of the House of Lords in Winkworth v Edward Baron Development Company Ltd. [1986] 1 W.L.R. 1512, 1516F, which creates complications more apparent than real for the argument here.

creditors. Beyond this point, creditors are protected against loss which could reasonably have been avoided. But this is only at the expense of the directors, who lose the protection of limited liability with respect to this loss.[52] The loss of this protection constitutes an ex post diminution in the value of the bundle of rights with which the directors enter the insolvency forum. Even as between creditors, the section simply does not concern itself with relative values. To confirm this, it need only be asked whether directors challenged under it would be able to escape liability by showing that there was a strictly proportionate increase in (avoidable) loss to all the creditors once the company entered the insolvency forum. Conversely, it is unlikely the liquidator would be able to succeed in challenging a director under s. 214 on the basis that, while the steps taken by the latter decreased loss to all categories of creditor, the decrease in that loss was greater for some than for other creditors. Again, then, it is clear the wrongful trading provisions, in addition to being redistributive, are not concerned with preserving relative values of pre-insolvency rights.

III. CAN THE HYPOTHETICAL BARGAIN JUSTIFY THE S. 214 DUTY?

It has been pointed out that the notional creditors' bargain provides a satisfactory justification of the coercive basic structure of insolvency law by suggesting that creditors themselves, negotiating ex ante, would value the accompanying benefits enough to accept the restrictions. This view is normatively attractive because it appeals to the virtue of autonomy: the insolvency regime would be voluntarily accepted as being in their collective best interest by the very parties subject to its coercion. Could it be shown that obligations similar to those imposed by s. 214 would also be voluntarily accepted if all the parties affected could be allowed to participate in the ex ante bargain?

Keep in mind why the hypothetical bargain has been labelled with reference to the insolvent firm's creditors. Why for example are the shareholders not mentioned? The ex ante bargain seeks to adopt the standpoint of the parties most directly affected by the mandatory provisions of the insolvency regime, and asks whether these parties themselves would accept such restrictions. When the firm enters insolvent liquidation, not even its creditors -- those entitled to line up in front of the shareholders for the firm's assets -- would get back all they are owed. A fortiori, shareholders have little hope of recovering anything, and little real interest in the conduct of the proceedings. So understandably, expositors of the hypothetical bargain can

[52] That s. 214 pierces the corporate veil has been recognised both judicially and academically. For example, see Yukong Lines Ltd. of Korea v Rendsburg Investments Corp. of Liberia and Others (No 2) [1998] 1 W.L.R. 294, 306-A, per Toulson J. quoting Lord Cooke delivering the 1997 Hamlyn lecture, and Williams and McGee, "Unfit directors", 5.

drop any reference to them. Creditors give their name to the bargain because the insolvency proceedings deal most directly with their interests, and the coercion inherent therein most directly affects them.

Note, though, that the firm's shareholders are in fact silent parties to the hypothetical agreement. They have bargained for the residual claim on the firm's profits and assets, once other liabilities are met. Put differently, they have agreed to postpone their claims to those of the firm's creditors in return for the final and unlimited, though contingent, rights to the firm.[53] If the firm were to be liquidated solvent, its shareholders would be waiting patiently at the end of the queue while prior claimants vindicated their fixed rights. In an insolvent liquidation, shareholders drop out of the picture ex post, but this is precisely because they are parties to the agreement ex ante, inducing creditors to lend to the firm by promising to subordinate their position to that of the lenders. Once it is realised that shareholders are in fact party to the "creditors'" bargain, it becomes possible to attempt an exposition of the bargain with a view to justifying the s. 214 duty.

Let's start with an introduction to the notion of agency costs.[54] Lawyers are of course familiar with the legal concept of agency. In the economics literature, an agency relationship is defined much more broadly as existing whenever "there is an arrangement in which one person's [the principal's] welfare depends on what another person [the agent] does".[55] Agency costs will arise whenever both parties are concerned to maximise their own utility, and this being so, "there is good reason to believe the agent will not always act in the best interests of the principal".[56] The principal can try to overcome this problem by designing a set of incentives which bring together the agent's interests and his own. The principal can also divert resources to checking on and controlling the agent's activities. The costs of these efforts are referred to as monitoring costs. In certain circumstances discussed below, the agent himself would have an incentive to offer guarantees against his own misbehaviour, perhaps by providing for mechanisms which

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[53] This does no more than re-state the basic nature of the shareholders' claims, while focusing on the fact that a firm is essentially a voluntary nexus of various contractual rights. Note that whatever lawyers may think, there is no inherent fundamental economic difference between debt and equity claims. Both sorts of claimant contribute to the firm's assets, and both bear some degree of risk. See the seminal work by Modigliani and Miller, "The cost of capital, corporate finance and the theory of investment" (1958) 48 American Economic Review 261.

[54] Most relevant here is Jensen and Meckling, "Theory of the firm: managerial behavior, agency costs and ownership structure" (1976) 3 J. Financial Economics 305.

[55] Pindyck and Rubinfeld, Microeconomics, (New Jersey 1998) (4th ed.), at 632. See also Jensen and Meckling, "Theory", at 308.

[56] Jensen and Meckling, "Theory", at 308.

would compensate the principal at the agent's expense, if the latter does misbehave. Such activities are generically called bonding. Finally, and despite the existence of monitoring and bonding mechanisms, it is suggested there would still be some divergence between the decisions the agent ought to take in order to maximise his principal's utility, and the decisions he would in fact take.[57] This loss in utility is referred to as the residual loss. Agency costs are then defined as the sum of monitoring and bonding costs and the residual loss.[58] It is to be noted that all references to agency in this paper are to this -- and not the legal -- notion of agency.

Look again at the typical (and grossly over-simplified) structure of a limited liability firm. Shareholders provide the initial capital in return for a contingent but unlimited residual claim on the firm, and decision-making and day-to-day oversight are entrusted to the company's managers. Creditors lend a certain amount at a price, with the promise of repayment over a specified period. Note that the managers are under legal obligations to further the interests of the company, which equates to the interests of the shareholders while the firm is solvent. With this in mind, assume for the moment that managers act on behalf of shareholders in administering the firm, and that there is an identity of interests between them.[59] It should be obvious that the existence of debt in the firm's capital structure creates agency costs. The welfare of creditors lies in being paid interest over the pendency of the loan, and in having the capital repaid in full at the loan's maturity. But once the debt contract is concluded, the money is dealt with by the firm's managers, who wish to benefit a totally different class of claimant. In trying to maximise the shareholders' collective utility, managers rationally have an incentive to deviate from the course most likely to maximise utility to creditors. Note that this incentive becomes more potent as the firm teeters on the brink of insolvent liquidation:

> As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehavior. But once the business environment deteriorates, the

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[57] This is because "the cost of full enforcement of [monitoring and bonding] contracts exceeds the benefits"; see Fama and Jensen, "Agency problems and residual claims" (1983) 26 Journal of Law and Economics 327, at 327.

[58] Jensen and Meckling, "Theory", at 308.

[59] The assumption is reasonable, obviously for managers of closely-held firms, but to a degree, even for those of publicly-held ones. See Cheffins, 522: "In public companies, this alignment [of shareholder and manager interests] can occur because of a combination of contractual terms (e.g., managerial remuneration packages) and market factors (e.g., the market for corporate control)" [footnote omitted]. But of course it should never be forgotten that rational managers would actually seek to maximise their own utility, and this creates conflicts (i.e. agency costs) between them and shareholders. So the assumption made in the text here is relaxed in the next Section, when the differences between openly- and closely-held firms is considered, and in the final Section of this paper, where the incentives created by s. 214 are examined.

> [firm's decision-maker] is increasingly influenced by a "high-roller" strategy. The poorer the prospects for a profitable conclusion to the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct.[60]

At least three different forms of creditor/manager agency costs are relevant to the argument here.[61] The first, labelled asset substitution, arises because, after the debt contract has been entered into, managers have an incentive to increase the riskiness of the relevant part of the company's business, choosing to opt for a strategy which promises to pay more but with a smaller probability. Since debtors are limited to their fixed claims, any increased returns are captured wholly by the shareholders, but losses are shared by the creditors as well. Crucially, the incentive to substitute is heightened when the firm becomes financially distressed. If it enters insolvent liquidation, shareholders would simply drop out of the picture. There is every reason for managers, acting in the shareholders' interests, to venture the firm's resources on increasingly desperate strategies, gambling on the possibility that the firm would recover. At the very least, in a bid to stave off liquidation, managers might sell off the firm's less essential physical assets (eg. "nonspecific equipment that comprises excess capacity"), using the money to buy employee hours, which are valuable only if the firm recovers.[62] Physical assets previously available to meet creditors' claims no longer remain in the company's ownership.

The second type of cost arises because once managers have committed the firm to a particular debt contract, they have an incentive to offer equal or higher priority to another creditor. This dilutes the original lender's claim, forcing him to compete with, or be subordinated to, the new lender. Again, this conflict intensifies when the firm is in trouble. "Management might, for example, have the debtor borrow from a later secured creditor to meet payroll in an attempt -- foolish from the investors' collective perspective -- to keep the firm in business long enough for a possible but unlikely reversal of fortune."[63]

A third category of cost arises because managers possess more, and more accurate, information about the firm's prospects and the riskiness of its strategies, than creditors.[64] Yet again, this is critical when the firm is having difficulties. Creditors need reassurance this

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[60] Scott, "Relational theory", at 624.

[61] For an overview, see Drukarczyk, "Secured debt, bankruptcy, and the creditors' bargain model" (1991) 11 International Review of Law and Economics 203, 205-7 and Scott, "Relational theory", 919-921.

[62] Adler, "An equity-agency solution to the bankruptcy-priority puzzle" (1993) 22 J. Legal Studies 73, 82.

[63] Ibid., at 80.

[64] Drukarczyk, "Secured debt", at 206-7.

information would be used to decide in the collective interest when the firm should be made subject to the collective insolvency proceedings, but managers have an incentive to withhold it for precisely that reason. They serve the sectional interests of shareholders. To allow the firm to enter the insolvency forum is to lose the chance of preventing the shareholders' equity becoming worthless.[65]

Imagine now the (hypothetical) instant in time when the ex ante bargain is concluded. Creditors and shareholders alike realise that lending to the firm by creditors would give rise to the agency costs described above, managers striving to act in the shareholders' interests and to the creditors' detriment. Now creditors could contract for the right to monitor managers' actions. Monitoring would then be carried out during the pendency of the loans to the point where the additional advantage from monitoring any further equals the additional cost of the monitoring activities. It is important to realise, though, that as long as creditors anticipate the existence of these additional costs, they take them into account when deciding what to charge the firm for their loans. So monitoring costs are passed on to the firm, and to those who have bargained for a residual claim on it. It is the firm's shareholders and not its creditors who suffer these costs, since more of the firm's income goes to service its debt, and less remains for disbursement to the residual claimants.[66]

How would creditors monitor the managers' activities? They would bargain, for example, for the right to have the firm's accounts audited by independent experts, to include explicit contractual terms restricting managers' freedom of action, and to arrange for the firm's control to pass to those owing allegiance to them once insolvent liquidation is inevitable. But shareholders might want managers to have independent accounts prepared in any case for their own inspection. It would also be cheaper for shareholders simply to accept that in case the firm becomes seriously troubled, managers should be required to protect the interests of creditors. Note that anticipating the specific steps required of the managers of a troubled firm in all circumstances would be expensive for creditors and shareholders bargaining ex ante. Managers themselves, actually faced with the particular circumstances of their firm, would presumably be best placed to ascertain what needed to be done, and shareholders would offer at the bargaining stage to put them under an open-ended duty.[67] To put it differently, it is in the shareholders' own interests to require managers to bond themselves broadly to the creditors when there is no reasonable prospect of the firm avoiding insolvent liquidation. Whether it is the creditors who

[65] Other types of agency costs include asset conversion and under-investment; ibid.

[66] For a formal proof, see Jensen and Meckling, "Theory", 338-339.

[67] IA, s. 214 (3) reverses the burden of proof, requiring managers to demonstrate they took "every step" they ought to have taken (s 214 (4)) to minimise potential loss to creditors.

monitor managers, or the managers who bond themselves to creditors, it is the shareholders who bear the costs. Shareholders would prefer bonding over monitoring since that is likely to be cheaper in many circumstances:[68] "When monitoring costs, such as direct supervision, are high relative to actions by the debtor that reassure the creditor, both parties will agree ex ante to substitute cost-effective bonding alternatives."[69]

So a s. 214-type duty would be accepted by shareholders in the ex ante bargain. It is important to emphasise here that contrary to appearances, it is not generally the managers who suffer most directly because of this coercive duty. It is the shareholders who "pay" for this duty in the broad sense by being deprived of the managers' allegiance at the time that they have the most to lose. But of course they would choose to be thus deprived, in return for the lower interest rates the firm would have to pay on the credit it incurs during its lifetime. This is not to imply that managers are not affected at all by s. 214. Managers might, for example, want to keep the troubled firm trading in order not to lose their job, and the freedom to do so is curtailed by the wrongful trading provisions. The next Section shows how they too would voluntarily accept a s. 214-type obligation.

IV. PREDICTIONS AND OBSERVATIONS

The agency cost analysis of s. 214 suggests that the duty imposed thereunder would not be equally relevant to all types of firm, nor would all types of creditor stand equally in need of its protection. Section 214 is merely one way in which parties bargaining ex ante would seek to overcome creditor/manager agency problems. The view outlined above implies that where more effective or more focused ways of overcoming these problems are available, s. 214 would be far less important. In this respect, the role of the market for managerial labour, and of secured credit, is especially important.

A. The influence of the market for managerial labour[70]

[68] Jensen and Meckling, "Theory", 325-6 and 338.

[69] Scott, "Relational theory", 927-8.

[70] The ground-breaking work on this point is Fama, "Agency problems and the theory of the firm" (1980) 88 J. Political Economy 288.

In an "openly-held" firm, where the residual risk-bearers (shareholders) are different from the decision-makers (managers), the latter are subject to the discipline of the managerial labour market. The firm itself is always in the market for new talent, and seeks to attract it by promising to reward performance. Existing managers too are concerned with the efficiency with which the firm can differentiate the good from the indifferent decision-maker; the former would be the first to leave if the firm responds sluggishly to the distinction.[71] Further, how well the manager performs in his current position determines not just his present but his future income as well. Remember that managers have invested their human capital heavily in the firm's fortunes. More than the typical shareholder, who is likely to hold a diverse portfolio of equity in many firms, and the typical creditor, who is likely to be supplying goods or credit to many firms, the manager's investment is firm-specific. So the value of the manager's human capital is linked very closely to the fortunes of his firm:

> For the purposes of the managerial labor market, the previous associations of a manager with success and failure are information about his talents. The manager of a firm... may not suffer any immediate gain or loss in current wages from the current performance of his team, but the success or failure of the team impacts his future wages, and this gives the manager a stake in the success of the team.[72]

The managerial labour market exercises control over the manager by ensuring that his future wage reflects his current performance. Indolence or mismanagement on his part affect the fortunes of his firm, which in turn signals the managerial labour market to revise downwards the rewards he can expect in the future. If he has contracted to provide a certain quality of oversight of the firm's affairs, the market judges him according to how successfully he delivers it. Any failure on his part is compensated for by the lower wages the market is willing to offer him in the future.[73] The <u>impact</u> of this downward revision on the performance of the rational manager does not just lie in the future, though. The <u>present</u> value of his human capital is a function both of the stream of present wages, but also of the stream of future wages. So the manager's current performance affects his current wealth. He has an incentive to deliver the performance he promised.

Crucially, though on the margins, the managerial labour market's assessment of his performance encompasses how the manager is likely to behave towards his firm's creditors when the firm is distressed. Remember that the <u>capital</u> market anticipates the incentives he has at that

[71] <u>Ibid</u>., 292.

[72] <u>Ibid</u>.

[73] <u>Ibid</u>., 297-8.

time to act in the shareholders' (and his own) interest, and thus to the creditors' detriment. The additional costs implied by this are passed on to the firm's residual claimants as a rise in the interest rate. This affects the labour market: shareholders (residual claimants) would seek to pass on this extra cost to the managers themselves by ensuring that the firm pays less to managers if employing them makes it more expensive for it to borrow. Similarly, they would have an incentive ex ante to send the correct signal to their company's creditors by employing the right sort of management:

> [T]he reputational integrity of managers is a bond that shareholders can post to other stakeholders [especially creditors] that reduces the costs of monitoring and contracting... [M]anagerial reputational bonds are so valuable in facilitating cost effective contracting that 'shareholders... (will) seek out or train individuals who are capable of commitment to stakeholders, elevate them to management, and entrench them'.[74]

And as explained above, this creates an incentive for managers not to misbehave vis-à-vis the firm's creditors when the firm gets into difficulty. The fact that a firm (partially) under a manager's control is at the point where there are no reasonable prospects of avoiding insolvent liquidation is itself likely to convey information about the manager's abilities to the managerial labour market detrimental to his future prospects. The need for him to act competently and scrupulously after this point therefore becomes even more important. He has an incentive to signal to the market that he is capable of effectively doing all any reasonably competent manager would do to abate the damage done to the company's creditors (who, as it happens, are also the company's new residual "owners"):

> [I]n light of their imminent re-entry into the job market, managers may reason that the best strategy to adopt in a distress situation is one of honesty and integrity. Rather than using wrongdoing as a way of gambling the company back to success, the managers may decide to avoid scrupulously any hint of wrongdoing out of a concern for inflicting irrevocable damage to their reputational capital in the managerial job market.[75]

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[74] Daniels, "Must boards go overboard?" (1994-5) 24 Canadian Business Law Journal 229, 241 fn 43, quoting Shleifer and Summers, "Breach of trust in hostile takeovers" in Auerbach (ed.), Corporate Takeovers (Chicago 1988), at 40.

[75] Daniels, "Boards", 241.

This argument yields the prediction that the s. 214 duty would be more important for firms whose managers are not concerned about the value of their managerial services in that market. Here, s. 214 would be the primary way of countering creditor/manager agency problems. Returning for a minute to the hypothetical bargain, creditors would therefore be more interested in being offered a s. 214-type bond when dealing with firms likely to be run by decision-makers immune to labour market discipline. Further, managers who are so immune would want to offer a s. 214-type bond in order to signal that they would not misbehave, since the freedom to misbehave they otherwise have creates additional costs for the firm which are passed on to them in the form of lower salaries and less desirable employment prospects.[76]

Now the wording of the actual section of the Insolvency Act 1986 makes no distinctions based on how severely a particular manager is subject to the labour market's discipline. But this is reasonable. Firms might go through periods where its managers were more or less subject to that discipline. For example, a manager approaching the end of his working life would be increasingly unaffected by the incentives of the labour market. It would be prohibitively expensive to design a bond which applied with the correct force just at the right time. An all-encompassing obligation is more cost-effective, given the variability of the degree of influence of the managerial market and the diverse reasons for those differences. Still, one would expect the practical significance of the bond to be greater, the smaller the influence of the market.

Most obviously, managers of closely-held firms, who also own a substantial proportion of the firm's equity, are somewhat more immune to labour market incentives.[77] They are not threatened with the loss of their job if they deliver a performance inferior to the one they promised ex ante, since they are in a position qua shareholders to ratify this breach. Put differently, the firm derives idiosyncratic (i.e. non-market) value from employing them. Further, most closely-held firms restrict the alienability of their shares.[78] This means that the take-over mechanism, which limits managers' ability to engage in behaviour detrimental to the value of the firm, is "unimportant in creating incentives to operate efficiently".[79] A consistently poor performance of course decreases the shareholder-manager's wealth, but there is nothing to overcome manager/creditor agency problems. The manager is not going to be fired by his firm, and is therefore not as concerned with keeping a clean record to smooth his future passage in the

[76] Or a lower return on their shares in the firm; see below on closely-held companies.

[77] Generally on closely-held companies, see Easterbrook and Fischel, "Close corporations and agency costs" (1986) 38 Stanford L.R. 271.

[78] Ibid, 273; Farrar et al, Farrar's Company Law (London 1998), 519.

[79] Easterbrook and Fischel, "Close corporations", 276.

managerial market. Entrenched as he is in his current position, he does not see himself in the market for managerial talent.

When the firm is on the verge of insolvent liquidation, it might be thought that a more detached actor in the shareholder-manager's shoes would realise that, his firm no longer being viable, his behaviour vis-à-vis creditors might affect his future prospects. But this is not necessarily the case:

> At least for some [closely-held] firms, the owner-manager will anticipate making substantial nonpecuniary or sentimental investments during the life of the enterprise. These investments are reflected in common metaphors such as "It's my life's work," and "My name is over the door." Furthermore, an owner-manager's firm-specific investment is essentially nondiversifiable.[80]

Since the shareholder-manager is likely to have invested a significant proportion of his wealth, material and non-pecuniary, in the firm, and since this investment is likely to be undiversified, he can be expected to fight even more single-mindedly to keep the firm afloat.

So the shareholder-manager's identification with his firm remains strong. Correspondingly, the influence of the managerial labour market remains small. The agency cost view of s. 214 suggests the legal duty to have regard to the interests of creditors when insolvency becomes inevitable would be more relevant to directors of closely-held firms. Creditors lending to such firms would want to charge a higher interest rate in order to be compensated for the greater risk of eve-of-insolvency misbehaviour. For the same reason and in order to avoid having to pay more, shareholder-managers would be willing ex ante to offer a s. 214-type bond.

A similar argument applies to shadow directors. Consider a simple example. Director D calculates that the value of his human capital varies in line with the fortunes of Firm X, for which he has contracted to provide oversight and decision-making. Yet the board of Firm Y, which is wholly owned by Firm X, are accustomed to act according to the directions of either D himself, or of the whole of Firm X's board of directors. In fact, then, D or X itself might be shadow directors of Y.[81] But neither is subject to the discipline of the managerial labour market. This is obviously true in case of X; the rise and fall of the value of Y might have an effect on X's own well-being, but X simply is not an actor on the supply side of the managerial labour market, and there is no counter-weight provided by that market to X's incentive to further its own self-

[80] Jackson and Scott, "Bankruptcy", 174.

[81] IA, s. 251.

interest to the detriment of Y's creditors. But X's director D too considers that the market has no reason to judge him by looking at the fortunes of Y. D has no explicit contractual obligations towards Y, and *prima facie*, in calculating D's future wages, the labour market disregards the actions he induces Y's board to take, even though those actions hurt Y's creditors on the eve of Y's insolvent liquidation. This is because the interests of Y's creditors would not necessarily be coterminous with those of X's creditors. There might even be a conflict between them. Director D's future prospects in the labour market depend of course on how his actions affect the fortunes of his own firm's stakeholders. Here again, it can be predicted that s. 214 would provide the more important bulwark against anti-creditor actions. One normative recommendation would then be that courts, contrary to their present bias,[82] be somewhat more willing to hold shadows liable for wrongful trading.

Is there any empirical confirmation for these predictions? An interesting exercise would be to examine decided cases where wrongful trading (as defined by s. 214) was an issue. It must be emphasised that such an exercise would not produce results which were statistically significant, since the sample size would be too small in relation to the total number of financially distressed firms, and since there is probably a preponderance of closely-held firms as a proportion of all the firms in the economy.[83] Further, decisions which find their way into print, or whose transcripts are readily available, are not necessarily a good guide to the factual circumstances where a legally-imposed s. 214-type duty is most relevant, especially in cases where the s. 214 claim in never litigated. Having said that, a particular trend in these decisions might provide some ('impressionistic') insight into the role of s. 214 as a secondary device for controlling agency problems.

A rough and ready survey of the English and Welsh cases provides interesting results. Information is available about five decisions where a s. 214 claim was successful, and in all these cases, at least one of the wrongfully trading directors had a substantial shareholding.[84] In another seven decisions, the court indicated that the facts revealed the directors might have been trading wrongfully. These decisions concern claims under s. 214 by the liquidator where a

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[82] see Bhattacharyya, "Shadow directors and wrongful trading revisited" (1995) Company Lawyer, 16(10), 313.

[83] Farrar, 518-9; Carsberg et al, Small Company Financial Reporting (Englewood Cliffs, 1985) at 79.

[84] The brackets following the case citation indicate the proportion of the issued shares of the company held by the relevant director, where this information is available or can be surmised from the facts: Re Brian D Pierson (Contractors) Ltd. [1999] B.C.C. 26 (H and W between them held 100%); Re Fairmont Tours (Yorkshire) Ltd. (unreported) noted in Insolvency Litigation and Practice, July 1996, 12 (100%); Re Purpoint Ltd. [1991] B.C.L.C. 491 (100%); Re DKG Contractors Ltd.; Lewis v DKG Contractors Ltd. [1990] B.C.C. 903 (98%); Re Produce Marketing Consortium Ltd. (No 2) [1989] B.C.L.C. 520 (50%).

preliminary point was litigated, or where an allegation amounting to wrongful trading was made as part of an application to disqualify a director. Again, all of these cases concern closely-held firms.[85] Further, there are six decisions where applications for a s. 214 contribution were abandoned or lost at trial or struck out for want of prosecution, or where an application to disqualify a director on charges amounting to wrongful trading failed, and all of these firms seem closely held as well.[86] Even these 'failures' are instructive for the purposes of this paper: whether the allegations of wrongful trading stick or not, it is only where the influence of the managerial labour market is weak that issues concerning the legal solution to creditor/manager agency problems are likely to arise. Eight cases concerned with possible wrongful trading issues were litigated where the target of the (potential) action was alleged to be a shadow director.[87]

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[85] Re TLL, Secretary of State for Trade and Industry v Collins and others (Ch. D, 27 November 1998) (Transcript) (5%, plus an option for another 5%); Re Leading Guides International Ltd. (in liq.) [1998] 1 B.C.L.C. 620 (100%); Re Sykes (Butchers) Ltd. (in liq.); Secretary of State for Trade and Industry v Richardson and another [1998] 1 B.C.L.C. 110 (at least 20% of one relevant company by director against whom the application to disqualify succeeded); Secretary of State for Trade and Industry v Laing and others [1996] 2 B.C.L.C. 324 (the disqualified *de jure* director held at least 51% shares at all material times); Re Living Images Ltd. [1996] 1 B.C.L.C. 348 (99%); Re Keypack Homecare Ltd. [1987] B.C.L.C. 409 (unclear, but seems to be closely-held); International Westminster Bank plc v Okeanos Maritime Corporation [1987] 3 All E.R. 137 (again unclear, but again, seems to be closely-held).

[86] Secretary of State for Trade and Industry v Blake and others [1997] 1 B.C.L.C. 728 (seems closely-held); Re Grayan Building Services Ltd. (in liq.) [1995] Ch. 241 CA, [1995] B.C.C. 554 HL (100%); Re Farmizer (Products) Ltd.; Moore and another v Gadd and another [1997] 1 B.C.L.C. 589 (CA), [1995] 2 B.C.L.C. 462 (HC) (100%); Re MC Bacon Ltd. [1991] Ch. 127 (again, seems closely-held); Re Sykes (Butchers) Ltd. (in liq.); Secretary of State for Trade and Industry v Richardson and another [1998] 1 B.C.L.C. 110 (80% by director against whom the application to disqualify failed); Ward (liquidator of Span Technology Ltd.) v Sellors and others (CA, 27 October 1997) (Transcript) (100%); Re Sherborne Associates Ltd. [1995] B.C.C. 40 (36%, 36%, and 3% of the initial shares issued).

[87] Burgoine and another v Waltham Forest London Council and another (Transcript), 95 L.G.R. 520, *The Times*, 7 Nov. 1996 (The Council here was clearly a shadow director, as well as owning 50% shares in the company); Re Oasis [1998] Ch. 170 (very inadequate information on the subject, but some directors were shadows); Re Hydrodam (Corby) Ltd. [1994] 2 B.C.L.C. 180 (on the facts, claim against the parent company as shadow failed); Re Latreefers Inc., Stocznia Gdanska SA v Latreefers Inc. [1999] 1 B.C.L.C. 271 (Court thought a s. 214 claim might exist); Re a Company (No 005009 of 1987), ex p Cropp and another [1989] B.C.L.C. 13; International Westminster Bank plc v Okeanos Maritime Corporation [1987] 3 All E.R. 137 (seems shadows were involved); Secretary of State for Trade and Industry v Laing and others [1996] 2 B.C.L.C. 324 (Held that directors of the company which had abortively tried to purchase the now-insolvent firm were not shadows); Re PFTZM Lid [1995] 2 B.C.L.C. 354 (Bank was major creditor of closely-held company; its officers were held not to be the insolvent company's shadows).

For the sake of completeness, no relevant information was available in two cases,[88] and the one reported case where an administration order was sought (in extreme haste), inter alia, explicitly to avoid any wrongful trading by the directors seems to involve an openly-held company.[89]

So of the 25 decisions where relevant information was available, 24 concern either closely-held firms, or shadow directors, or both.[90] Bearing in mind the statistical insignificance of these results and the possible bias in the sample, all that can be said is that they at least do nothing to disconfirm the hypothesis that the s. 214 duty is relevant primarily to managers who are not subject to the full discipline of the managerial labour market. It can be expected that most wrongful trading claims would be brought against such managers.[91]

B. The role of secured credit

Consider now the effect of the existence of secured credit. The role of security in overcoming agency problems has long been recognised, even though there is little consensus on how it works, on what sort of incentives it creates, and on whether it is cost-effective collectively for the firm and its creditors![92] But the debate rages mainly on whether there are net benefits of secured

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88 Hughes and another v Beckett and others (CA, 6 April 1998) (Transcript) (public company, but no information as to whether any director had substantial shareholdings, or whether a shadow was involved); R v Millard (CA Criminal Division) (unreported) noted in [1994] Crim. L.R. 146 (conviction for fraudulent trading; issue was length of disqualification).

89 Re Chancery plc [1991] B.C.L.C. 712.

90 The one exception is Re Howard Holdings Inc.; Norton Coles and Others v Thompson [1998] B.C.C. 549. An interesting feature of this case is the fact that, while the three directors subject to the present claim were not shareholders of the company or shadows, neither did they exercise any real control over the company's affairs. The company's management was actually undertaken by E, who was either a *de facto* or a shadow director (550F; Millet J's *dictum* in Re Hydorodam [1994] 2 B.C.L.C. 180 emphasising the mutual exclusivity of the two relationships is duly noted here, but there simply isn't sufficient information to ascertain which label better describes E's position). Proceedings against the three nominal directors seem to have been initiated because E had been adjudged bankrupt, and his whereabouts were uncertain (551E).

91 Discussion here has been restricted to directors of closely-held firms and shadows. But the prediction generated by the agency analysis of the wrongful trading provisions applies wherever the labour market's influence is weak. This is truer for older directors than younger ones, and for non-executive directors who are not professional managers than career managers, etc.

92 See e.g. Jackson and Kronman, "Secured financing and priorities among creditors", (1979) 88 Yale L.J. 1143; Levmore, "Monitors and freeriders in commercial and corporate settings", (1982) 92 Yale L.J. 49; Scott, "Relational theory" (1986); Drukarczyk, "Secured debt" (1991); Adler, "Equity-agency" (1993); LoPucki, "The unsecured creditor's bargain" (1994) 80 Virginia L.R. 1887.

credit.[93] Hardly anyone doubts that security helps control agency for the secured creditor himself, and it is this uncontroversial proposition which forms the basis for the argument in the rest of this section.

It is important to realise that secured credit itself represents a form of bonding by management to secured creditors.[94] Recall the various forms of creditor/manager agency costs discussed in the previous section as they exist on the eve of the firm's insolvent liquidation. The secured creditor has the first claim against the assets the debtor has offered as collateral, and this priority is good against any subsequent purchaser or lender. The initial creditor is immune from having his claim diluted by the debtor taking on (unauthorised) higher priority debt after contracting with him. He is also protected from the incentive the debtor's managers have to increase the risk he must bear:

> If... after a fully secured loan, management has the firm borrow additional funds from a subsequent creditor and then squander those additional funds on a risky project, the initial creditor receives payment in full before the subsequent lender receives any property from the firm... [When the firm approaches insolvent liquidation,] [s]ecured credit's restriction on asset substitution can be valuable, [even] if it does nothing more than prevent a firm from cannibalizing itself, perhaps one Xerox machine at a time [to buy time outside the collective insolvency forum].[95]

Security also has a role as "hostage",[96] because the creditor can seize the collateral if the debtor attempts to misbehave; alternatively, the creditor can assume control of the relevant portion of the business by appointing a receiver. In addition, when the firm is financially distressed, other creditors are reluctant to lend and be subordinated to the secured creditor, and approaching the latter might be the only way the firm can obtain ready credit. The debtor firm's managers therefore have an incentive to keep the secured creditor abreast of the state and prospects of the firm's business, and he is unlikely to be surprised by the firm's distress.

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[93] For a persuasive argument and evidence that "new money" secured credit has benefits for secured and unsecured creditors, see Schwarcz, "The easy case for the priority of secured claims in bankruptcy" (1992) 47 Duke L.J. 425.

[94] See e.g. Adler, "Equity-agency", at 77.

[95] Ibid., 78 and 82. Of course the debtor can still do so, but only with the secured creditor's consent.

[96] Scott, "Relational theory", 927-8.

With this in mind, return again to the moment when creditors and shareholders come together to conclude the hypothetical bargain. It should be obvious that creditors who intend to extract security have no need for -- and the firm's shareholders and managers have no incentive to offer -- a s. 214-type bond. All the advantages associated with the s. 214-type duty have already been obtained by secured creditors for their own benefit in the process of acquiring security. It is only the unsecured creditors who have no contractual protection against manager misbehaviour, and shareholders and managers would benefit from offering only them the s. 214 bond.

This analysis provides a justification for the Court of Appeal's decision in Re Oasis Merchandising Services Ltd. that recoveries from errant directors under s. 214 are held by the liquidator on a statutory trust for the insolvent firm's unsecured creditors.[97] This serves to highlight the fact that wrongfully trading directors have breached their bond obligations to unsecured creditors, who have also suffered the costs resulting from this breach. Secured creditors do not benefit from the recoveries under this section because, simply, they do not need its protection.

This analysis also suggests how secured credit might have evolved as an alternative to a more general s. 214-type bond. If shareholders and managers derive benefit from the s. 214 duty, why did something very similar not appear voluntarily in corporate debt contracts before s. 214 was enacted?[98] Note that creditors themselves could not extract a bond too similar to the s. 214 duty. In the real world, all the creditors who would lend to the firm during its existence can not come together to negotiate collectively with the firm's shareholders and managers before any lending takes place. Each creditor must transact separately on his own behalf. The problem is that to extract a promise from the firm that on the eve of the debtor's insolvent liquidation, managers would act to minimise loss to all creditors, would be to create an externality: the one creditor pays for benefit to be conferred on all. Conversely, a promise to minimise loss only to the one creditor would be to confer a preference on him, and this offends the policy of insolvency law.[99] Another way would be for the duty to appear in the articles of association of firms, inserted by the firm's founders to signal to all creditors that they were protected against eve-of-insolvency manager misbehaviour. But the articles of association constitute a contract,

[97] [1997] 2 W.L.R. 764, 773A-777F.

[98] This question is posed by Cheffins, 547, as a possible objection to viewing s. 214 as mirroring the agreement interested parties themselves would strike.

[99] Re MC Bacon [1990] B.C.L.C. 325. The debtor's desire to prefer would be obvious from the actions of its managers in having contracted ex ante to do so.

though a distinctive one with its own special features,[100] between the firm's shareholders, or between them and the firm's directors as representing the company.[101] Legal doctrine regards the firm's creditors as "outsiders", not privy to that contract, and therefore unable to enforce anything contained in the articles of association.[102] So a duty imposed there for the benefit of the firm's creditors, not being enforceable by the latter, would provide, at best, a very weak signal. That component of the interest rate charged to compensate creditors for the risk of eve-of-insolvency misbehaviour by the firm's managers would therefore be unlikely to be reduced.

The solution to this would-be problem surely lies in the existence of third party security. Commercially powerful lenders (i.e. banks) seek a charge especially from shareholder-managers of closely-held firms over their personal property, including family homes. This creates a powerful bond, providing banks with effective ways of preventing misbehaviour at the time that the business is in trouble.[103] The predominance of this form of bonding might have compensated for the lack of -- and even impeded -- the evolution of a more inclusive s. 214-type alternative.

V. PERVERSE INCENTIVES

The previous sections of this paper have suggested that despite being redistributive, the s. 214 duty would be accepted as being in their interest by the relevant parties negotiating ex ante. This section examines the effect of the duty on directors both while their company is healthy, and when it is in terminal decline. Three different types of incentive have been identified,[104] and these are analysed in turn. Each of these incentives exists because of the agency relationship between both managers and creditors, and managers and shareholders, and because when the firm is financially distressed, there is a sharp divergence of interests between shareholders and managers on the one hand, and creditors on the other. Inefficiency exists because managers try

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[100] Companies Act 1985, s. 14; Bratton Seymour Service Co. Ltd. v Oxborough [1992] B.C.L.C. 693, CA.

[101] Eley v Positive Government Security Life Association (1876) 1 Ex.D. 88.

[102] Hickman v Kent or Romney Marsh Sheep-Breeders' Association [1915] 1 Ch. 881; Beattie v Beattie [1938] Ch. 708; see generally Farrar, 118-124.

[103] Cheffins, 547, also points out that lenders do not usually seek such protection when dealing with public companies. Adopting the analysis in this Section, this is easy to understand: contractual protection against eve-of-insolvency misbehaviour by managers of publicly-held companies is generally superfluous because of the stronger influence of the market for managerial labour.

[104] Adopted with some modification from White's insightful modelling of bankruptcy costs in "The costs of corporate bankruptcy: a US-European comparison" in Bhandari and Weiss (eds.), Corporate Bankruptcy (New York 1996), 467.

to maximise their own utility. Such behaviour is not utility-maximising from the creditors' perspective (the punishment, delay and haste effects). It might even be disadvantageous to shareholders (the punishment and haste effects).

A. The punishment effect

The punishment effect exists for all firms, whether they are healthy or troubled. Consider the suggestion that the expected value of the firm is a function of (inter alia) the efforts and abilities of its managers. To create incentives for managers to give their best, the firm's shareholders, who benefit from a rise in its value, would design a pay structure which rewarded the managers when the firm did well, and punished them when it performed poorly. The existence of debt in the corporate structure opens up the possibility that the firm would be forced into insolvent liquidation if management fails to provide adequate decision-making and supervision. In this way, debt itself bonds management to shareholders, encouraging them to work to avoid this eventuality and thus in the shareholders' interest. But "for the bonding role of debt to be effective, management must suffer a significant penalty for nonpayment of debts, that is, for going bankrupt."[105] This line of reasoning suggests a provision of insolvency law which penalises managers when the firm becomes insolvent creates the correct incentives for diligence and hard work.

But if the managers are risk averse, the punishment effect may create perverse incentives. Recall that if Claim A carries a certain £100 return, and Claim B carries a return which might be either £200 or £0 with equal probability, the risk averse actor chooses Claim A.[106] Put differently, he prefers a lower but more stable stream of income over a higher but more variable one. There is in fact some evidence that managers in real life are risk averse,[107] which means they "may work harder if the variability of their incomes is reduced (i.e., lower income when the firm is successful in return for more lenient treatment when the firm is in financial distress)... This suggests that real world managers may work harder if they are treated leniently, rather than harshly, when the firm is [seriously troubled]."[108]

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[105] Aghion et al, "The economics of bankruptcy reform" (1992) 8 J. Law, Economics, & Organization 523, 531 (footnote omitted).

[106] See generally Pindyck and Rubinfeld, Microeconomics, Ch. 5.

[107] White, "Costs", at 481, citing Jensen and Murphy, "Performance pay and top-management incentives" (1990) 2 J. Political Economy 225.

[108] White, "Costs", at 481.

A policy punishing risk averse managers in their firm's insolvency might not then create the correct incentives. It is important, though, to examine <u>why</u> managers might be risk averse:

> One reason for managers' risk aversion may be that the value of the firm depends both on managers' effort and on industry-wide or economy-wide factors that are beyond the manager[s'] control. If a firm is unsuccessful, it could either be because managers' effort level was low or because factors beyond managers' control were unfavorable and shareholders may not be able to distinguish between these two.[109]

In other words, managers might be willing to accept responsibility for the variation in their firm's value attributable to their efforts, but they do not wish to act as insurers for shareholders against a downturn in the firm's fortunes totally unrelated to any action or omission on their part. This would imply that an insolvency law rule which focused only on the efforts of managers in penalising them would create an incentive for them to provide the right level and quality of decision-making. The same must hold <u>mutatis mutandis</u> as to the managers' incentives to work in the creditors' interest, especially on the eve of the firm's insolvent liquidation, when creditors replace shareholders as the firm's residual "owners".

Now s. 214 does penalise managers,[110] making them personally liable for harm done to the company's creditors. The concern is not with management's culpability in bringing the firm to the brink of insolvent liquidation, but on what happens past this point. Interestingly, the provision concerns itself exclusively with the managers' actions, requiring them to demonstrate they took "every step [they] ought to have taken" to minimise potential loss to creditors.[111] Note also that the steps required of them are those "which would be... taken[] by a reasonably diligent person" having both the skill and expertise "that may reasonably be expected" of someone occupying that position, and the knowledge and experience possessed by the actual managers respectively.[112] It is clear, then, that s. 214 does not require of managers anything they ought not to be expected to bring to their job, and it does not require them to bear the risk of extraneous factors affecting the firm's health. If the analysis above is correct (and depending on what other

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[109] <u>Ibid</u>, fn 36.

[110] The use of the word "penal" in relation to s. 214 in this paper should be taken to mean no more than that it compensates the insolvent company's creditors for a particular category of loss <u>at the expense of</u> its managers. But see the text later in this sub-section as to the primary role of the provision.

[111] Section 214(3).

[112] Section 214(4).

reasons, apart from the one mentioned, make managers risk averse), s. 214 does in fact create the proper incentive for managers to provide the service they were contracted to provide.

A final word on the punishment effect. It is vital to realise that "if the goal is to design an economically efficient bankruptcy law, then the effects of the law on firms that are in financial distress or bankruptcy are less important than the incentives that the law sets up for managers of healthy firms."[113] The reason is that only a small proportion of the firms in the economy at any time are in the formal insolvency forum, and only a somewhat greater number are in financial distress. The punishment effect is by far the most important of the incentives discussed in this Section because it applies to managers of <u>all</u> the firms in the economy.[114] It follows that it would be misguided to judge the efficacy or otherwise of the punishment effect created by s. 214 only by looking at the number of proceedings brought by liquidators or the number of successful recoveries made under it.[115] In fact, the effect of the section is somewhat more abstract, bringing very close to home for all directors the reality of the interests of unsecured creditors throughout the firm's life. Empirically, a more accurate approach would be to compare the dividends paid out in all insolvent liquidations as a percentage of the value of all unsecured claims, before and after the coming into force of the provision.[116] This would indicate whether the section is successful in its aim of encouraging directors to minimise loss to creditors on the eve of their company's insolvency.

The analysis above also suggests a partial answer to critics of penal provisions like s. 214 who argue that it is pointless to pursue directors of failed companies who might have offered personal security to banks etc., or have invested heavily in their firm while it was on its deathbed. The liquidator, wielding his s. 214 claim, would be unable to recover much from them for the company's creditors.[117] This criticism focuses too narrowly on the position when the firm is already distressed, and overlooks the fact that the punishment effect associated with the wrongful trading provisions exists through out the time that the firm is in operation. The <u>dominant</u> role of s. 214 is not to make good a particular category of loss to the company's

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[113] White, "Costs", 467; see also 496.

[114] <u>Ibid</u>, 491.

[115] Criticism on this basis has come for example from <u>Cheffins</u>, 545, and the sources cited therein (fn 269).

[116] The ratio of recoveries to claims should rise as knowledge of the section and the duties it imposes becomes more widespread.

[117] See <u>e.g.</u> Baird, "Initiation", 223, and Williams and McGee, "Unfit directors".

creditors, but to encourage managers to do all they reasonably ought to, to minimise that loss in the first place.[118]

B. The delay effect

This incentive arises where managers anticipate a harsh treatment in insolvency proceedings, and take steps to avoid putting their financially troubled company into the insolvency forum. Recall also the argument that creating new rights only within the insolvency forum causes those who lose out as a result (the insolvent firm's directors, in the case of s. 214) to try to avoid that forum altogether.[119] If the company is inefficient, so that its assets would be better used elsewhere or under new management, the incentive to delay the onset of formal proceedings is perverse.[120] The paradox is that the harsher the treatment of the managers of insolvent firms, the greater is the incentive for managers to work hard,[121] and the smaller the number of firms which are financially distressed because of manager inefficiency in the first place.[122]

Look at the costs resulting from maintaining the firm's assets in an inefficient use U1; let the value of the firm engaged in U1 be V(U1). Suppose these assets can be put to another more profitable use, U2, which would increase the value of the firm to V(U2). Creditors would benefit from the firm being committed to the new enterprise. Alternatively, the diktats of economic efficiency might demand that the firm be liquidated at the earliest, so that the assets can move to the higher value use.[123] But managers might not choose either alternative. They would not adopt the more efficient use of the firm's assets because "[their] human capital [was] specialized to the old use of [the firm's] capital",[124] and they would not cause the firm to enter the insolvency forum because they would lose their jobs. The delay effect includes the opportunity cost of the forgone use U2, which is V(U2) - V(U1).[125] In addition, managers would contrive to keep the firm out of the insolvency regime's reach either by choosing excessively risky projects (over-investment), or by conserving cash (under-investment), or by inducing creditors to lend to

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[118] For the view that lack of litigation under the section might be undermining its ability to influence manager behaviour, see Cheffins, 545.

[119] see Section I, above.

[120] White, "Costs", 485.

[121] Subject to the remarks about risk aversion, above.

[122] White, "Costs", 485. As has already been noted, firms might be distressed for industry- and economy-wide reasons and not because of any management shortcoming.

[123] Ibid, 486.

[124] Ibid.

[125] that is, the excess in the firm's value, had its resources been applied to U2, over the value of the firm with its resources sunk in U1.

them in return for a charge on the firm's assets (claim dilution).[126] When the firm is finally liquidated, there would not be much left for its unsecured creditors.

Consider now the effect of s. 214, which is redistributive and "harsh".[127] Does it create perverse incentives for directors to postpone the moment at which the insolvency regime applies? It is suggested here that the reverse is in fact true. Recall that once there remains no reasonable prospect of their firm avoiding insolvent liquidation, directors are required to take every step they ought to take to minimise harm to creditors. To continue with the notation employed above, s. 214 compels directors to choose at the earliest to commit the firm's assets to their most valuable use, U2, since that is one of the steps reasonable directors faced with that situation would take. If this is not done, the opportunity cost [V(U2) - V(U1)] is in fact the harm done to the firm's creditors by the directors' omission, and this amount is a constituent of the total amount of their liability. In the alternative and more generously for them, they might be ordered to contribute "the amount by which the company's assets can be discerned to have been depleted"[128] by the continuation of the company's business beyond the point at which the directors ought to have concluded liquidation was more efficient a choice than continuation in use U1.

Finally, note that if a creditor enables the business to be continued in return for a charge over the company's assets and the directors continue to ward off liquidation, the amount they are eventually ordered to contribute would be immune from any claim the secured creditor might later make.[129] The result is to focus the loss on those making the inefficient decision to continue, and to direct the recoveries towards those who would otherwise lose out because of that decision. As has been mentioned above,[130] the secured creditor can effectively monitor assets subject to the charge, and is unlikely to be taken by surprise when the firm becomes seriously distressed. Directors are unlikely to be able to substitute assets which form part of the collateral without the secured creditor's consent, and in many cases, they would be unable to continue the troubled business without his collusion. The effect of the Re Oasis decision is to ensure the secured debt is not insured, beyond the value of the collateral, by the personal assets of directors. To hold otherwise would have been to reward secured creditors either for inefficient monitoring or for collusion with errant directors.

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126 Ibid, 487.

127 Because it punishes directors for their acts or omissions by making them personally liable for the resulting harm to creditors.

128 Re Produce Marketing Consortium Ltd. (No. 2) [1989] 5 B.C.C. 569, 597.

129 Re Oasis [1997] 2 W.L.R. 764, 773G.

130 Section IV, above.

C. The haste effect

Does s. 214 encourage liquidation of efficient but troubled firms? The costs result from the loss of going concern value,[131] because the firm's assets are more valuable together than if they were split up and sold piecemeal. As a preliminary point, it must be emphasised that the obligation to take "every step" the directors ought to take to minimise loss to creditors should enable directors subsequently challenged under s. 214 to show that continuation of the business was in fact in the creditors' interests at the time that they concluded there was no reasonable prospect of avoiding insolvent liquidation. This view can only gain support from the fact that, when enacting the section, Parliament rejected an attempt to define the obligation with reference to the incurring of further debts or other liabilities, and the word "trading" was omitted from its formulation.[132] In fact, then, the immediate shutting down of the business, while presumably avoiding any further (variable) costs, would not prevent the directors being held liable under the section. By the same token, it should in appropriate circumstances be a good defence that the firm was kept trading, even though this adds to its liabilities: "If directors reasonably believe that creditors may fare worse in a premature forced sale of assets, and that this combined with the cost of liquidation proceedings may well be disastrous from unsecured creditors' point of view, the directors' duty under section 214 may well include a duty to attempt a company rescue or to stay at the helm."[133]

But the concern about over-hasty liquidation becomes important against the background that -- at least in the early days of the wrongful trading provisions -- directors were repeatedly urged to seek a winding up or administration order, or to invite the appointment of a receiver, in order to avoid a s. 214 order against them.[134] Against that background, fears were expressed that "There is a clear risk that this may now seem the safest course for directors, faced as they are with the threat of personal liability and possible disqualification, even when in their own business judgment there is a good case for carrying on."[135]

Note that if the costs of acquiring and transmitting information about the firm's business prospects, and of transferring its assets from an inefficient management (or use) to a

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[131] White labels these as Type-II costs; ibid., at 489.

[132] Sealy and Milman, Annotated Guide to the 1986 Insolvency Legislation (Bicester 1987), 223.

[133] Finch, "Directors' duties: insolvency and the unsecured creditor", in Clarke (ed.) , Current Issues in Insolvency Law (London 1991), 96.

[134] See again e.g. A Revised Framework for Insolvency Law (Cmnd 9175, 1984), above, para. 12; Goode, Insolvency, 472-3.

[135] Sealy and Milman, above, 224.

more efficient one, are low, the going concern value would not be lost. The liquidator or administrative receiver[136] would be able to dispose of the business as a unit, and the new management would decide to keep it running as such.[137] In such a situation, s. 214 does not create unnecessary costs even if directors interpret their obligations under it so as to give undue emphasis to the appointment of outside managers.

But suppose information and other transaction costs are high. In this case, the liquidator might find it difficult to dispose of the business as a going concern because potential buyers are not informed enough to arrive at the correct conclusion that it would pay to keep the business together. Or the reason might be the difficulties inherent in "assembling a suitable group of investors to be risk bearers" of an extensive and costly undertaking.[138] Perhaps most troublesome is the absence of any "stay" on the right of secured creditors to seize the collateral once the winding-up order is handed down.[139] This is regardless of whether adequate protection could be guaranteed, ensuring they would not be worse off with the subject assets remaining part of the going concern than they would be if allowed to remove them for an independent sale.[140]

Be that as it may, it is to be noted that these costs arise because of the misguided elevation of the appointment of outside management as a panacea to all s. 214-related problems and the absence of a stay on secured creditors. Even in this limited situation where s. 214 might create perverse incentives, though, it is difficult to see how it is its redistributive nature that is to blame. Recall that the perverse incentive to hasten the company into the insolvency forum is supposed to arise because the claimants in whose favour the redistribution is carried out would want to capture the advantages available only in that forum.[141] Under s. 214, the firm's unsecured creditors benefit from the redistributive nature of these provisions. But the quantum of the benefit they receive under the insolvency regime is determined by reference to the loss that is attributable to the actions or omissions of the management once insolvent liquidation becomes inevitable. So if the firm's managers <u>delay</u> the inevitable, or otherwise fail to respond appropriately, any additional loss to unsecured creditors would be recovered from them. But if one or more of the unsecured creditors unduly <u>hasten</u> the firm's demise, then it would be easy

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[136] The latter relying in part on IA, s. 43, which empowers the court to authorise disposal of property subject to a prior charge.

[137] White, "Costs", 490.

[138] Aghion <u>et al</u>, "Bankruptcy reform", 528-9.

[139] See again <u>e.g. Re David Lloyd & Co.</u> (1887) 6 Ch. D. 339, 344-5, per James L.J.

[140] This exaggerated deference to the property rights of security-holders is difficult to justify: see Clarke, "Security interests as property".

[141] See Section I, above.

for directors to show they took every step they ought to have taken -- including taking steps to oppose the winding up petition -- to minimise loss to creditors.

VI. CONCLUSION

The analysis in this paper has operated on two levels. First, this paper has shown that the wrongful trading provisions would be voluntarily accepted by the shareholders and managers of the archetypal firm negotiating ex ante with its creditors as being in their own best interest. Creditors, shareholders, and managers alike anticipate the incentives of managers to misbehave towards creditors when the firm is on the brink of insolvent liquidation, and the associated costs are passed on by creditors to shareholders, who in turn would pass it on to managers. A provision like s. 214 bonds managers to creditors when the firm is terminally distressed, and thus signals the credit and labour markets not to penalise shareholders and managers. Of course where a market solution is available -- as it is in the shape of the discipline imposed by the market for managerial labour, and the existence of security -- the s. 214 bond takes the back seat. This paper has suggested that wrongful trading claims would generally be brought against shareholder-managers of closely-held companies, and shadow directors, and has examined 'impressionistic' evidence which agrees with this hypothesis. It has also been shown that the Court of Appeal's decision in Re Oasis, directing s. 214 recoveries away from secured creditors, is perfectly reasonable as a matter of economic efficiency.

On another level, the well-established law and economics proposition -- that to redistribute in insolvency leads to perverse incentives -- has been put to the test within the law and economics framework. It has been argued that the wrongful trading provisions are redistributive. They strip away the benefit of limited liability from the insolvent company's directors, making their assets vulnerable to a claim by the liquidator on behalf of the company's unsecured creditors. This takes place only within the specialised insolvency forum, and only because the distinct insolvency regime creates new rights and liabilities which are incapable of existing while the company is still solvent. Three types of perverse incentive which might potentially lead to socially inefficient results are described. The analysis has suggested that, far from creating perverse incentives, s. 214 in fact encourages directors of troubled and healthy companies alike to operate with some much-needed regard for the company's unsecured creditors.

One way to respond to this analysis would be to argue that the wrongful trading provisions are exceptional in not being inefficient despite being redistributive. It might be suggested that "the question of relative mismatch [between the value of pre- and post-insolvency rights] may not be decisive."[142] One must focus also "on the incentives to misuse bankruptcy created by one rule or the other."[143] It is only if a change in the value of rights creates incentives to use the insolvency regime strategically that the change should be condemned. But this response gives the game away. The position then taken amounts to saying that insolvency redistribution creates perverse incentives, but <u>only</u> where it creates perverse incentives! It is tentatively suggested here that, using Occam's Razor, the objection to the redistribution of rights <u>per se</u> can be cut out altogether. A provision, like s. 214 of the Insolvency Act, may or may not encourage strategic misuse of the insolvency regime, but its redistributive nature is only one relevant factor to be taken into account, and by no means is it decisive. The dogmatic opposition to any alteration of the relative values of parties' rights can be dropped. If this cautious suggestion is accepted, then the law and economics approach can free itself of a self-imposed shackle in dealing with insolvency issues.

A better response would be to concede that the wrongful trading provisions are redistributive. They create new rights and liabilities, and upset the relative values of pre-insolvency rights. But this redistribution still serves maximisation goals. The redistribution is principled, focusing on minimising further loss once the firm enters the insolvency forum, and the quantum of the new rights created is determined with reference to this aim. The section quite clearly preserves and maximises the pool of assets with which the firm enters that forum. It therefore serves the primary goal of insolvency law. It also encourages a smooth transition from the individual pre-insolvency to the collective post-insolvency regime by creating a counter-weight to the value-destroying incentives which otherwise come into existence (unjustified delay in initiating insolvency proceedings is penalised, for example). The wrongful trading provisions also therefore serve the collectivisation goal.

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[142] Jackson, <u>Bankruptcy</u>, 74.

[143] <u>Ibid</u>, commenting on McCoid, "Bankruptcy, the avoiding powers, and unperfected security interests", (1985) 59 Am. Bankr. L.J. 175.