NORMS IN PRIVATE INSOLVENCY PROCEDURES: THE ‘LONDON APPROACH’ TO THE RESOLUTION OF FINANCIAL DISTRESS

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Abstract
Law and economics scholarship has recently begun to investigate the role of social norms in shaping actors' incentives. This paper presents empirical findings on the way in which a group of such norms, known collectively as the 'London Approach', guide the resolution of financial distress by creditors of large UK firms and act as a substitute for legal insolvency proceedings. It appears that regulatory pressure applied by the Bank of England may have been critical in 'seeding' these norms. The paper also examines the prospects for the London Approach's future in light of changes in the financial environment brought about by globalisation.

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1 Introduction

Until recently, 'law and economics' scholarship has tended to assume that, in a world of positive transaction costs at least—law has a direct regulatory role to play in the economy. The last few years have, however, seen a relaxation of this assumption to incorporate the role played by social norms in guiding the behaviour of agents. Where once it was commonplace to assume that laws take on a directly price-like character in individual optimisation calculations, it is now understood that norms may bypass (or substitute for) law's impact altogether. Another possibility is that the law's effect on behaviour may be indirect, depending on subtle interactions with embedded norms.

This shift in analytical perspective has not yet filtered through to the law and economics literature on corporate insolvency, which has concentrated exclusively on the role of legal rules in resolving financial distress. The principal debate has been whether insolvency law need be mandatory. Positive scholarship in the tradition of Jackson (1982) analyses mandatory insolvency laws as a necessary mechanism for resolving the prisoner's dilemma faced by creditors of a distressed firm. Normative work building on this seeks to derive optimal insolvency laws. On the other hand, Haugen and Senbet (1978, 1988), applying the Coase theorem, argue that creditors will contract *ex ante* to minimise the costs of financial distress. A second generation of normative papers applied the standard arguments for freedom of contract to the insolvency context, suggesting that party-designed or 'default' insolvency laws would have desirable efficiency properties. The debate is thus about the optimal*source* of substantive insolvency rules, and it has been common ground that parties' incentives will be shaped by *legal* enforcement mechanisms. Our paper's contribution is to point the way towards an incorporation into

insolvency scholarship of the role played by social norms in regulating 'insolvency' processes.

We present and analyse data—principally interviews with specialist professionals—on the way in which the debts of financially distressed public firms are renegotiated in the UK. We find that these negotiations are conducted according to a process known as the 'London Approach', which has the following general features: on being informed of the debtor's financial distress, bank creditors first adopt a 'standstill' whereby none enforce individual rights, and existing lines of credit are maintained. An informal creditors' committee is appointed which supervises the appointment of investigating accountants, who report on the firm's financial position. If the firm is not economically distressed, a debt restructuring then takes place, under which: (i) new finance is accorded priority; and (ii) losses and gains are shared *pro rata* according to creditors' seniority and exposure at the time of the standstill; (iii) a unanimity rule is applied to voting. Whilst the resulting restructuring agreements are legally binding, creditors are not legally obliged to engage in any part of the process leading up to them. How, then, can we account for these regularities?

English corporate insolvency law is clearly relevant to the way in which parties behave. Insolvency proceedings can be commenced by an insolvent debtor or any of its creditors. Thus any attempt by a creditor to enforce its debt individually will provoke insolvency. Although attempts to renegotiate will not be costless, rational creditors will prefer to do so provided that they expect the costs of renegotiation to be lower than the costs of insolvency proceedings (Haugen and Senbet, 1978). In particular, if negotiations can be conducted in secrecy, then 'indirect' costs such as loss of goodwill which are associated with the public event of insolvency can be avoided. Empirical studies suggest such costs, generated by uncertainty about the firm's future, are large (Cutler and Summers, 1988), and thus the potential renegotiation surplus is significant.

However, the *legal* rules in the background of the 'renegotiation game' do not of themselves mitigate potentially significant obstacles to multilateral bargaining such as free-rider problems, 'ransom' demands, asymmetric information, and heterogeneous priorities. These could lead to renegotiations failing and the firm subsequently entering a formal insolvency procedure. If this happens, then creditors will have incurred professional fees during the renegotiation in *addition* to the costs of insolvency. Creditors anticipating this result would opt for immediate insolvency. Since insolvency may be provoked by a single creditor, we would expect to observe frequent collapse into insolvency of large firms. The fact that we do not suggests that non-legal constraints are operating on the parties' behaviour.

We find that professional negotiators consider that the procedure known as the 'London Approach' is more than just an empirical regularity, but has normative force. They give a variety of explanations of why they and their clients act in accordance with it. One is a perceived threat of regulatory sanctions from the Bank of England. We consider that this account is more plausible as a historical explanation for the origins of the London Approach than as the mechanism by which it continues to exist. Whilst the Bank of England did intervene directly in workouts during the 1970s and early 1980s, it subsequently withdrew from this role and encouraged market actors to organise workouts amongst themselves. Furthermore, its supervisory role as banking regulator was transferred to the Financial Services Authority in 1998.

Our data suggest that several *decentralised* enforcement mechanisms are currently at work. (i) Secured creditors with time-sensitive collateral who have an incentive to press for insolvency are dissuaded from doing so through the threat of exclusion from future business by other banks. This suggests an informal norm of reciprocal cooperation. Theoretical work has shown that such norms are stable in 'clubs' where parties are able to exclude noncooperators at low cost from a common resource. In this case, the common resource appears

to be future business. (ii) The 'unanimous consent' feature of the London Approach acts to eliminate free-rider problems. It appears to be self-enforcing (i.e. a Nash equilibrium): if all other creditors will renegotiate if creditor A renegotiates, but not if A does not, then A has no incentive to do anything other than renegotiate. (iii) Unanimity seems to create a risk of 'ransom' demands, whereby knowing that renegotiations can only succeed if it consents, creditor A may demand a bribe. Theoretical work suggests that parties will use backwards induction to deduce that threats not to cooperate under these circumstances are not credible. Models of noncooperative bargaining under symmetric information suggest that this process will result in immediate and equal division of the surplus. Our interviews suggest that parties do anticipate the likely responses of other creditors to an offer. However, the expected response is that creditors will not accept less than a *pro rata* share. This is consistent with experimental results about norms of 'fairness' in bargaining. It appears that the expectation of *pro rata* sharing of surplus imposes a constraint on the offers which are 'acceptable' to creditors. (iv) Asymmetric information problems are greatly reduced by the nomination of a 'lead bank' which oversees the gathering of information and then promulgates this to creditors as the information which will be 'authoritative' for negotiations. This seems to be a self-enforcing solution to a coordination problem: given that other creditors will abide by the lead bank's 'findings', then creditor A has no incentive to invest unilaterally in information-gathering and then attempt to persuade other banks to agree with it instead.

Looking backwards, the relative importance of these mechanisms appears to have changed over time. We speculate that the Bank of England's role may have been crucial at the outset, with the London Approach initially supported by a (perceived) threat of regulatory sanctions. The Bank's subsequent policy appears to have been more concerned with engendering *market expectations.* This is consistent with theoretical accounts of the possibilities of 'seeding' by the state in the formation of conventions and norms, and thereby highlights the

role played by formal legal and governmental mechanisms in stimulating the evolution of norms.

The marketplace within which the London Approach operates is currently changing as a result of increased globalisation of corporate finance, and the development of a secondary market for distressed debt in London. This has led to an influx of US-based 'vulture fund' investors, who do not appear to be familiar with the norms that constitute the London Approach. The consequences of these changes will impact differently on the various enforcement mechanisms we have identified. The debt traders are not in the business of participating in syndicated loans at the outset, and so are unlikely to be influenced by the threat of exclusion from this 'common resource' over which London banks control access. Thus the existing 'club' mechanism of enforcement may be destabilised. However, the new players are likely to come up against banks—and each other—quite frequently in debt renegotiations. Market associations have formed for the trading of distressed debt, and it seems plausible thatparties who consistently create difficulties may be excluded by such associations from the ability to purchase distressed debt.

The rest of this paper is structured as follows. Section 2 offers a review of the law and economics scholarship on insolvency. Section 3 seeks to clarify some definitional issues which have arisen from the contemporary debate over norms and conventions within law and economics scholarship. In section 4, a stylised account is offered of how a typical London Approach workout proceeds. Section 5 then considers the *functionality* of this procedure: the way in which assists parties in reducing transaction costs, and its *stability*: how are the 'norms' enforced? Section 6 then considers the evolution of these norms, speculating that their current form reflects the influence of institutional features of the environment in which they developed, including the role played by the Bank of England in stimulating their emergence and subsequent dissemination. The prospectsfor the future evolution of the London Approach under conditions of globalisation in financial markets are also discussed. Section 7 concludes, outlining

some implications for insolvency scholarship and a partial agenda for future research.

2 Financial Distress, Renegotiation and Corporate Insolvency

Making use of debt finance is costly for firms—in expected value terms—because it distorts the investment incentives of shareholders and managers acting in accordance with their interests, and brings with it a possibility of financial distress. Modern corporate finance theory holds that firms incur these costs because of offsetting benefits debt brings. Quite apart from tax advantages, debt is thought to assist in reducing the costs of self-serving behaviour by corporate managers. The basic idea is that default on debt gives creditors the right to remove assets from managers' control. This will tend to focus managers' minds *ex ante* (Jensen, 1986, 1989), and also allows creditors to engineer the removal of underperforming managers *ex post* (Gilson, 1989; Gilson *et al*, 1990; Gilson and Vetsuypens, 1994).

Law and economics scholarship tends to assume that the enhancement of efficiency is the principal goal of corporate and commercial law. Accordingly, analysis of corporate insolvency law in this tradition began by seeking possible efficiency rationales for its existence. The best-known analysis is due to Jackson (1982). Outside insolvency proceedings, creditors are free to pursue individual debt collection remedies against a defaulting debtor. These operate on a 'first come, first served' basis, with the result that a 'race to collect' can ensue if a firm is in danger of being unable to pay its debts. Assets would be sold off separately, with the consequence that the firm's business would be dismembered. Where the firm is worth more as a going concern, the creditors of such a firm find themselves faced with a classic 'prisoner's dilemma'. All other strategies are strictly dominated by 'collect' which nevertheless leads to the collectively suboptimal outcome of piecemeal liquidation. Jackson argued that a primary rationale for insolvency law was that it forced creditors to abide by a collective procedure, thereby 'solving' the prisoner's dilemma.

Since Jackson's original insight, law and economics scholars have sought to establish the *content* of the 'optimal'—cost-minimising—insolvency procedure. Starting with the social costs generated by a 'race to collect', the frame of reference expanded to encompass optimisation across several margins: the deployment of the bankrupt firm's assets, the length of time taken and professional fees incurred in insolvency proceedings, the costs of bargaining over the distribution of assets in insolvency, and the *preinsolvency* incentives given to parties making investment decisions. This gave rise to a wide variety of proposals for improved regimes (Roe, 1983; Bebchuk, 1988; Aghion *et al*, 1992). As this literature developed, the optimisation 'problem' gradually expanded from one of minimising costs of collective action to one encompassing a variety of preinsolvency incentives (see Triantis, 1996).

Much of the 'optimal insolvency' literature proceeds from the assumption that formal legal proceedings are the way in which financial distress gets resolved.[1] However, this may pay insufficient attention to the Coase theorem. Wherever the transaction costs of bargaining are lower than the expected costs of insolvency, then rational creditors will choose to renegotiate instead of entering formal proceedings (Haugen and Senbet, 1978). 'Workouts' are indeed a frequent occurrence in the US (Gilson *et al*, 1990). Hence to understand insolvency fully we must also be able to account for the transaction costs of debt *renegotiation*. Their existence will be the 'slipway' to insolvency proceedings for financially distressed firms.

Given the existence of a collective insolvency procedure which can be resorted to if negotiations fail, creditors of a distressed firm no longer face a prisoner's dilemma. However, a number of other impediments to successful restructuring agreements have been identified: (i) Roe (1987) identifies a free-rider ('hold out') problem (see also Gertner and Scharfstein, 1991). Consider a creditor who reasons that its decision whether or not to participate in a restructuring will not affect the agreement's chances of success. If the creditor does not participate

and a workout goes ahead, it will benefit from the other creditors' decisions to reduce the face value of their claims.[2] Yet if many creditors reason in this way, an insufficient number will agree to the workout to allow it to succeed. (ii) Creditors may also engage in opportunistic 'hold-up' behaviour, demanding a larger share of the overall returns as the price for their agreement (Roe, 1987: 238). (iii) Creditors often have heterogeneous priorities.[3] This means that the loci of their interests are likely also to be different, and that disputes about the appropriate course of action for the firm are likely to become more difficult to resolve (Baird, 1986). (iv) Differences may be compounded by the presence of asymmetric information about the firm's financial prospects and other creditors' positions. Consistently with the existence of these types of problems, quantitative studies of US data show that out-of-court renegotiations of distressed debt are more likely where firms have relatively homogeneous capital structures (Gilson *et al*, 1990; Asquith *et al*, 1994; Chatterjee *et al*, 1996; *cf*. Franks and Torous, 1994).

Haugen and Senbet (1988) argue that these costs can be rendered insignificant by appropriately-designed financial contracts. For example, provisions could be incorporated into bond indentures which allow a majority to decide whether or not a workout offer should be accepted. This would prevent individual creditors from engaging in 'hold-up' tactics and also remove any advantage to 'free-riding'. Interestingly, a parallel literature has advocated a similar approach to the provision of insolvency procedures (Rasmussen, 1992; Schwartz, 1998). These papers begin with the observation that the 'prisoners' in Jackson's model face no dilemma if they are able to contract in advance to co-operate. The argument is then that creditors do not face a co-operation problem but rather one of co-ordination—how to agree on which insolvency procedure they will 'contract for'. If credit markets are informationally efficient, then the *firm* will have appropriate incentives to offer a procedure that will maximise the net benefits of debt finance, solving any co-ordination problem.

There are significant legal obstacles to the utilisation of 'contractual' mechanisms for reducing the costs of financial distress. (i) Regulatory provisions directly restrict the range of contractual provisions that are permitted. For example, the US Trust Indenture Act 1939 prevents majority voting clauses from being incorporated in bond indentures in relation to changes of interest and principal (Roe, 1987; Coffee and Klein, 1991).[4] (ii) Firms and their creditors may not 'contract out' of their right to use state-supplied insolvency procedures (Schwartz, 1993). This limits the set of *ex ante* contracts which will be achievable: in order to ensure that no party has an incentive to defect, they must make all parties better off than they would be were insolvency to take place. The efficiency of these contracts may therefore be constrained by a redistributional insolvency procedure. (iii) Perhaps most importantly, firms are unable to *commit* themselves to using a particular 'private' procedure. Creditors who offer firms an interest rate discount in return for their commitment to employ a favourable insolvency regime are open to the risk that the firm will subsequently borrow from other creditors on different 'insolvency terms' (Adler, 1993).[5] Even were the law to be changed to facilitate such contracts, there is considerable potential for these arrangements to be subject to inefficient 'lock-in'. The firm's financial or business environment may change after it has committed itself to a particular procedure. The ability for firms to *commit*, necessary in order to capture *ex ante* savings from customisation of insolvency procedures, may thus make for costly restrictions *ex post* (LoPucki, 1999).[6]

The literature to date has thus focused on techniques for reducing the costs of financial distress either through a state-supplied insolvency law, or through private contracting. Whilst the legal impediments to 'contractual' solutions provide a robust explanation for their non-utilisation in the US, little attempt has been made to study practices in other jurisdictions where the law is less restrictive. Such comparative work as has been done has tended to investigate the content of state-supplied insolvency laws (e.g. Franks and Torous, 1992; Hart, 1995: 156-185; Kaiser, 1996). There has been little investigation of the extent to which parties in different jurisdictions can and do customise

insolvency procedures by contract, or the impact of different insolvency laws on the choice between workouts and formal proceedings.[7] A more fundamental weakness in the existing literature is, however, its failure to consider the possible role of *non-legal* institutions in reducing the costs of financial distress.[8] A common feature of both state-supplied laws and 'contractual' procedures is that they both alter parties' incentives through the threat of *legal sanctions*. The recent expansion of the frame of law and economics research to include the function and evolution of social norms appears not yet to have filtered through to the corporate insolvency literature. Our paper provides insights into how debt contracts with large corporate borrowers are restructured under English law. We find that norms play a significant role in the resolution of financial distress in large UK corporates. This points the way to an enriched understanding of 'insolvency' processes, and thereby a broader framework for their improvement through state intervention.

3 An overview of norms theory

The study of norms has acquired a particular importance in contemporary law and economics debates because of a conjunction of empirical and theoretical findings. Empirical work has demonstrated that, in a number of contexts, social norms may provide a basis for co-ordination among agents, apparently without reference to the formal legal rules and sanctions which purport to govern the relations in question (Macaulay, 1963; Beale and Dugdale, 1975; Ellickson, 1991; Bernstein, 1992). At the same time, theoretical models have been developed which explain norms as the outcome of agents' interactions, rather than being derived from formal institutions (Ullmann-Margalit, 1977; Schotter, 1981; Sugden, 1986). These theories seek to explain 'how rules regulating human action can evolve without conscious human design, and can maintain themselves without there being any formal machinery for enforcing them' (Sugden, 1989: 86).

A particularly important suggestion is that norms can be understood in terms of *focal points* (Schelling, 1960) or *conventions* (Lewis, 1969), that is to say, as units of shared information which provide a basis for co-ordinating the actions of individuals. In an interaction between agents which can be modelled as a 'game of pure coordination', individual rationality alone cannot predict which actions individuals will take (Kreps, 1990). If, however, agents are able to align their expectations by reference to a convention (such as driving on a particular side of the road), they can achieve a co-ordinated (high) pay-off and avoid a low pay-off (such as regular head-on collisions).

In a 'non-cooperative game' such as the prisoner's dilemma, the problem is somewhat different: individual agents, acting rationally, may have no incentive to deviate from strategies which lead, overall, to sub-optimal outcomes. The existence of a convention may help agents to coordinate a set of strategies which maximise their joint welfare (Sugden, 1986). As we explain in further detail below (see sections 4-6), the London Approach is an illustration of this effect.

Both these meanings of the term 'convention' emphasise the existence of common knowledge or common understandings among a population of agents as the basis for the coordinating effects of norms (Binmore, 1994: ch. 3). It is in the interests of each agent to follow the convention in question, given that he or she can expect other agents within the relevant population to do the same. Once established, then, conventions may well be self-enforcing, with all the appearance of 'order without law' (Ellickson, 1991). The central question, however, is how they come to be established in the first place.

The answer given by evolutionary game theory is that this can take place through a series of dynamic selection processes occurring within a population of agents, through which less adaptive strategies are deselected. In these models, bounded rationality and adaptive learning replace the 'hyper-rationality' and perfect calculativeness which characterise 'classical' game theoretical approaches (see

Young, 1998). Sugden (1986, 1989) associates conventions with the concept of an *evolutionarily stable strategy* ('ESS'), which is due to Maynard Smith (1982). A strategy is an ESS if, were it generally followed within a population, would result in any small number of individuals deviating from it doing less well than the rest (Sugden, 1989: 91). In Maynard Smith's work, the models use payoffs which denote biological 'fitness', with the result that low payoffs mean lower replication. In Sugden's account, biological fitness is replaced by utility, and natural selection by adaptive learning. Agents encounter other individuals who are randomly drawn from a population of players. The idea is that agents choose strategies which they expect will produce better payoffs, given what they know about what others are playing. Young (1996), likewise, offers a model in which players select their strategies through a process of retrospection as to what has been the most successful strategy in previous periods of play, in effect producing a system in which norms emerge on the basis of precedent.

These models formalise the emergence of one particular type of convention under conditions which are in effect those of a state of nature; no assumptions are made about the institutional environment in which interactions between agents occur. They suggest ways in which stable conventions can emerge even in an environment where institutionalised rules and centralised enforcement mechanisms are lacking. They can also be read as implying that in environments where legal or other collective institutions (such as trade associations or professional bodies) *are* present, regard must still be paid to the dynamics of norms and conventions operating 'below' the level of institutionalised rules. However, the models do not tell us anything about the nature of the relationship between tacit or social norms on the one hand, and institutionalised and state-enforced norms on the other, in contexts where these different types of norms operate side by side.

If the function of norms is to save on the transaction costs of endlessly searching for the solution to commonly recurring co-ordination

problems, it may be said that norms are a kind of information resource – they embody information about the likely strategies of players (Warneryd, 1998). In the states of nature considered by Sugden and Young, the information contained in norms is obtained through mechanisms of social learning, including trial and error, observation and imitation. These mechanisms do not depend upon any centralised articulation or enforcement of norms.

In practice, however, we frequently observe the institutionalisation of norms, such as 'drive on the right', which theoretical models show could have emerged spontaneously. 'Institutionalisation' here refers to processes of codification and systematisation of norms, which are explicitly stated and linked together in a body of doctrine, and sanctions of various kinds attached to them. In the context of the commercial transactions which we are considering here, in addition to numerous tacit and uncodified conventions, there are many institutionalised norms which derive from the legal system, as well as from the activities of trade associations and professional bodies.

There are various ways in which institutionalised norms may play a role in overcoming coordination problems. One reason for thinking that institutionalised norms may be important in practice relates to the precariousness of informal norms. Mutations or perturbations in established patterns of behaviour, which could be caused by players' mistakes or by the entry of new players, can lead to a situation where a well-established convention is undermined because it is no longer effective against a new strategy. When strategies are matched against each other pair-wise, there may be no guarantee that the successful one will represent an outcome which increases the aggregate welfare of the population as a whole. This is because there may well be higher returns *to each individual* in following a strategy of defection when faced with an opponent whose strategy is based on cooperation (see Hargreaves-Heap and Varoufakis, 1995: ch. 7). A cooperative solution to a coordination failure may be arrived at by spontaneous means, only to be 'tipped' over by random mutations in patterns of behaviour or by the entry of new players.

For this reason alone (and there may well be others), we should be sceptical of the suggestion that spontaneous orders are entirely*self-correcting* (Posner, 1998). At the same time, the precise role of institutional mechanisms within the processes of norm formation is not well understood. Extending the insights of evolutionary game theory to the institutional level is one way forward here. From this point of view, norms produced by institutional means are, like social norms, subject to an evolutionary process, in the sense that they too result from the experience of the relevant agents in dealing with conflicts and resolving coordination failures. Institutional norms, therefore, are a form of encoded information about strategies which have been shown to be successful in overcoming coordination problems. They share essentially the same function as social norms, but differ from them in terms of the particular mechanisms by which the processing, coding and dissemination of information takes place. The emphasis is shifted away from individual learning, based principally on observation and imitation, to mechanisms of social or institutional learning of the kind involved in the articulation of generalised standards of behaviour. We now turn to an examination of this hypothesis in the context of our empirical study.

4 The London Approach

4.1 Context and History

The 'London Approach' has been described as:

'[A] non statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring' (British Bankers' Association, 1996: 1).

Prior to explaining its operation, it will be helpful to outline three background factors: (i) English corporate insolvency law's strongly pro-creditor stance; (ii) the importance of bank debt in financing large

UK debtors; and (iii) the historical role of the Bank of England in orchestrating informal solutions to financial distress.

English corporate insolvency law contains no 'debtor-in-possession' regime equivalent to Chapter 11 of the US Bankruptcy Code.[9] Instead, the law is strongly oriented towards the protection of creditors' rights, and those of secured creditors in particular.[10] The most basic corporate insolvency procedure under English law is *winding-up*, which involves the appointment of a court official to oversee the sale of the debtor's assets, usually on a break-up basis.[11] A winding-up order may be made in response to a creditor's petition stating that a debtor company is unable to pay its debts.[12] The order stays all enforcement actions by unsecured creditors,[13] but does not stay secured creditors, whose collateral is viewed as their property and not part of the debtor's estate.[14] The respect afforded to the rights of secured creditors means that absolute priority is respected almost entirely in English corporate bankruptcies (Franks and Torous, 1992).

Secured creditors are, however, stayed under the *administration* procedure introduced in 1986.[15] Like winding-up, this involves the displacement of the debtor company's management in favour of a court-appointed official, but in this case she continues to run the business.[16] An administration order may be made for one or more of a variety of purposes: to preserve the business; to obtain a better realisation of the assets than in winding-up; or to enable a reorganisation to take place.[17] A variety of statutory 'cram down' provisions, whereby a majority of a company's creditors can agree to bind a dissenting minority, exist to facilitate reorganisation.[18] However, these do not in themselves stay creditors from enforcing their claims (secured or unsecured) during the period leading up to the vote. Thus their use is often coupled with an administration order.[19]

The appointment of an administrator can be blocked if the debtor has granted a creditor a security interest (known as a 'floating charge') covering substantially the whole of the company's assets.[20] Such a creditor may veto the appointment of an administrator, and instead

appoint an *administrative receiver*, who will take over the management of the debtor company and auction its assets.[21] The appointment of a receiver, because it is based on the rights in the collateral enjoyed by the secured creditor, will act as a *de facto* stay of the claims of junior creditors (Buckley, 1994). Such all-encompassing security interests are found most frequently in small firms with a single dominant (bank) creditor. Hence administrative receivership tends to be used mainly in small-firm bankruptcies.

Unlike their US counterparts, large UK companies have not, at least until recently, raised significant parts of their debt finance in the form of bonds (see Brierley and Vleighe, 1999: 175). Instead, they have tended to source the majority of their debt finance through syndicated bank loans.[22] Depending on their size and financing policies, firms may in this way develop lending relationships with up to two hundred banks. The City of London is a major international banking centre, containing the head offices of over five hundred domestic and international banks. Relations between the banks are 'regulated' by several different mechanisms. At a fairly specific level, they are contractually bound by the terms of the syndicated lending agreements in which they have participated. More generally, their behaviour is also guided by the formal and informal authority of regulatory agencies. Until recently, the most important of these has been the Bank of England. Quite apart from its 'core' function as a central bank, the Bank has traditionally played a role in guiding and overseeing the development of the institutions and markets for financial services which comprise the City of London. As lender of last resort, it has a long tradition, stretching back to the 'first' failure of Barings Bank in 1890, of involvement in support operations for distressed financial institutions (Cairncross, 1995: 60-61; Roberts, 1995: 177-179).[23] In the mid-twentieth century, its authority in the financial sector was strengthened through being given responsibility for the prudential regulation of banks.[24] Whilst its formal regulatory responsibility for the banking sector was transferred to the Financial Services Authority in 1998,[25] the bank still has considerable *informal*

power vis-à-vis banks, similar to that which it enjoys as respects other City institutions.

The history of the 'London Approach' can be traced back to the early 1970s, when a crisis in the UK secondary banking sector provoked the Bank to intervene on a large scale in supporting financial institutions (Slatter, 1984: 254). A number of high-profile British companies also became financially distressed. At that time, syndicated bank loans were a relatively recent innovation, meaning that the creditors of these firms had no experience of coordinating the exercise of their rights. The Bank then transferred the expertise it had developed in dealing with the banking crisis to the orchestration of support operations for non-financial firms. Over the next fifteen years, the Bank became involved as a broker and 'ring-keeper' in a number of large corporate debt workouts. A policy decision was subsequently taken that the Bank's role should become less overt, with the responsibility for workout management being devolved to market participants themselves (Kent, 1997). Hence in 1990 a number of discussions were held with London-based banks and their professional advisers, as a result of which a set of principles of best practice were formulated. The Bank's strategy was deliberately *not* to reduce these to 'rules', but rather to publicise the general nature of the 'Approach' through a number of papers by Bank officials (Kent, 1993; 1994; 1997), which avoided dealing with specific details. The idea was that these principles would be developed and applied by market participants without any need for 'hands-on' intervention by the Bank.

4.2 What does the London Approach involve?

Our account of the content of the 'London Approach' is based primarily on data obtained from interviews with practitioners, and relates to workouts that took place during the 1990s. We conducted fourteen open-ended interviews with accountants, bankers and lawyers who are regularly involved in restructuring the debt of large public companies.[26] Data of this nature may present an incomplete or even misleading picture, and hence we have sought to reinforce them

by reference to other sources wherever possible.[27] Nonetheless, we consider that the interview data enable us to gain access to valuable insights about the *processes* of renegotiation which we would not otherwise have appreciated.

To the extent that it is possible to generalise, a London Approach workout involves two distinct phases. First, the debtor firm notifies its banks that it is financially distressed and would like to initiate a workout. At this stage, the banks agree amongst themselves to a 'standstill', during which no enforcement actions are taken against the debtor, and all existing lines of credit are kept open. The banks will also agree to provide additional working capital where this is necessary for the debtor's continued survival. Such 'new money' is accorded priority ahead of the existing loans. The standstill will typically be for a short period of time—measured in months—during which a team of accountants will investigate the firm's finances. Their findings are then used to *inform* a collective decision-making process about what should be done with the firm. If the firm has a viable business—and our interviewees tell us that this is the case with the vast majority of multi-banked firms—then some form of financial restructuring will be called for. Should the firm turn out not to be viable, then any losses incurred by the banks in subscribing to the standstill will be shared *pro rata* according to their exposure at the time of the standstill.

The second phase of the workout will consist of the negotiation and implementation of a restructuring plan. Negotiations in both phases will be spearheaded by a 'lead bank' (Flood *et al*, 1995: 28-29), which acts as a conduit for information from the company and the investigating accountants to other financial institutions, and *vice versa*. The terminology is drawn from that used in arranging syndicated loans.[28] Traditionally, the lead bank in a workout would have been the debtor firm's principal lender. However, over time, some banks which have developed expertise at mediating workouts have come to offer their services—in return for an appropriate fee—as 'lead' banks in rescue operations where they are not the main lender

(Donaldson, 1995: 48-51; British Bankers Association, 1996: 4). The lawyers acting for the lead bank are usually instrumental in structuring the terms of the negotiations.[29] In workouts involving large numbers of banks, a single co-ordinating lead bank will be insufficient to manage this role, and a 'steering committee' will be appointed, containing representatives from the various loan syndicates and jurisdictions (Borrett, 1987: 7; Donaldson, 1995: 51-53). Interviewees emphasised that the more representative the composition of the committee, the more effective it was as a mechanism for reducing negotiating costs.[30] The restructuring may range from a simple debt forgiveness package through to a debt-equity swap, with a variety of more exotic structures in between.[31] It will apportion 'write-downs' *pro rata* amongst lenders, in proportion to their relative priorities and outstanding exposure at the time of the standstill.

Plans proposed in London Approach negotiations typically provide that the banks share the benefits from avoiding insolvency, and the costs of the restructuring process, *pro rata* to their outstanding exposure at the time of the standstill. For example, consider a debtor which has borrowed £50,000 on a secured basis and also £100,000 on an unsecured basis. To keep things simple, assume that each loan has been raised from syndicates consisting of only two banks. The senior syndicate consists of banks A and B (£25,000 each), and the junior syndicate of banks A and C (£40,000 and £60,000 respectively). The investigating accountants estimate that the debtor's business has a net present value of £100,000, but that £40,000 of this would be lost if formal insolvency proceedings were commenced. The 'exposure' is calculated by reference to the value which the banks would expect to receive, *given their priority rankings across various firms*, at the time the standstill commences. Thus bank B is not exposed at all, because the secured syndicate will recover in full in insolvency. However, bank A holds 40 per cent of the junior debt, which will lose 80 per cent of its face value in insolvency. Thus its exposure is £32,000. Similarly, bank C's exposure is £48,000. A London Approach type plan would keep the senior debt in place, and also involve some new senior debt to fund the debtor during the restructuring. In this

example, assume that the extra borrowing is £5,000. The plan will also give something to the existing shareholders, who typically retain around 15 per cent of the firm's value, in this case £15,000.[32] That would leave £30,000 of present value in the restructured firm to be allocated amongst the junior creditors. This could comprise a package of some fresh debt and equity. The claims would be apportioned between banks A and C in proportion to their exposure, 2:3.

The entire process of a London Approach workout is kept secret, with participating banks and their advisers entering confidentiality agreements. This means that trade creditors, employees and shareholders are unlikely to be aware that a restructuring is taking place. It also makes obtaining quantitative data on the number of workouts that take place very difficult. Kent (1997: 173) states that the Bank 'has been actively involved in over 160 cases since 1989, but this is only a small proportion of the company workouts which have taken place.' Conversely, large UK-based firms rarely enter legal insolvency proceedings.[33]

5 Norms and the London Approach

Section 5 analyses the role played by norms in 'London Approach' workouts in a static sense. Section 5.1 considers the *function* of the London Approach norms, by examining the payoffs anticipated by banks faced with a distressed firm. If it is common knowledge amongst the banks that non-enforcement will lead to a workout with a larger expected payoff than insolvency, then enforcement is not rational. The London Approach procedure functions to reduce the transaction costs of renegotiation, and thereby increase the expected payoff to participating creditors, and the fact that its content is common knowledge amongst the community helps to align creditors' beliefs. This in turn requires consideration of the *enforcement* of the London Approach norms: given that they are not embodied in legislation or caselaw, what is the role of *non-legal* mechanisms in ensuring that creditors attempting a workout do so according to this procedure? Section 5.2 considers a variety of 'enforcement'

mechanisms: regulatory *fiat* by the Bank of England, self-enforcing conventions, internalised norms, and 'mutual aid' arrangements whereby non-cooperating banks are excluded from future business. It does not explain how these norms developed over time, or whether they are likely to be stable in the future. These questions are addressed in section 6.

5.1 Function of London Approach norms

When the debtor firm is, or is about to become, in default on any one of its loan obligations, then cross-default clauses will mean that this will constitute a default on all of its others.[34] Creditors who are notified that such a situation has arisen must decide whether or not to attempt renegotiation. It is important to note that the legal framework of insolvency law ensures that creditors do not face the 'prisoner's dilemma' identified by Jackson (1982).[35] Each knows that individual enforcement will trigger other creditors to commence insolvency proceedings. Conversely, if another creditor seeks to enforce, it has the option to commence insolvency. Thus it is rational for such a creditor to refrain from enforcing if it thinks that the returns to renegotiation will be higher than its likely return in insolvency. However, entering into such negotiations will be costly for parties, in terms of professional fees, and if they do not anticipate that the outcome will be a successful restructuring, they would prefer immediate insolvency proceedings.

For it to be rational for a creditor to enter renegotiation, the following conditions must be satisfied. (i) There must be a renegotiation surplus. The most significant cost to insolvency proceedings is thought to be the 'indirect' destruction of the value of intangible assets generated by uncertainty about the firm's future (eg Cutler and Summers, 1988). If renegotiations are kept secret, these costs can be avoided. However, the creditor must anticipate that renegotiations will be conducted in such a way that the transaction costs they generate do not amount to more than the expected insolvency costs. (ii) The creditor must also expect that the surplus will be *divided* in such a way that they will be

at least as well off as in insolvency proceedings. If even one creditor attempts to enforce, then this will precipitate insolvency proceedings. (iii) Each creditor must therefore anticipate that all other creditors will also consider the renegotiation conditions to be satisfied. In other words, the satisfaction of these conditions must be common knowledge. We consider that the fact that all market participants expect that renegotiations will be conducted according to the 'London Approach' procedure described in section 4 plays an important role in ensuring that the satisfaction of these conditions is common knowledge. The *content* of the London Approach functions to minimise the transaction costs of renegotiation and to ensure that it is individually rational for each creditor to participate in renegotiation.

Coordination on the gathering of information. An important source of transaction costs in renegotiation is thought to be the presence of asymmetric information between the debtor and its creditors, and amongst creditors. Such problems are reduced through the mechanism of appointing a lead bank which appoints investigating accountants. As a result of the 'investigation', better information is made available to all the creditors about the debtor firm's business. If the investigating accountants take the view that it is worth more as a going concern than on a break-up sale, then a reorganisation plan will be proposed. It can thus be seen as a mechanism for allowing parties to co-ordinate on a particular set of information which will be used as the basis for the restructuring.[36] As one accountant put it:

'If you call in your debt you will trigger the insolvency of the company. Of that there is no doubt. That will in most cases ensure you of some certain loss, whereas if you agree to a standstill—providing you are not in an environment which is too rapidly changing—there is the reasonable prospect that at the end of the standstill period, the thing will not have deteriorated to any material extent. And at the end of that period, you can make an informed decision.' (Interview 3).

Free-riders and unanimous consent. Syndicated lending agreements typically require unanimous consent of participating banks to agree to a rescheduling of principal or interest. This ensures that there is no free rider problem, since each bank knows that it is pivotal to the agreement's success (Roe, 1987; Coffee and Klein, 1991; Gertner and Scharfstein, 1991). And to avoid free-rider problems *between* syndications, London Approach restructurings usually make the consent of each syndicate conditional on the consent of *all* being obtained. In other words, complete unanimity is required.

Debt overhang. The well-known 'underinvestment' or 'debt overhang' problem (Myers, 1977) means that lenders will be unwilling to advance further funds to the debtor on terms that are junior to or *pari passu* with existing lenders. However, this difficulty is avoided in London Approach workouts by according 'superpriority' to new value that is advanced.

Division of surplus. The principle of 'equity' employed to apportion debt write-offs in London Approach workouts is a form of *pro rata* sharing of the renegotiation surplus. Thus each unsecured creditor will be at least as well off as they would be in winding-up proceedings. This makes it individually rational to participate in the workout.

Heterogeneous Priorities. The principle that no party seeks to enforce their debt, but rather participates in a 'standstill', ensures that secured creditors whose collateral is time-sensitive will not enforce and thereby bring about the collapse of the debtor company.

If it is common knowledge amongst the creditors that the procedure will be conducted according to these 'norms', it will be rational for all of them to participate in a renegotiation provided they believe that the firm is likely to be worth more as a going concern than if it is closed and its assets sold piecemeal. Our interviewees told us that this was almost invariably the case with large debtors that had become financially distressed, an assertion which is supported by the very limited quantitative research that has been done.[37] Given this

background, and the common knowledge that the norms of the London Approach will govern renegotiations, it is trivial that rational creditors will participate in a workout rather than enforce their debts.

5.2 Enforcement of the London Approach

Up to this point, we have focused on the functionality of the London Approach. We have shown how it is rational for creditors faced with a 'financial distress game' in which the London Approach defines part of the rules (i.e. the procedure which will be employed if renegotiation is chosen) to opt for renegotiation. We now turn to the question of the *enforcement* of these 'norms': how can rational creditors be sure that renegotiations *will* in fact be conducted according to this procedure? To put the matter another way: if any creditor can benefit by deviating from the procedure *ex post*, the whole process will unravel. Other creditors will anticipate this deviation *ex ante* and this will reduce the anticipated payoff of renegotiation.

The role of the Bank of England. A number of our interviewees suggested that banks which refused to participate in workouts might find their senior management being invited for a 'cup of tea with the Old Lady'. This would involve a meeting behind firmly closed doors with officials of the Bank of England at which 'eyebrows would be raised' at the behaviour in question (see also Flood *et al*, 1995b: 30-31). The implication was that if the bank persisted with the behaviour in question, dire sanctions would follow. It should be stressed that none of our interviewees claimed any personal experience of this, and furthermore that the Bank of England and its representatives deny that it acts, or acted, in any sort of 'policing' role over London Approach workouts (eg Kent, 1997). Rather, it views itself as merely having been a facilitator of negotiations, an honest broker mediating discussions where parties were unable to do so for themselves.

The non-observance of such intervention is equally consistent with the non-existence of such sanctions, or the existence of *very heavy*

sanctions. The latter would deter parties so effectively that they do not need to be used—what Ayres and Braithwaite (1992: 40-41) term a 'benign big gun' model of regulation. A consideration of the historical role played by the Bank of England in influencing City institutions is entirely consistent with this theory. The Bank has made use of tacit, informal 'guidance' of market actors in a variety of contexts: the implementation of monetary policy through the use of credit controls, its regulation of discount and gilt-edged markets, and its encouragement in the formation of self-regulatory bodies in the financial sector, such as the Takeover Panel.[38] Until recently, the Bank has had formal authority for the prudential regulation of UK banks, and it is also able to exert considerable informal influence through its exercise of market power as a 'private' contracting party (Hadjiemmanuil, 1996: 315).

One possible conclusion would therefore be that the London Approach is sustained *exclusively* by the threat of direct but covert enforcement by the Bank of England. We do not, however, find this conclusion compelling. First, the observed data (no enforcement activity) do not allow us to reject the 'null hypothesis' that the Bank simply does not make this type of threat to creditors. Second, the public statements of the Bank and its officials clearly point to a shift in its policy over time, with a reduction in its involvement in workouts. Thus the idea of direct enforcement by the Bank is more plausible for workouts taking place in the 1970s and 1980s than those in the 1990s. Third, the Bank's formal authority for the prudential regulation of banks was transferred to the Financial Services Authority in 1998, so its ability to threaten banks has been greatly reduced. For these reasons, we turn now to consideration of *decentralised* non-legal enforcement mechanisms.

Individual rationality. A large part of the London Approach can be analysed as 'self-enforcing' conventions, in the sense described in section 3. Consider the following features of the procedure: (i) superpriority for new value; (ii) unanimity; and (iii) coordination on information-gathering and dissemination through a lead bank. If it is

common knowledge that each creditor will participate in a procedure which has these features, no creditor has an incentive to deviate, because they have nothing to gain by it. Consider for example the convention that voting must be unanimous. This requirement is partially derived from loan syndication agreements, which require the unanimous consent of syndicate members before any reduction of interest or principal can take place. However, the agreements do not prevent a single *syndicate*—and London Approach firms typically have many syndicated loans—from unilaterally renegotiating. Provided they anticipate that all other creditors will agree to a restructuring on the basis of 'unanimity', then members of an individual syndicate have no incentive to do this, as it would allow other syndicates to free-ride on their downward renegotiation.

Internalised bargaining norms.[39] It is widely thought that unanimity procedures create transaction costs of their own: creditors may engage in so-called 'hold-up' or 'ransom' tactics, demanding more than their *pro rata* share under the plan as the price for their consent (eg Roe, 1987: 238; Kent, 1997). We therefore need to investigate the dynamics of the bargaining process to see whether or not such threats are credible. If they are not, hold-up tactics will not succeed, and a policy of abiding by unanimity will be a Nash equilibrium for creditors.

A creditor who attempts a 'hold-up' can make two types of threat: (i) 'give me more or I will not agree', or more brazenly, (ii) 'give me more or I will enforce and precipitate insolvency'. Threats of type (ii) are transparently incredible, because carrying them out would result in destruction of the entire renegotiation surplus, which is not individually rational for the putative enforcer.[40] This is consistent with what interviewees told us about continuing negotiations. Standstills often do not consist of formal contracts, but rather, the non-pursuit of individual rights is a sort of tacit agreement between the banks:

'It was a sort of convention that nobody was going to bring [the standstill] down, and they didn't bring it down. It worked on that

basis. And it was written down—what it would have been, if somebody had signed it. And that could go on for months and months and months.' (Interview 12).

'Now we used to try to get everyone to sign up to a standfast. I don't think I've ever achieved that in my life – I don't think so, not on the big ones. But you had a de facto standfast, where some banks couldn't sign it, but they'd always stick to it and wouldn't be seen to be the person to pull the plug.' (Interview 10).

Threats of type (i) are only credible if the hold-up creditor can realistically expect to gain by withholding agreement. The Rubinstein (1982) alternating-offer bargaining model has been used in a number of papers to model bargaining in, and in the shadow of, insolvency (Brown, 1989; Baird and Picker, 1991; Bebchuk and Chang, 1992; Kordana and Posner, 1999). This gives the result that under conditions of symmetric information, two parties with equal discount rates will negotiate to an *equal* sharing of the surplus. However, the modelling of multi-party bargaining is still at a relatively early stage. Kordana and Posner (1999) derive results for two-party (debtor and creditor) bargaining which they then extend in an admittedly 'impressionistic' manner to a situation involving multiple creditors. Interestingly, these authors suggest that under multiple-creditor bargaining with a unanimity rule, creditors with equal discount rates and bargaining power will receive equal shares of the surplus, *regardless of the size of their claims.* In this framework, the expected payoff to any exit option—i.e. the option to commence insolvency—puts a *floor* on what a party may expect to receive. If the share which they would otherwise expect to obtain by bargaining is larger than the exit option, the latter is irrelevant as an incredible threat. However, this result seems at odds with the distributions observed in London Approach workouts, which turn on *pro rata* 'equity' rather than strict equality.

The Rubinstein model relies on parties being gifted with very strong rationality, sufficient to support the use of backwards induction over

an indefinite number of possible offers. Thus the party which makes the first offer anticipates the likely reply of the other party, which in turn will anticipate its likely reply to it…and so on indefinitely. Our interview data certainly gives us cause to consider that creditors do seek to anticipate the likely response to their offers. One interviewee, with many years of experience acting for a lead bank in trying to persuade other creditors to sign up to a restructuring, explained an argument which he would invariably put to them.

'[What] I've always said, and it's always been a very compelling argument – is:

"Don't tell me your position is unacceptable, because we'll never get a deal done! All I want you to do is put something on the table to improve your position. It must be demonstrably fair to all the banks. Now if you don't like what I've proposed, put something else on the table: not only better for you but better for everyone—and I'll go round … pursuing *your* system."

Now I can hear myself saying that in the past, over and over again. They don't like it, but eventually, they come to accept it.' (Interview 10).

Effectively, this asks the respondent bank either to accept the offer, or to make a counter-offer which will be accepted by the other banks. This has (or is intended to have) the effect of making the respondent bank aware of the strategic implications of their offer or counter-offer. Why, then, is backwards induction not followed through to the result predicted by the Rubinstein model? One explanation may be that what is being anticipated is not 'hyper-rational' behaviour, but the application of an *internalised* norm of 'equity' in bargaining which imposes an *action constraint* on the parties involved.[41]

It is well-known that experimental results do not support the equilibrium 'predictions' of alternating-offer bargaining games (see Kagel and Roth, 1995: 253ff). Rather, experimenters have found that

offers may be rejected in circumstances which are predicted 'equilibria', because they violate parties' notions of 'fairness'. Elster (1989) argues that norms—in his view constraints on, or delimiters of, rational action—are important constraints on bargaining processes. Using examples drawn from Swedish collective bargaining processes, he suggests that norms of 'equity' are operant. These relate 'acceptable' offers to the payments received by others. The description of the London Approach set out by the British Bankers' Association (1996: 4) states:

'It is a cardinal principle that:
a. each lender is entitled to exercise its own commercial judgement, but,
b. each lender is expected to be realistic and pragmatic and recognise the impact of its decision on others. No lender should try to obtain terms for itself that are *inequitable* to other lenders, but be sympathetic to the overall objectives of supporting the company.' (Emphasis added).

This suggests that a norm of 'equity' is perceived to exist regarding the distribution of the surplus. Parties consider that the distribution of surplus *ought* to be *pro rata* to the underlying claims. The backwards induction appealed to by interviewee 10 in the quotation on the previous page is not that of considering what an hyper-rational opponent will or will not accept. Rather, it is one of considering what an opponent *subject to a norm of pro rata sharing* will accept. The implication is that if the respondent's counter-offer purports to give it proportionally more than the other banks receive, they will not resign themselves to the fact that with the given discount rates it may be rational to accept the offer. Rather, they will refuse as it offends their norms of fairness.

Norms of reciprocity. So far, we have ignored the difficulties for renegotiation raised by the presence of secured creditors. Creditors who are *fully* secured will be indifferent as between insolvency or renegotiation, since their payoff will not change either way. Creditors

who are less than fully secured, however, may have a preference one way or the other. For example, if the collateral is worth considerably less than the outstanding debt, the secured creditor will face similar incentives to the unsecureds. Under some circumstances, however, secured creditors do have an incentive to prefer insolvency. For example, if the realisation value of their collateral is likely to be damaged by delay, then they will have an incentive to enforce and precipitate bankruptcy regardless of whether this creates externalities. This is a classic example of the inefficiencies which may be created by heterogeneous priorities. Their presence may destabilise renegotiations at an early stage. If parties anticipate that secured creditors will enforce and precipitate insolvency, then they are unlikely to incur the costs of attempting a restructuring at all.

Such difficulties may be avoided by keeping secured debt out of the debtor's capital structure. To be sure, large UK corporates do not as a rule issue significant amounts of secured debt (Lasfer, 2000). Yet it is nonetheless still present in one form or another. Another approach may be for the secured creditor with delay-sensitive collateral to be given a side payment *ex post*, to ensure that they lose nothing by agreeing not to enforce. Yet this may give parties an incentive to claim that their collateral is time-sensitive, or to take such collateral. Our interviewees suggested that in these circumstances, norms of reciprocal co-operation could be called upon to persuade such creditors to agree to participate in a restructuring. The 'folk theorem' of game theory posits that it is possible to sustain cooperative outcomes even in a prisoner's dilemma game, provided that the game is repeated indefinitely and parties have sufficiently low discount rates. These results can under certain circumstances be extended from two players to a larger population. Sugden (1986) demonstrates this by reference to a 'mutual aid' game, where members co-operate with each other when in need, on the basis that the others will co-operate with them in turn when needed. Those who do not co-operate are excluded from the benefits of future co-operation.[42] As our interviewees put it,

‘[T]hese situations are rarely one-offs, because what you’re talking about is participation in syndicated lending and the syndicate did the round and so I suppose the first thought was that you might be on the other side of the argument next week…’ (Interview 5).

‘[If] you work on restructuring, you nearly always have the same individuals round the table. The banks have relatively small departments—even the big banks—who deal with these situations and … when there’s a lot of potential insolvency or restructuring work about, they will go to a steering committee meeting with one company in the morning and in the afternoon half the people round the table will have been at the meeting in the morning. They can draw direct comparisons…When he goes to that meeting in the afternoon the people are going to remember’ (Interview 4).

Another aspect of reputation is to do with repeat business, in terms of being offered participation in future loan syndications:

‘The recalcitrant bank can be taken on one side, possibly at a very senior level, and reminded that … in the next case which is being syndicated, they may not get offered a piece of the action.’ (Interview 1).

‘Then there’s the question of commitment to the market and the need to remain a bank with which other banks can do business.’ (Interview 5).

‘I think, though, that they would certainly get a name in the market place and, for example, if there was a call for one of the well known banks in the UK, or indeed big US banks, to do a syndicated loan they might think twice about offering a slice of that to that particular bank. So it could damage that bank’s business in that sense.’ (Interview 4).

The ‘mutual aid’ models require for stability that it is possible to exclude non-cooperators from the shared resource at negligible cost. Otherwise the threat of enforcement is not credible, and the ‘norm’

will not affect parties' incentives. Our interview subjects perceived that two possible sanctions would be imposed for violations of the norm of 'standstill': noncooperation in repeated play of the same game, and exclusion from future business. We consider that the latter is more significant. Noncooperation in future restructurings would hurt the 'punisher' as well as the defecting bank, and norms which rely on costly enforcement are difficult to sustain (Axelrod, 1986). However, the exclusion of noncooperating banks from these syndications—whether permanently, or for a limited 'punishment' period—is unlikely to cost the other participating banks anything, and is therefore credible. Thus this seems to suggest a 'mutual aid' game being conducted with a 'shared resource' of limited opportunities to profit from future loan syndications.

6 Evolution of the London Approach

We now move from consideration of the incentives of creditors of a financially distressed firm in any given restructuring—a static analysis—to an investigation of the evolution of the norms of the London Approach over time.

6.1 The past

From minimal beginnings in the early 1970s, the London Approach has evolved to the point where successful practices for resolving creditor conflicts have been codified into a series of practices (such as those which relate to the composition and voting practices of committees) and principles (such as the 'rules' of standstill and 'equity'). In this sense, the London Approach has acquired an existence separate from the individual cases in which it is applied, notwithstanding the difficulty of pointing to any single set of documents which embodies the rules which make it up. At the same time, these rules appear to be largely self-enforcing, since they do not depend upon statutory support, nor on the active intervention of the Bank of England.

The role of the Bank of England is difficult to identify precisely, in part because commercial confidentiality makes it hard to judge how far the Bank was prepared at any stage to exercise sanctions against banks failing to toe the line. However, it is possible to see that the Bank played a vital role in co-ordinating the activities of creditors. The Bank's long-standing role in dealing with the consequences of large-scale corporate failures made it well equipped to undertake these tasks. The London Approach, then, may be seen as an adaptation of expertise which the Bank acquired during the period in the 1970s when the British economy was undergoing exceptional turbulence. The particular, the historical role played by the Bank was one of the conditions which initiated the development of the common understandings and expectations out of which the London Approach grew.

The Bank also played an important role in disseminating information about the London Approach at a stage, in the mid-1980s, when it began to be more formally articulated. At a certain point, the London Approach ceased to be simply a matter of common knowledge and understanding among the financial professionals who applied it in practice. It was subject to a process of partial but nevertheless significant codification, which was later extended by one of the relevant trade association bodies, the British Bankers Association, when it published its guidelines of 1996. The dissemination of information about the London Approach was therefore no longer based only on observation and imitation of previous good practice. Rather, the rules of the London Approach began to operate as a benchmark against which participants in the rescue process would measure their own conduct and their expectations of the conduct of others.

Both these aspects of the Bank's role fit well with the suggestion of Picker (1997) that the state may be able to shift parties between conventions in games of pure co-ordination by 'seeding' norms and with Lessig's claim that the state can induce social or economic change by altering the environmental or 'architectural' constraints on

individual decision making (Lessig, 1998). It seems that the Bank of England's historical role may have been an example of norm seeding in action. Without the Bank's capacity for institutional intervention to assist the development of the London Approach, it is possible that informal rescue procedures would not have been developed in such an effective way, and it is highly unlikely that practices in the City of London would have gone on to form the basis for procedures in other financial centres, as is now proving to be the case (Bullock, 1998).

6.2 The future

The London Approach exists in a market place which is itself changing rapidly. Since the recession in the early 1990s, three key developments in the financing of large UK firms have injected further pressures into negotiations between creditors of financially distressed firms. First, the pace of 'globalisation' in financial markets has intensified during the 1990s.[43] Second, large UK corporates are making more frequent use of disintermediated debt finance, in particular bond issues.[44] Third, markets for distressed corporate debt, including the trading of participations in syndicated bank loans, have developed in London.[45]

These three factors may have profoundly destabilising consequences for the norms which have in the past 'regulated' the London Approach. Each of these tend to reduce the likelihood of repeated interaction amongst parties with claims against a distressed firm. Buyers of bonds or distressed debt (so-called 'vulture' investors), or parties based abroad, are less likely to have any expectation of repeat business with the banks in question.[46] This increases the likelihood that one or more such parties may incorrectly observe the conventions operating in London Approach workouts and adopt strategies which precipitate insolvency. Simultaneously, it reduces the efficacy of the sanctions which the 'club' of London banks can threaten to exert: they are unable to exclude buyers of bonds or distressed debt from participating in future loan syndications.[47]

Trading in distressed debt brings with it particular problems. The costs of communicating with the parties to a renegotiation rise when they are continually changing. The risk that breaches in confidentiality will occur, and that the debtor's difficulties will become public knowledge—with all the associated costs—is also greatly increased. Speculative traders subject to high pressure to make quick returns may have a strong preference for making recoveries sooner rather than later. As one interviewee put it:

'[T]hey can be quite destructive: they've bought the debt for 30 pence in the pound and they see a model that tells them they're going to get 40 pence on a formal liquidation. They'll say: well, you know, why wait? And then you've got a hell of a job pulling those people into line.' (Interview 4).

It seems that a trader relying on such an argument is suggesting that they apply a very high time discount rate, which if true would reduce the relative attrativeness to them of any share they would receive in a negotiated restructuring, as this might take several years to implement. The alternative to participating in a renegotiation is to enforce and provoke insolvency proceedings, where the repayment will be more rapid. Enforcement is therefore an 'exit option' for the debt trader from the renegotiation game. Noncooperative bargaining theory suggests that an exit option places a floor on what a party can expect to receive in a negotiated settlement: no party will accept an offer for less than they can receive by exiting negotiations. Thus the trader may be seeking to convince the other creditors that their high discount rate means that their insolvency payoff would be higher, when discounted to present value, than a*pro rata* settlement under the renegotiation, and that they will therefore require a higher return in the renegotiation in order to make it worth their while. There are, however, reasons for doubting that such an outcome would ever transpire. If a holder of distressed debt really had a very high discount rate, then they could profitably sell the claim to a party with a lower discount rate, and the use of this type of 'threat' in negotiations would not be credible.

Other subjects distinguished between ‘speculative’ debt trading, of the sort we have already described, and purchasers who would buy with a view to a longer-term return, based often on the idea of taking an equity participation in a successfully turned-around debtor company.[48] The returns to such a strategy, provided the investee company and the exit capital structure are chosen carefully, can be very high. Indeed, empirical evidence from US firms suggests that vulture investment has a positive effect on corporate performance (Hotchkiss and Mooradian, 1997).[49] Large-scale investors of this sort are likely to interact with one another repeatedly. It is therefore unsurprising that one of our interviewees, a lawyer who acted principally for such investors, suggested that traders of this variety would observe principles of reciprocity as between themselves, of a similar—although perhaps slightly looser—nature to those which, we were told, were operant between bankers in the London Market. He explained:

‘They will all be free to do whatever they like, but they know each other well and they operate in the same markets. They are essentially co-operative, in that if they come up in all these different positions against each other [they think], “If I hold that against you here, you are going to completely rain it down on me there.”’ (Interview 8).

It is also worth noting that in the last two to three years, market associations for distressed debt have formed in New York and London.[50] Whilst their principal function appears to be the production of standard terms for trading debt, it is plausible that these associations could in time come to perform a ‘policing’ function, excluding players who are known to adopt noncooperative negotiating strategies from the pool of acceptable purchasers.

7 Conclusions

In this study of the London Approach, we have seen how norms operate to co-ordinate parties’ expectations and strategies during debt

renegotiations. Norms play the role which, according to some analyses, would be performed by a state-supplied reorganisation procedure of the kind contained in Chapter 11 of the US Bankruptcy Code, or in other analyses by contractual agreements enforced by the courts. We consider that our findings have a number of important implications for insolvency scholarship and for regulatory design in general.

Our findings show that private norms can substitute for publicly supplied and/or enforced legal rules in the context of corporate reorganisation. This suggests that analysis of the '(in)efficiency' of legal insolvency procedures proceeding from the assumption that they will actually be employed may give misleading conclusions. The substitution is not however complete, and it appears that existence of legal insolvency procedures 'in the shadows' plays an important role in underpinning the stability of the observed norms. This points the way to an expanded frame of reference for normative analysis of insolvency procedures. The optimality of a given procedure is a function not just of the rules in question, but of the way they interact with norms operant in the relevant market place.

In this paper we have suggested that norms are a form of 'information resource' which make it possible to short-circuit lengthy processes by which actors search for, and imitate, successful solutions to co-ordination problems. The evolution of norms is a process of continuous reception, codification and dissemination of information. This process, however, does not take place in isolation from institutional features of the environment in which commercial or social relations are located. The appearance of the London Approach as a set of self-enforcing conventions conceals the active role played by state authorities, in particular the Bank of England, in creating the conditions under which those conventions became established. The history of the London Approach may be an example, then, of how the state can influence the development of self-enforcing norms. This can occur through 'norm seeding' (Picker, 1997), or the process by which norms which are first established among a small, relatively

homogeneous group of actors come to be adopted by a wider and more diverse population.

This suggests that state institutions may have an important role to play in the *generation* of norms which guide processes such as the resolution of financial distress. We have seen that early efforts by the Bank of England to save large firms which were in financial distress established a pattern which over time became self-reinforcing. After a certain point, the Bank itself withdrew from active participation in the organisation of rescues, and the rules and principles became contained in standard form contracts and other legal instruments which were in widespread use within the financial sector in London. It finally became possible to state the London Approach in terms of a series of guiding principles (British Bankers' Association, 1996). For market professionals, this has not detracted from the fundamentally flexible and open-ended way in which the rules were interpreted. At the same time, it has made it possible for a process aimed at transplanting the essential features of the London Approach to other jurisdictions to begin (see Bullock, 1998). This flexibility may give norms an efficiency advantage over publicly-supplied legal procedures, or private contracts to which parties are 'locked in' over time.

The reverse process may also take place: shifts in the composition of a population of agents may lead to the destabilisation of a body of norms which previously enjoyed widespread and general adherence. The globalisation of financial services, which has led to the growing disintermediation of corporate debts and the entry of distressed debt dealers into the London markets, may therefore endanger the stability of the London Approach (just at the moment, ironically, when efforts are being made to export it to other jurisdictions). Thus as Posner (1996) has warned, faith in the efficiency properties of norms must not be accorded too readily.

Our findings give rise to a number of important questions for future research. Comparative studies of the norms operant in reorganisations in other jurisdictions will assist in understanding the interrelationship

between legal rules, market norms, and restructuring outcomes. Similarly, studies of the origins and development over time of such norms will enhance our understanding of the role of state institutions in fostering their development. It is our hope that in time, normative work on insolvency procedures will incorporate analyses of the interplay between law and norms, the role of regulatory intervention in shaping norms, and the dynamic efficiency properties of law and norms as means of shaping outcomes.

Notes

1 There are exceptions. Hart (1999: 2) discusses the features of a good insolvency procedure on the basis that it could be supplied either as a set of mandatory rules, or on the basis that firms 'opt in' to it.

2 For example, imagine a restructuring proposal for an insolvent firm which asks creditors to swap £100 of debt for £50 of debt and equity with an expected value of around £25. This will ensure that the firm is solvent again and that the remaining debt will be paid. However, for a creditor holding a small amount of debt—say £100—it is rational to abstain from participating in the restructuring, provided he is confident that this will not affect his chances of success. If he does so, his entire £100 will become repayable in full by the (now) solvent firm. Of course, if more than a few creditors do this, there will be insufficient overall surplus to make the deal worthwhile to any of them, and it will fail.

3 This can follow from the taking of security interests with differing priority levels, or simply through the use of subordination agreements and loan covenants.

4 There is no similar prohibition under English law.

5 The law of security interests is a well-analysed example (Schwartz, 1997). English law provides a route for the generation of private insolvency procedures through the

privileged treatment which it accords to secured creditors. The Insolvency Act 1986 provides that the creditor(s) holding a floating charge which covers the whole, or substantially the whole, of the debtor's assets, may appoint an administrative receiver. The receiver then acts in the interests of the creditors who appointed her. In small and medium-sized enterprises, this is indeed the dominant form of dealing with financial distress (Armour and Frisby, 2000).

6 Proponents of 'contractual' insolvency procedures are sensitive to this objection. Rasmussen (1992) proposes the use of a 'menu' of state-supplied procedures, and Schwartz (1998) offers a complex proposal designed to allow regular updating of the procedure to reflect changes in the firm's circumstances.

7 An important exception is Penati and Zingales (1998), who consider the impact of Italian bankrutpcy law on the US$20bn restructuring of the Ferruzzi group's debt.

8 A notable exception is LoPucki and Whitford (1990), who offer a valuable insight into the norms which guide the behaviour of lawyers negotiating in US Chapter 11 bankruptcies.

9 The Insolvency Bill 2000 will introduce a limited debtor-in-possession procedure. However, this will only be available to 'small' companies (defined as companies which satisfy two or more of the following three criteria: (i) annual turnover≤ £2.8m;

(ii) balance sheet total ≤ £1.4m; and (iii) employees ≤ 50. Companies Act 1985 s 247(3)).

10 On English corporate insolvency law, see generaly Goode (1997); Pennington (1997); Sealy and Milman (1999).

11 Insolvency Act 1986, Part IV.

12 Insolvency Act 1986 ss 122(1)(f), 124,125.

13 Insolvency Act 1986 s 128, 130(2), 183, 184.

14 *Re David Lloyd & Co* (1877) 6 ChD 339.

15 Insolvency Act 1986, ss 10(1), 11(3).

16 Insolvency Act 1986, Part II.

17 Insolvency Act 1986, s 8(3).

18 Companies Act 1985, ss 425-427 ('schemes of arrangement'); Insolvency Act 1986, Part I ('company voluntary arrangement').

19 See generally Goode (1997: 324-342).

20 Insolvency Act 1986, ss 9(2)(a), 10(2)(b), 10(3).

21 Insolvency Act 1986, Part III. See generally Armour and Frisby (2000).

22 Conversely, small and medium-sized firms tend to concentrate their borrowing in the hands of a single bank creditor.

23 Had Barings been allowed to fail, it would have brought down many other institutions in its wake. The Bank responded quickly

by orchestrating a support operation funded largely by other commercial banks. Other notable interventions over the years to save financial institutions have included a moratorium arranged to rescue merchant banks exposed to losses under international bills of exchange in 1914 and the provision of emergency assistance to Lazard Brothers in 1931 (Hadjiemmanuil, 1996: 46-53).

24 Bank of England Act 1946; Banking Act 1979; Banking Act 1987.

25 Bank of England Act 1998.

26 In most cases, the interviews were tape recorded and subsequently transcribed. In cases where there was no tape recording, notes were taken during the interview. Further information about interviewees is given in Table 1, although names and specific details have not been disclosed for reasons of confidentiality. References in this section to interview numbers correspond to those in Table 1.

27 At least one other study of the London Approach has been conducted using a similar methodology. The findings were consistent with ours. See Flood and Skordaki (1995); Flood*et al* (1995); Flood (2000). A number of practitioners have also written about the London Approach in similar terms (Donaldson, 1995: 48ff; Floyd, 1995; Bird, 1996).

28 Syndicated bank loans are usually structured so that initial negotiations with the debtor are carried out with only one bank, which then solicits participation from other banks in the marketplace. The institution performing this function is referred to as the ‘lead’ bank (Wood, 1995).

29 For example, interviewees noted that standstill agreements would typically be drafted by the lead bank or its legal team.

30 Interviews 10; 11; 12.

31 This does not mean that the disciplinary function of debt is weakened. If the investigating accountants consider that the firm’s management are underperforming, the creditors may require that they be replaced as a condition of the refinancing.

32 Interview 6.

33 Society of Practitioners of Insolvency (1999). Some large firms do nevertheless enter formal insolvency proceedings. Well-known examples from the 1990s, which generated considerable amounts of litigation, were the ‘rescue’ of Olympia & York plc and the failure of British & Commonwealth Holdings plc, both of which involved administration proceedings. See *Re British & Commonwealth Holdings plc (No. 3)* [1992] BCC 58; *Re Olympia & York Canary Wharf Ltd* [1993] BCC 154; *Re Olympia & York Canary Wharf Ltd (No. 2)* [1993] BCC 159; *Barclays Bank plc v British & Commonwealth Holdings plc*

[1995] BCC 1059; *Soden v British & Commonwealth Holdings plc* [1997] BCC 952.

34 Cross-default clauses, standard in syndicated lending agreements, provide that the debtor's default under *any* of its loan obligations shall constitute an event of default (Wood, 1995).

35 If the debtor has no secured debt, then winding-up or administration will ensure that all unsecured claims are stayed. If the debtor has some secured debt, then the claims of secured *and* unsecured creditors can be stayed using the administration regime. If the debtor has issued a package of security that covers the whole, or substantially the whole, of its undertaking, then the creditor(s) holding the rights to this security are not bound by an administration order. Although the existence of security of this type will itself solve the common pool problem (Buckley, 1994), it is rare to find the borrowing of a large public firm structured in this way.

36 An 'outside' bank will fear that the lead bank and the debtor may form a coalition to expropriate them. This type of disagreement is minimised by the convention that the steering committee is composed of a selection of representatives from across the spectrum of involved parties (see Donaldson, 1995: 51-53). Each separate identifiable 'constituency of interest' has

a representative on the committee, thereby assisting in the formation of a consensus of opinion.

37 Franks, Nyborg and Torous (1996) report on an unpublished study by Olsen (1996) of 35 distressed debt restructurings in the UK, where the average creditor recovery in a workout was 0.85 of the face value of their claims. In contrast, a number of studies show the average recovery in receivership to be around 0.44 of the face value of creditors' claims (e.g. Society of Practitioners of Insolvency, 1999).

38 See Deakin and Slinger (1997).

39 On the internalisation of norms in commercial contexts, see Cooter (1996).

40 Indeed, where insolvency proceedings *are* a certain alternative, the proposer of the plan has the ability to extract *all* of the surplus from the other parties. The analysis by Penati and Zingales (1998) of the Ferruzzi restructuring is an example of a plan which is largely redistributive, with much of the potential surplus failing to be captured, in order to maximise the payoffs to the proposers of the plan. Italian law contains a provision mandating liquidation or recapitalisation within 90 days of an announcement that a company's net assets are less than half its share capital. This provision appears to have allowed the controlling blockholders to have credibly committed the firm to insolvency if their offer was not accepted.

41 Another explanation could be that the results of the Rubinstein model simply do not extend to multi-party bargaining environments. Sutton (1986) demonstrates that the results of this model do not hold for a large class of *n*-person bargaining games.

42 The exclusion need not be permanent, provided the loss is sufficient to outweigh, in expected value terms, the gain from defection in any given round.

43 The global aspect of corporate finance has always been an issue in London Approach workouts. For example, the Massey Ferguson workout in 1978-1980 involved over 200 banks worldwide (Interview 11). See Baldwin and Mason (1983).

44 Brierley and Vleighe (1999: 175) show that whilst in 1990 under 20% of the debt of UK corporates was raised in the form of bonds, by 1999 this had risen to nearly 35%. The level of bank debt had fallen over the same time from 70% to under 65%.

45 Some details of the market for distressed corporate debt can be found at the website of the Loan Market Association <http://www.loan-market-assoc.com/lmaex/Publicdisc.asp?Main=Search>.

46 Interview 9.

47 The use of bonds brings additional difficulties, in that the unanimity principle becomes more problematic to implement.

For example, where bearer bonds have been issued, it may be impossible to trace the bondholders. However, under English law, this problem is more apparent than real. It is legal to write majority-voting clauses into bond issues, which provide that a restructuring proposal may be accepted by a majority of the holders. The majority's decision will be binding provided that it does not compromise the *entire* debt outstanding (*Mercantile Investment and General Trust Co v International Co of Mexico* [1893] 1 Ch 484n, 489 *per* Lindley LJ).

48 Interviews 8; 9; 14.

49 Interview 14.

50 See <http://www.loanpricing.com/lsta1.html> (New York Loan Syndication & Trading Association); <http://www.loan-market-assoc.com/> (London Loan Market Association).

TABLE

Table 1: Interviews

No.	Date	Profession	Geographic Location	Expertise	Transcript
1	16-03-99	Accountant	London	1b 2bc	Y
2	15-04-99	Accountant	London/NE	1ab 2bc	N
3	08-06-99	Accountant	London	1ab 2bc	Y
4	24-02-99	Lawyer	London/HK	1b 2bc	Y
5	09-03-99	Lawyer	London/SW	1b 2bc 3c	Y
6	20-05-99	Lawyer	London	1b 2b	Y
7	27-07-99	Lawyer	London/US	1b 2b	Y
8	28-07-99	Lawyer	London	1b 2bc	Y
9	15-03-99	Banker	London	1a 2a	Y
. 10	22-03-99	Banker	London	1b 2b	Y
. 11	23-03-99	Banker	London	1b 2b	Y
. 12	24-03-99	Banker	London	1b 2bc 3c	Y
. 13	27-04-99	Banker	London	1b 2b	Y
. 14	25-05-99	Banker	London	2bc	N

Expertise codes

Numerical: size of firms : 1 International; 2 Large domestic; 3 SME
Alphabetical: type of work: a Turnaround consulting; b Debt restructuring; c Receivership / Administration; d Liquidation

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