Insolvency in anglo american law

Law

Introduction

A. General

1. The concept of security

There are many attempts to define “ security”, but this concept varies in different countries, and even in different fields of economic and financial activity. Simply put, it can be understood that “ security” is originated from the instinctive fear of risk of financiers. It is similar to a guarantee that someone’s investment, at least, will not make him loose more than what he expects to gain. As clarified by Professor Goode, the concept of security depends on concepts of ownership and possession; it “ involves the grant of a right in an asset which the grantor owns or in which he has an interest”.

‘ Security’ is not officially defined under English law. Its scope has to be drawn from judicial interpretations. Pursuant to the judgment of Re Paramount Airways Ltd, security is defined as “ created where a person (the creditor) obtains rights exercisable against some property in which the debtor has an interest in order to enforce the discharge of the debtor’s obligation to the creditor.” However, this definition is not fixed. The problem of lacking an official definition results in some uncertainties in regulating secured credit under English law.

Under American law, in contrast, ‘ security interest’ is clearly defined as “ an interest in personal property that secures either payment ofmoneyor the performance of an obligation”. The functional approach in secured transaction under American legislations is preferred than the formal approach under English law.

There are two main types of security which are fixed and floating charges. A fixed charge is defined as “ a charge or mortgage secured on particular property, such as land and buildings; and intellectual property such as copyrights, patents, trade marks. A floating charge is an equitable charge on assets which can continued to be traded from time to time without the reacceptance of the mortgagee. Between these two, floating charge is used more commonly.

2. The purpose of taking security

According to Professor McCormack, there are several reasons of taking security. Firstly, security will give priority to a creditor over other unsecured ones in the event of insolvency. According to a survey by the Society of Practitioners of Insolvency, about 75% unsecured creditor received nothing after asset distribution. Suggested from the definition of insolvency, which is a situation that a company loses its ability to pay all of its creditors, priority in insolvency proceedings is very important.

Another reason is that a creditor who takes security will have more control on the lent assets as well as insolvency proceedings. The regime in England under the Enterprise Act 2002 allows a floating charge’s holder to appoint an administrator, whose duty is to ensure a certain share of the insolvent company’s assets for the benefit of such holder. This type of “ self-help” remains controversial. It is criticized a lots as such control is too substantial.

Last but not least, the taking of security is regarded as useful to reduce the cost of investigation into the debtor’s financial situation. Professor Buckley called such costs the “ screening costs”. According to his arguments, as the

borrower has to reveal information to the lender so as to ensure that it is financially able to take the loan, a securely informed creditor will benefit from avoiding more risk in the market. Such information, in insolvency proceedings, will aid in determining the debtor's creditworthiness and anticipated bankruptcy value.

Sub-conclusion: To sum up, security plays a significant role in financial activities of companies. It gives both the borrowers and the lenders benefits which are crucial in their transactions' decisions. However, from the perspectives of a unsecured creditor, the ability of taking security by some creditors results in their higher possibility of receiving nothing in return in the event of insolvency. This essay will discuss such misallocation of resources to the unsecured creditors and examine the reform proposal to solve these problems in 2 main parts respectively. At the end, a conclusion will be drawn that although security causes troubles to non-consensual creditors, any reform needs to be taken with a lot of considerations on the method and in the system as a whole.

B. Problems caused by security

1. Problems of misallocating resources

Lynn LoPucki, in his analysis, has demonstrated that most unsecured creditors are given such status against their will and awareness. Therefore, it is unfair when they are given even less than what they can gain because of the security's usage. By taking securities, the secured creditors, with all the control and benefits as examined above, may take a substantial part of the debtor's assets. The unsecured creditors, who usually outnumber the secured ones but only receive a much smaller part of the insolvent's

resources. Although the basic principle of insolvency law is “ equalityof misery”, many people are forced to be more miserable than others. In order to detect a solution for this matter, this part is illustrated in 2 smaller parts, the first deals with the classification of unsecured creditors and the second discusses the problem in allocating the debtor’s resources.

a. Types of unsecured creditors

There are three types of unsecured creditors, depending on their reaction to such status: uninformed creditors, voluntary creditors and involuntary creditors. Each category is suffered different problems caused by security to their group.

i. Uninformed Creditors

Uninformed creditors are those who accept the status of unsecured creditors despite their acknowledge of the debtor’s situation because they do not properly estimate the risk they are about to take. These creditors are similar to voluntary creditor because they know the situation before making their decision of invest into such debtors. But they are also similar to involuntary creditors because if they had known the “ true state of the law and the debtor’s finances when they made the fatal decision to extend credit (or not to withdraw from an extension already made), [they] would have decided differently.” Their consent, therefore, is not meaningful due to the lack of true understanding of what they are consent to. The example for this type is trade creditors who are so “ uninformed that they systematically undercharge for the extension of credit”

ii. Voluntary Creditors

Examples of voluntary creditors are employees and customers.

Employees: In case employees' wages are not paid, they become creditors of their employer. The missing of payment by an employer serves as the most alarming precaution of its financial situation to the employees. However, as stated by Buckley, " claims for unpaid wages are not substantial in most bankruptcies […] because few employers are willing to risk work stoppages by gambling with unpaid wages."

Customers: Customers are also classified as voluntary creditors of a retailer in case they have warranty claims. In certain cases, the prices they are willing to pay may reflect their ability to foresee the default. Therefore, customers become creditors only if they have proper reaction to such foreseen possibility.

iii. Involuntary Creditors

It is estimated in a study by Sullivan, Warren, and Westbrook that 23% of unsecured creditors filling bankruptcy under Chapter 7 and 13 of the Bankruptcy Code was involuntary creditors. This category includes governmental claimants (tax agencies, pension agencies), tort victims, environmental agencies, utility companies. We will now examine the first two examples of this type.

Governmental claims: A company has many governmental responsibilities. This is shown by its duty in many tax related activities ranging from corporate taxes to employees' income taxes. Moreover, it may have to be involved in some social security program. Thus, in the event of insolvency, it may become debtors of several state entities. And in common cases, the

governmental claims will not consent to be under the status of creditors because it is likely that they will gain nothing due to the unsecured characteristic of debts the company owed to them.

Tort claims: Tort victims are regarded to be the most typical kind of involuntary creditors. As indicated by a study of Manville Corporation cases, the company's book value when it filed for insolvency was only $1. 2 billion book value, while its tort liability was $1. 9 billion is in asbestos-related claims.

It is common that tort claimants do not agree with their unsecured creditor status. In many cases, they even do not agree to be creditor if it is not because of wrongful acts by the debtor violating their rights and benefits. Such wrongful acts may ranging from harmful business acts (negligence, interference,…) to infringement of intellectual property rights However, the insolvency law has not treated them with sufficient priority over other creditors (especially secured creditors).

b. Problems

In the context of this essay, we will discuss the influences of consent-based theory in examining the problems of involuntary and uninformed creditors.

It may be argued that to identify the direct consequences of the lack of consent of a creditor when involving in a company's business is not always easy. Brian Mccall has illustrated an example where a supplier sell inventory on credit to a buyer. The buyer then sells the inventory and uses the proceeds to pay a bill instead of paying the supplierAs a result, the supplier

becomes an non-consensual creditors as resources are misallocated without his consent. Mccal concluded that this can happen because the supplier does not have the general right to consent to every action of the buyer that has an effect on him.

However, that problem should not preclude the idea of fairness and sympathy for unsecured creditors, which is basis for the argument of consent-based theory. The theory provides that it is a violation in taking away the right to payment of creditors who are not consent to such status. By granting security for some creditors, a debtor affects the shares in the asset pool of other involuntary and uninformed creditors. Followers of this theory emphasized that there should not be any distinction between secured and unsecured creditors because both types are entitled to receive their and only their proportional distributions of their respective debts Any priority to one group will result in an " unjust" distribution to the other. We will now analysis the problems resulted by security which are challenging unsecured creditors.

i. Involuntary creditors

In his work, Lynn LoPucki has explained why security is used despite the fact that a major of creditors does not agree with it. The relationship, after using security, between the debtor, the secured creditors and the unsecured ones is indicated as a contract where the first two agree with each other that the last will gain nothing. Therefore, security is widely used because of two parallel stimulations: no one wants to be in the situation of an unsecured creditor whose value in the debtor's asset is contracted to expropriate for

others; and, a debtor also wants to take benefits from “ selling secured status to its voluntary creditors”.

This problem threatens the right to payment of tort victims most. They clearly do not give their consent to the unsecured creditor status as well as the granting of security for other creditors. However, instead of giving them some priority as usual in tort judgement, the introduction of security to insolvency proceedings reduce their chance of receiving exposure to the debtor’s tort liability. This issue is originated from an argument that the consent of the unsecured creditor – the third party, on the contract – the granted security, between the debtor and the secured creditors, is “ implied”. Such argument, according to Lopucki, is “ not likely to save the institution of security”.

It is also argued that it is a principle in economic theory that tort victims should be fully compensated. In regulating the issue of security, legislators who allow its use may not necessarily decide that by granting security, a company can limit or eliminate the exposure to tort liability. Where a company can give full compensation to its tort victims, it should do so “ to the full extent of their wealth”.

ii. Uninformed creditors

Sympathy should also be given to creditors who do not really understand the meaning and consequence of their consent when voluntarily entering in insolvency proceedings. It is not a “ meaningful consent” because they would not agree with their status and extend credit if they are well-informed to proper estimate the risk of debtor’s business.

It may be reasoned that the system should not be changed for the benefit of uninformed creditors because they are responsible for their own decision. Also, some security-supporter may consider that the harm caused to uninformed creditors is " slight". However, it is not unreasonable that a substantial number of creditors do not really know what trouble they are falling into due to the complexity of the insolvency regime.

Taking Art. 9 of the UCC, which govern insolvency matter in American system, as an example, Lynn LoPucki regards it as " highly complex, unintuitive, and notoriously deceptive". Many creditors are small business. Thus, they have to struggle in understanding the principles provided under Art. 9 because they may not afford qualified lawyers. Moreover, this Article is clearly in favor of creditors who are secured and have full knowledge inrespectof the company's financial situation. It becomes easier for them to win in the filing " race" of insolvency proceedings in spite of the fact that in certain cases, their loans are not justified; or even despite a founded principle to protect legitimate expectations of other creditors.

For the purpose of further analysis, uninformed creditors are grouped with involuntary creditors to be referred to as non-consensual creditors.

2. The efficiency of secured credit

According to Steven Schwarcz, there are two types of efficiency of secured credit. The first one is where the taking of security ensures the benefit of both secured and unsecured creditors by increase the debtor's value to cover both types of debt. The second one focus on the harm to unsecured creditors, which is acceptable if it " does not exceed the benefit to the debtor

and the secured creditor”. However, it is unlikely that secured credit can achieve either types of efficiency.

The debate over whether secured credit is efficient is triggered by an article by Professors Jackson and Kronman, in which they argued that it is so. Subsequently, many scholars approved this argument by indicating the economic benefits of secured credit such as lowering screening costs or giving more control and benefits to secured creditors. These are the purpose of taking secured status in transactions, which has been analysed in details above (section A(2)).

In contrast, David Carlson casted doubts on the efficiency of secured credit because “ secured lending is not necessarily inconsistent with economic efficiency, though whether any given security interest is efficient is highly contingent and probably unknowable.” Brian Mccall further emphasized on the fact that even if the proof of economic efficiency can be established, it “ merely tells us one of the effects of a given course of action it does not tell us normatively if such a thing should be done.”

By demonstrating the nature of security under the regime provide by Art. 9 in the UCC, Lynn LoPucki also proved that security is not efficient. The main reason given to establish such conclusion is that the features of security are not always present. There are three features which the author referred to as “ priority, encumbrance and remedy”. Each of those may exist in one type of security but not others; and some arrangements which include an above feature may not be regarded as “ security”. Thus, it is difficult to ensure the “ efficiency” of all secured credits granted.

Sub-conslusion: Not all creditors are granted their unsecured status in the same circumstances. Depending on the reasons which results in their involvement in the debtor’s business, there are three different types: uninformed creditors, voluntary creditors and involuntary creditors. Among these three, uninformed creditors and involuntary creditors are the most vulnerable by the effects of secured credit. Generally, the lack of their consent may be regarded as a detriment to the right and the legitimate expectation for payment of these creditors. In addition, it is established that the use of secured credit may not always be efficient and granting security for creditors may not always be the best solution for the economy. Therefore, these problems of security should be solved by a reform of nonconsensual creditors’ treatment.

C. Proposals of reform

As analyzed above, only a smaller proportion of creditors in insolvency proceedings may be benefited in the use of security, and their benefits are originated from the detriment of a major number of non-consensual creditors. Besides, the using of secured credit is not always effective. The question is now raised that whether there are any persuasive proposals of reform.

In considering the position of non-consensual creditors in secured credit, there are three alternatives: (1) leaving the situation as it is now; (2) ensuring the payment to unsecured creditors by mandatory insurance; or (3) giving priority for nonconsensual creditors over the secured creditors As leaving the situation as it is now (alternative 1) is considered as ineffective above, we will only examination two later proposals.

1. Ensuring the payment through insurance

This alternatives may be used to achieve the first type of efficiency mentioned above – the debtor can ensure the payment for all creditors, regardless of their status as secured or unsecured despite its situation of insolvency. It is suggested by LoPucki that mandatory insurance should be taken by a company which may incur liability over involuntary creditors, especially tort claimants. By doing so, such company make it possible for their involuntary creditors to fully recover from the insurer instead of pursuing for payment from the debtors. Concurrently, the first position of secured creditors in insolvency proceedings is not arguable.

2. Non-consensual Creditors are given Priority over Secured Creditors

Professor Paul Shupack has argued that if non-consensual creditors are given priority over secured creditors, no loss will be caused to the secured creditors because they may be fully compensated for the conditional risk by conditioning their loans on the debtor's payment of a premium.

To reach the same conclusion with Professor Paul Shupack, LoPucki put the relationship among debtors, secured and unsecured creditors in an assumption that a debtor has two creditors, one unsecured (nonconsensual) and one secured, and that in case of being insolvent, he can only to pay one of them. The aggregate loss to the economy is calculated in two alternative models: where the secured creditor has priority over the unsecured; and where the unsecured creditor has priority over the secured.

In the first model, there is no other choice for the nonconsensual creditor but to extend his credit in a hope to receive some payment. Concurrently, the

secured one will also extend his credit because he will be repaid. Priority is given to the later. Therefore, the unsecured will receive nothing. It may be concluded that " except to the extent, if any, that the debtor derived benefit from inflicting loss on the [nonconsensual] creditor, [that] creditor's loss would be an aggregate loss to the economy".

In contrast, if nonconsensual creditors have priority as in the second model, the loss to the economy is claimed to be zero. LoPucki argued that because in this case, the secured creditor knowing that priority is granted to the other, will not extend credit beyond the debtor's ability to pay. Accordingly, the nonconsensual creditor will receive expected payment and there will be no loss to the economy.

If the above analysis is correct, giving priority to the unsecured instead of the secured creditor will be the most effective way to reduce the summative loss to the economy and resolve the problems of misallocating resources as well as inefficient secured credit. However, it is not easy for a regime which has been considered to operate smoothly for long to accept any kind of change. Consequently, the above proposals have been subsequently criticized.

3. Are these proposals persuasive?

First of all, regarding the proposal of using insurance, LoPucki himself realized the disadvantages of applying this solution. Firstly, it is a phenomenon that a company may be more likely to commit wrongful acts if such acts' consequences have been insured. The acts may be committed intentionally or unintentionally, but the counter-productive result is that the

company will be less alert to avoid them. Consequently, insurance in this case may bring more bad than good things, to the company, any potential tort victims and the society as a whole. Moreover, insurance will left over a large number of uninformed creditors, who are in most cases also non-consensual but can be benefit from the debtor's mandatory insurance policies.

Concerning LoPucki's best solution that is to give non-consensual creditors priority over secured creditors, it becomes a controversial topic where everyone expresses their own view on the relationship between security and insolvency, law and economic regulations. Professor Block-Lieb, in her reply to LoPucki's argument, even concluded that " his reformulation of the unsecured creditor's bargain is insufficient justification for drastic alterations to the law of secured transactions."

Professor White, in considering the proposal, questioned whether " Article 9 [of the UCC] is the place to deal with them". Firstly, he argued that governmental agencies would not need priority over secured creditors because they can use tax liens for themselves. Concerning tort claims, White's arguments are based on elevating the status of claimants if amending Art. 9 He suggested that " significant subordination of perfected security interest will drive secured creditors to look for security devices that are more wasteful but more effective (for them)".

In addition, there may be a distinction between claims for pain or suffering and claims for economic injury (libel, fraud, negligence victims). Thus, it is difficult to identify which claims should be granted priority or not. Besides, "

if the Bankruptcy Code grants priority to the tort claimants, it can give them superiority over not only personal property secured claimants but also over other lien holders and real property mortgagees[, but] Art. 9 cannot reach real estate mortgagees and only with awkward expansion could it possibly reach and grant priority over other liens in the law of every state. At best, modification of Article 9 would be only a half measure because it deals neither with claims secured by real estate nor with claims of nonconsensual lienors."

Sub-conclusion: It is submitted that there seems to be an agreement on the inefficiency of secured credit which requires many consideration for reforming. However, the reform of only a particular regime as Art. 9 in the case of the UCC is not the best solution. Security has been used for quite a long time. Its development has been so closely connected with other aspects of regulating rights and benefit of many economic factors. Therefore, a change of regime under Art. 9 alone cannot be expected to be effective.

D. Conclusion

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