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THE LEGITIMACY OF UNSECURED CREDITOR PROTECTION THROUGH THE LENS OF CORPORATE SOCIAL RESPONSIBILITY*

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In this article, the protection of unsecured creditors as a special group of stakeholders will be discussed from a progressive viewpoint, linking their position to the concept of Corporate Social Responsibility (CSR). CSR has been gaining impetus globally in the last two decades by promoting stakeholder- and society-friendly innovations and changes in governmental policies and business operations, and by promoting enforceable improvements in future strategic plans. The adoption of CSR principles results in a movement away from the separate consideration of the position of individual constituencies towards a broader and more philosophical consideration of the function of corporations in society, a change in focus in the UK to emphasise the long-term interests of corporations. With reference to the current legal inefficiencies, this paper addresses itself to the necessity of protection for unsecured creditors as a disadvantaged group of stakeholders in various insolvency regimes, and examines ways to expatiate this. The impetus gained from progressive discussions of CSR will provide a platform for future legislative reform and result in further protection for unsecured creditors.

‘Money, it’s a crime. Share it fairly but don’t take a slice of my pie.’

Roger Waters¹

I. INTRODUCTION

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¹ ‘Money’ from Pink Floyd, The Dark Side of the Moon (1973).

In a previous article written with John Tribe, we argued that directors owe duties to creditors, and, further, that they continue to owe duties to creditors during formal insolvency procedures. These duties take the form of obligations towards wider stakeholders, including those that fall under the umbrella of CSR, and they are evidence for the extent to which CSR concepts have become enshrined in English law.² In this article, the protection of unsecured creditors as a special stakeholder group will be further singled out, from the angle of a progressive view of corporate law.³ Within this progressive assessment, a broader variety of social and political values are considered which together form the basis of CSR; progressive theorists suggest that whether the company is useful or not should be measured by assessing the social effects of corporate activity – how effectively it improves the overall welfare of society.⁴ As well as the interests of shareholders, it is suggested that there are other important constituencies that warrant consideration from directors, such as creditors, employees, local communities, suppliers and consumers.⁵ This acknowledgment has led to arguments about more stakeholder-friendly reforms in the fields of corporate law and insolvency law, as well as an increasing amount of calls from the public and the academic community for more socially responsible behaviour from businesses in favour of those who are in vulnerable and disadvantaged positions.⁶

In the UK, one prominent legislative change that has demonstrated the progressive view is the enlightened shareholder value principle, enshrined in s172 of the Companies Act 2006, requiring directors to have regard to non-shareholder constituencies' interests in corporate operations. While the “regard list” in s 172(1) does not include creditors, their interests as an important stakeholder group have been specifically considered in s 172(3), which requires directors to act for creditors' benefits as any rule of law (mostly insolvency-related rules) provides. While the law as it currently stands might work as a pragmatic approach to progressive business practices, on the ground that it provided guidelines to directors for the execution of stakeholder- and society-friendly strategies,⁷ it falls short of taking care of one particularly vulnerable group – unsecured creditors. Indeed, a glance at the unsecured creditors' position in a distressed company suggests a disappointing reality and a need for further protection. Before the process of insolvency has even begun, the fees for the insolvency proceedings, which are paid ahead of the settlement of creditors' claims, have already eroded or exhausted a large amount of “what would otherwise be available to creditors, particularly

² J. Zhao & J. Tribe, 'Corporate Social Responsibility in an Insolvent Environment: Directors' Continuing Obligations in English Law' (2010) *International Company and Commercial Law Review* 305 at 315.

³ For discussions on progressive scholarship of corporate law see L.E. Mitchell (edn) *Progressive Corporate Law* Boulder, Colo.; Oxford: Westview Press (1995); L. Talbot, *Progressive Corporate Governance for the 21st Century* London Routledge (2012).

⁴ D. Sullivan & D. Conlon, 'Crisis and Transition in Corporate Governance Paradigms: The Role of the Chancery Court of Delaware' (1997) *Law and Society Review* 713; D. Millon, 'Communitarianism in Corporate Law: Foundation and Law Reform Strategies' in L.E. Mitchell (ed.) *Progressive Corporate Law*, Boulder, Colo.; Oxford: Westview Press (1995).

⁵ E.M. Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45 *Harvard Law Review* 1145.

⁶ H. Anderson, 'Corporate Social Responsibility – The Case for Unsecured Creditors' (2007) *Oxford University Commonwealth Law Journal* 93 at 93.

⁷ DTI (Department of Trade and Industry), *Corporate Social Responsibility: A Government Update* (2004).

unsecured creditors”⁸. Even when there are still some crumbs left after the enormous proceeding fees, the position of unsecured creditors is still not favourable. Given the fact that creditors’ claims in insolvency proceedings are ranked according to priority, groups of unsecured creditors, who stand at the end of the line as the lowest ranking group, often end up penniless.⁹ Evidence from a recent study, carried out in 2010 by the OFT within five hundred administrations, revealed that the recovery rate for unsecured creditors was 4%, while preferential creditors had the highest average recovery rate of 83%.¹⁰ To make things even worse, these disadvantaged unsecured creditors overpay in fees by around £15 million per annum during the administration process, as a result of their lower ranking and limited influence. This is in stark contrast to secured creditors, who have direct control over setting the fees of Insolvency Practitioners (IPs).¹¹ As commented by Office of Fair Trading, “current regulatory regimes did not do enough to rectify the lack of power on behalf of unsecured creditors”.¹²

There has been much discussion of the status of secured and unsecured creditors in insolvency regimes, and of how to balance the interests of these two parties both in Commonwealth countries¹³ and across the Atlantic¹⁴ in order to maintain a fair balance of assets distribution in various insolvency cases. So far, concerns have mainly been raised in the legal domain, focusing on the vulnerability of unsecured creditors under various insolvency regimes and the inadequacy of present legal frameworks in ensuring the protection of some non-shareholder constituencies’ interests.¹⁵ Suggestions are also put forward in the field of insolvency law, e.g. certain restrictions that may be placed on the powers of secured creditors in enforcing their securities.¹⁶ Through the lens of CSR, this article seeks to complement and further contribute to the existing field of research by justifying the morality of protecting

⁸ The Insolvency Service, Consultation on Reforms to the Regulation of Insolvency Practitioners, February (2011) para 2.22.

⁹ The Insolvency Service, Consultation on Reforms to the Regulation of Insolvency Practitioners, February (2011) para 2.22.

¹⁰ Office of Fair Trading, The Market for Corporate Insolvency Practitioners (2010) 13.

¹¹ The Insolvency Service, Consultation on Reforms to the Regulation of Insolvency Practitioners, February (2011) para 2.29.

¹² The Institute of Chartered Accounts of Scotland, ‘Consultation on Reform to the Regulation of Insolvency Practitioners’ (2011) available via <http://www.bis.gov.uk/assets/insolvency/docs/insolvency%20profession/consultations/ipregulation/responses/27%20%20institute%20of%20chartered%20accountants%20in%20scotland.pdf>

¹³ See R.M. Goode, ‘The Death of Insolvency’ (1980) 3 *Company Lawyer* 123; R.M. Goode, ‘Creditors’ Rights: the Cork Proposals’ (1983) *Company Lawyer* 51; R.J. Mokal, ‘The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit’, (2002) 22 *Oxford Journal of Legal Studies* 687; G. McGormack, ‘The Priority of Secured Credit: An Anglo-American Perspective’ (2003) *Journal of Business Law* 389; V. Finch, ‘Security, Insolvency and Risk: Who pays the price?’ (1999) 62 *Modern Law Review* 633; D. Milman, ‘A New Deal for Companies and Unsecured Creditors’ (2000) *Company Lawyer* 59; D. Milman, ‘Priority Right on Corporate Insolvency’ in A. Clarke, *Current Issues in Insolvency Law*, London: Sevens & Son, (1992) 57; D.D. Prince, ‘Some Observations on the Law Relating To Preferences’, Chapter 19 of R. Cranston, *Making Commercial Law: Essays in Honour of Roy Goode*, Oxford: Clarendon Press, (1997) 445; J Hudson, ‘The Case Against Secured Lending’ (1995) *International Review of Law and Economics* 47.

¹⁴ See S.L. Schwarcz, ‘The Easy Case for the Priority of Secured Claims in Bankruptcy’ (1997) *Duke Law Journal* 425; L.A. Bebchuk & J.M. Fried, ‘The Uneasy Case for the Priority of Secured Claims in Bankruptcy’ (1996) *Yale Law Journal* 857; D.G. Carlson, ‘On the Efficiency of Secured Lending’ (1994) 80 *Virginia Law Review* 2179; S.L. Harris & C.W. Mooney, ‘A Property-Based Theory of Security Interests: Taking Debtors’ Choice Seriously’ (1994) 80 *Virginia Law Review* 2021; T.H. Jackson & A.T. Kronman, ‘Secured Financing and Priorities Among Creditors’ (1979) 88 *Yale Law Journal* 1143; H. Kanda & S. Levmore, ‘Explaining Creditor Priorities’ (1994) 80 *Virginia Law Review* 2103; L.M. LoPucki, ‘The Unsecured Creditor’s Bargain’ (1994) 80 *Virginia Law Review* 1887.

¹⁵ H. Anderson, ‘Corporate Social Responsibility – The Case for Unsecured Creditors’ (2007) *Oxford University Commonwealth Law Journal* 93 at 94.

¹⁶ See Insolvency Law and Practice: Report of Review Committee, *Chairman: Sir Kenneth Cork, GBE, Presented to Parliament by the Secretary of State for Trade by Command of Her Majesty June 1982*; since the surname of the chairman is Cork, the report is generally known as the Cork Report. The phrase “Cork Report” will be used to refer to the Report of the Review Committee throughout this article.

unsecured creditors and suggesting plausible ways for doing so above and beyond the current legislative protection. It advocates the legitimacy of unsecured creditors' protection by disputing the narrow economic rationale of secured creditor protection, and offers a new perspective on the safeguarding of unsecured creditors' interests.¹⁷ The theme of the paper will be outlined by exploring the following questions: How are secured creditors favoured in current insolvency regimes? Are these treatments justifiable in the light of wider realistic considerations rather than idealistic economic scales? Is it feasible to conduct any radical reform in current insolvency regimes, in order to place limits on the excessive power granted to secured creditors and promote the position of unsecured creditors? Finally, can the concept and practice of CSR be related to the protection of unsecured creditors, beyond their position simply as a cohort of stakeholders who are seeking legislative protection?

Putting the CSR theme onto the agenda for reform, this research further juxtaposes itself with existing research on unsecured creditor protection by promoting a shift from the separate consideration of the position of individual constituencies towards a broader and more philosophical consideration of the function of corporations in their societies, and a change to focus on the long-term interests of corporations in Britain.¹⁸ It initially identifies the inferior position of unsecured creditors in comparison with the priority given to secured creditors in various insolvency contexts, thus setting the ground for the necessity of protecting unsecured creditors according to the principles of CSR. The legitimacy of unsecured creditor protection through the lens of CSR will be asserted, initially by disputing the narrow economic rationale for secured creditor protection, and then by investigating the normative implications of CSR, which would be an appropriate platform to trigger both legislative reform and soft law developments. Last but not least, detailed statutory and soft law modifications will be proposed, aiming for a progressive approach towards greater unsecured creditor protection.

II. A WORLD OF UNDUE EXPLOITATION OF UNSECURED CREDITORS – AN EXPLORATION

A Secured and Unsecured Creditors

Before examining the unfair legal position of unsecured creditors, it is worthwhile first to delineate the various types of creditors in different insolvency regimes. Under the modern corporate finance doctrine of maximising shareholder wealth, categories of creditors are not specifically distinguished in the company law context,¹⁹ but this issue is certainly a primary one characterising fields

¹⁷ H. Anderson, 'Corporate Social Responsibility – The Case for Unsecured Creditors' (2007) *Oxford University Commonwealth Law Journal* 93 at 95.

¹⁹ For instance, section 172(3) of the CA 2006 provides that the duty to promote the success of the company has effect, subject to any enactment or rule of law

such as securities regulations and insolvency regimes. In general, depending on whether a creditor is a holder of a qualifying security interest in his debtor's property, these financial providers can be classified into secured and unsecured creditors. "The possession of a real right over one or more of the debtor's assets is what distinguishes the secured from the unsecured creditor."²⁰ This criterion is mainly governed by the law of contract, and lenders (creditors) and borrowers (companies) are normally free to bargain for such contractual terms as are appropriate to their particular circumstances and their assessment of risk.²¹ Money invested by secured creditors is always exchanged upon the creditor taking charge of some of the company's assets, i.e. security, which gives them privileged access to information as well as a certain amount of control over the conduct of the debtor's business – rights that cannot be gained by exclusive reliance on personal covenant.²² In the worst case scenario, where companies go into insolvency, this allows them priority payment in competition with a wide assortment of other claimants.

At the outset, there are five basic regimes to handle a company in financial distress. These are: administrative receivership, administration, winding up (liquidation), statutory compromise, and compositions and arrangements with creditors and organisations arranged contractually outside the framework of corporate insolvency law. While the liquidation of a company involves the cessation of its business and the realization of its assets in satisfaction of its debts, the other four regimes are primarily designed as rescue procedures, in the hope that through their operation the company's business can be revived, at least in part.²³ As will be presented, as well as the primary aim of allowing secured financing in the liquidation context – secured interests ranking above the claims of unsecured creditors – in practice secured creditors gain further advantages throughout all five regimes, including privileged access to information,²⁴ undue influence over the market behaviour of the debtor and the IP, and distortion of competition by prejudicing non-adjustable unsecured creditors.²⁵ In stark contrast, the rights of unsecured creditors, who make up the vast majority of creditors and have been said to "receive a raw deal",²⁶ are not as positive. These creditors lack even a vestigial interest in the debtor's property,²⁷ and they have "no claim either to a specific asset or to a fund, merely the right to sue for his money and to invoke the process of the law to enforce a judgment against the defendant"²⁸.

requiring directors to consider or act in the interests of creditors of the company.

²⁰ E. McKendrick, *Goode on Commercial Law*, London: Penguin Books, (2010) p.624.

²¹ J. Birds, A.J. Boyle, B. Clark, I. MacNeil, G. McCormack, C. Twigg-Flesner & C. Villiers, *Boyle & Birds' Company Law* 8th ed, (2011, Jordans), p. 311.

²² R.M. Goode, 'Is the Law too Favourable to secured creditors?' (1983) 8 *Canadian Business Law Journal* 53 at 56.

²³ J. Birds, A.J. Boyle, B. Clark, I. MacNeil, G. McCormack, C. Twigg-Flesner & C. Villiers, *Boyle & Birds' Company Law* (8th ed), (2011, Jordans), 858–9.

²⁴ V. Finch, 'Security, Insolvency and Risk: Who pays the price?' (1999) 62 *Modern Law Review* 633 at 637–638.

²⁵ The principal objection against secured financing is that when a corporate debtor arranges a secured loan with a creditor, this has the prejudicial effect of transferring the insolvency value from other involuntary unsecured creditors to the secured creditor, since unsecured creditors are not in a position to adjust their claims against the debtor. See L.A. Bebhuk & J.M. Fried, "The Uneasy Case for the Priority of Secured Claims in Bankruptcy" (1996) 105 *Yale Law Journal* 857–934, at 882–7.

²⁶ *Borden (UK) Ltd v Scottish Timber Products Ltd* [1981] Ch25 at 42 per Templeman LJ. See also *Business Computers v Anglo-African Leasing* [1977] 1 WLR 578.

²⁷ *Re Ebrmann Bros Ltd* [1906] 2 Ch 697.

²⁸ E. McKendrick, *Goode on Commercial Law*, London: Penguin Books (2010), 625.

B. Priority and Control: Undue Favours accrued to Secured Creditors in Insolvency Regimes

As with other systems of insolvency law, the UK legal system for insolvency has been developed on the foundation of two basic propositions: priority in terms of the allocation of assets, and control of the rights to affect the liquidator or other people in charge of the business. Though the positive value of secured financing, which goes some way toward accounting for the widespread use of this type of investment, should not be overlooked,²⁹ the present security and priority regimes seem to have gone out of their way to protect secured creditors according to the legal propositions, shifting the risks disproportionately to unsecured creditors.

1. Liquidation

In general, liquidation is a process which only occurs to a company when it becomes insolvent. This could be either because of a cash flow shortage, i.e. the company is unable to fulfil its duty of payment when debts fall due, or else it might fall foul on the balance sheet, i.e. its collective liabilities exceed the assets on the books.³⁰ Regardless of the differing criteria applied, a common aim shared by all liquidators in a winding-up process is to provide “an equal, fair and orderly procedure in handling the affairs of insolvents, ensuring that creditors receive an equal and equitable distribution of the assets”.³¹ To this end, the *pari passu* principle, a fundamental and legally-enshrined rule of corporate insolvency law laid down in 1542,³² seemingly works for the benefit of unsecured creditors, with the stipulation that all creditors are put on an equal footing and share the insolvency assets *pro rata* according to their pre-insolvency entitlements or the sums they are owed.

Despite its apparent appeal, however, the *pari passu* principle is almost defunct, owing to the substantial number of qualifications and exceptions it is subject to.³³ A primary one of these is the existence of security interests. The principal aim of permitting some creditors to hold additional rights *in rem* against a debtor’s assets is to reduce the risk they face in relation to the debtor’s present and

²⁹ A major advantage of secured financing, as noted, is to facilitate the raising of capital, particularly in companies having low credit ratings. For further discussions, see S. Harris & C. Mooney, “A Property Based Theory of Security Interests: Taking Debtors’ Choices Seriously” (1994) 80 Virginia Law Review 2021, at 2033–7.

³⁰ D. Milman, “Strategies for Regulating Managerial Performance in the ‘Twilight Zone’ – Familiar Dilemmas: New Considerations” (2004) *Journal of Business Law* 493; J. Birds, A.J. Boyle, B. Clark, I. MacNeil, G. McCormack, C. Twigg-Flesner & C. Villiers, *Boyle & Birds’ Company Law* (8th ed), (2011, Jordans), 858.

³¹ A. Keay & P. Walton, *Insolvency Law: Corporate and Personal*, 2nd Edn., Bristol: Jordans (2008) 22.

³² It was laid down in the Bankruptcy Act 1542 that “...for true Satisfaction and Payment of the said Creditors: This is to say, to every one of the said Creditors, a Portion Rate and Rate like, according to the Quantity of their Debt.” Also see Insolvency Act 1986 Section 107; the Insolvency Rules 1986 r. 4.181 (1).

³³ E.g. trust assets in allocation fall entirely outside the ambit of the *pari passu* rule.

future indebtedness, and to insulate them from the principle of *pari passu* distribution in insolvency.³⁴ Secured creditors will always retain their pre-insolvency priority for payment based on their proprietary and personal rights,³⁵ and are entitled to be repaid out of the proceeds of the realisation of their security in priority over other claimants on the company's assets.

Priority in the event of liquidation is a consequence of the proprietary interests vested in these holders, as well as being one of their primary reasons for taking up security.³⁶ However, this feature has a direct bearing on the interests of unsecured creditors, as it reduces the pool of assets available to them. It is also essential to note that the enforcement of security rights almost invariably causes damage to the interests of the general body of unsecured creditors, by removing assets which are required for the running of the business, forcing an untimely realisation, or asserting security rights so as to inhibit the liquidator's ability to deal with the company's trading stock for the purpose of the beneficial liquidation of the company.³⁷ As a result, pooled assets will usually be insubstantial and quite inadequate to meet the claims of unsecured creditors.³⁸ This is probably best illustrated by practical figures: nowadays 55% of unsecured creditors expect to recover nothing in an insolvency process.³⁹ This low expectation however still appears too optimistic in the real world, in which unsecured creditors only receive a payment in 20% of cases, with a startlingly low average return of 4%.⁴⁰

The high cost of liquidation has also become a substantial drain on the assets available for unsecured creditors. Before the Companies Act 2006 was implemented, common law traditionally regarded this expense as solely a matter for unsecured creditors.⁴¹ Although s. 1282 of CA 2006 seeks to improve unsecured creditors' unfavourable situation by providing that the expenses of winding up constitute a prior claim on floating charge proceeds, in practice this rule can easily be circumvented. As long as the first charge (or equal ranking charge) on the asset is a fixed charge, then the assets will not be subject to these rules relating to liquidation expenses.⁴² This provides a practical loophole for banks, who, as the biggest group of secured creditors, can easily pump out the asset pool via a combined use of fixed and floating charges, and leave unsecured creditors with literally nothing but the burden of

³⁴ See s. 107 of IA 1986.

³⁵ S.E. Weeler, 'The Insolvency Act 1986 and Retention of Title' (1987) May *Journal of Business Law* 180 at 180; also note the dissimilarity of the Court of Appeal's view in *Clough Mill v. Martin* [1984] 3 All E.R. 982; Re Law Merthyr Consolidated Collieries [1929] 1 Ch. 498; Insolvency Act 1986, section 251.

³⁶ Kenneth Cork, *Report of the Review Committee on Insolvency Law and Practice (Cork Report)*, Cmnd 8558 (1982), at Chapter 35; Paul L Davies, S Worthington & E Micheler, *Gower and Davies' Principles of Modern Company Law*, 8th ed, (2008, Sweet & Maxwell), at 1161.

³⁷ R. M. Goode, 'Is the law too favourable to secured creditors?' (1983) 8 *Canadian Business Law Journal* 53 at 70.

³⁸ B. Hannigan, *Company Law*, Oxford: Oxford University Press (2009) 687–688.

³⁹ The results yielded on basis of a survey distributed to 882 unsecured creditors. See Office of Unfair Trading, *The Market for Corporate Insolvency Practitioners – a Market Study*, (2010), OFT 1245, at 45.

⁴⁰ *Ibid.*, at 45.

⁴¹ See the House of Lords' judgment in *Buchler v Talbot* [2004] 2 AC 298, in which the decision in *Re Barleycorn Enterprises Ltd* [1970] Ch 465 was overruled on the ground that liquidation expenses should not be paid out of floating charge assets.

⁴² *Re Lewis Merthyr Consolidated Collieries Ltd* [1929] 1 Ch 498; also see discussions in Paul L Davies, S Worthington & E Micheler, *Gower and Davies' Principles of Modern Company Law*, 8th ed, (2008, Sweet & Maxwell), at 1178-9.

liquidation expenses. This sad fact was recently re-asserted by the Office of Fair Trading (OFT), who discovered that in more than 40% of cases, unsecured creditors waited for two to three years for the process to be completed with no money paid back, and unsecured creditors, including HM Revenue and Customs, also paid 9% more in insolvency fees than secured creditors.⁴³

To be fair, it would be wrong to conclude that the unfair footing of unsecured creditors in liquidation, particularly the difficulty of bearing high liquidation expenses, always goes unnoticed. As far back as 1897, there was the idea to dilute “the extraordinary benefits which come to the holder of a floating charge” in favour of unsecured creditors in cases of formal insolvency.⁴⁴ This *obiter dictum* was taken up by the Cork Committee in 1982 and was reflected in its report in the form of a recommended compulsory surrender of 10% of the net realisation of assets, subject to a floating charge being set aside for distribution among unsecured creditors.⁴⁵ The Enterprise Act 2002 Section 252 introduced s. 176A into the Insolvency Act, which imposes an obligation on the insolvency officeholder to hold back a prescribed portion of the net realisations achieved under any applicable floating charge, to be set aside for distribution among the unsecured creditors. The intention of the legislation was to transfer the benefits formerly enjoyed by the Crown⁴⁶ to unsecured creditors. However, it is important to be aware that s. 176A(2) of the Insolvency Act 1986 is subject to important exceptions: it will not apply if the net property of the company is less than a prescribed minimum,⁴⁷ or if the officeholder thinks that the cost of making a distribution to unsecured creditors would be disproportionate to the benefit, which is usually the case.⁴⁸ It is also crucial to note that this “prescribed portion” rule leaves some important issues unresolved.⁴⁹ For instance, what will happen if the holder of the floating charge realises his security before the prescribed part is distributed? Can he then be regarded as an unsecured creditor and benefit from the prescribed portion rule? In practice, the uncertainties in relation to this rule encourage creditors to take different kinds of security other than floating charges, which consequently hinders effective rescues and eventually leads to unsecured creditors being collectively even worse off.⁵⁰

2. Administration

⁴³ Office of Fair Trading, Corporate Insolvency In-Depth Interview with Creditors: A Report for the OFT, prepared by Marketing Sciences, June 2010.

⁴⁴ *Per* Lord Macnaghten’s comments in *Saloman v A Saloman & Co Ltd* [1897] AC 22 at 53, where he proposes giving trade creditors a limited form of preferential claim. Also see S. Davies, *Insolvency and the Enterprise Act 2002*, Bristol: Jordans, 2nd Edn., (2003) 51.

⁴⁵ This is the so-called “Ten Per Cent Fund” in paras 1538–1549 of the *Insolvency Law and Practice: Report of the Review Committee (The Cork Report)*.

⁴⁶ M. Andrews, ‘UK: Change And Uncertainty Under the Enterprise Act’ (2003) 22 *International Financial Law Review* 56 at 57; according to the DTI (now the BIS), The Enterprise Bill, Insolvency Provision—Regulatory Impact, para 5.29, the abolition of Crown preferences will release approximately £90 million per year to unsecured creditors. The vast majority of this sum will funnel into administrations and administrative receivership; recoveries by the Crown under its preferential rights in liquidation and bankruptcies will be considerably smaller.

⁴⁷ Section 176A(3), Insolvency Act 1986.

⁴⁸ S 176A (3) of Insolvency Act 1986. See *Re Hydrosolve Ltd* [2008] BCC 175, in which the court conveniently disapplied s. 176A; also see discussions in A.R. Keay, *McPherson’s Law of Company Liquidation*, London: Sweet & Maxwell (2001) 746.

⁴⁹ For detailed discussions on this matter, see Roy Goode, *Principles of Corporate Insolvency Law*, 4th ed, (2011, Sweet & Maxwell), at 211–1.

⁵⁰ See V. Finch, *Corporate Insolvency Law: Perspectives and Principles* 2nd ed, (2009, CUP), at 108–9; J Armour, “Should We Redistribute in Insolvency?”, at 223–4.

The main area of complexity in the protection of unsecured creditors is corporate rescue, as shown in the administration involved. The essential purposes of administration form a hierarchy, demonstrating the priority of the aims that administration is supposed to achieve:⁵¹ to rescue the company as a going concern; to achieve a better result for the creditors as a whole than would be likely if the company was simply wound up; and, in case the first two objectives are unachievable in the assessment of the administrator, to realise property in order to make a distribution to one or more secured or preferential creditors.⁵² At face value, it could be suggested that the overall delineation of the administration regime works towards the benefit of unsecured creditors, as they will at least be better off in the first two situations than their counterparts in a winding-up or an administrative receivership. Legislative support for this argument primarily comes from two aspects: the shift in focus of administrators' obligations, and the employment of the moratorium. In comparison with the fact that an administrative receiver's principal obligations are towards his appointer even though receivership impacts significantly on the interests of unsecured creditors, an administrator has a duty to act in the interests of all creditors, which presumably confers unsecured creditors more opportunities for input and participation.⁵³ Furthermore, when a moratorium is triggered, a freeze is imposed on all proceedings or executions against the company and its assets, which is intended to prohibit secured creditors from enforcing their rights during administration.⁵⁴

Nevertheless, upon investigation of the legal practices following the introduction of the administration regime, it is not difficult to see that it still fails to adequately protect the interests of unsecured creditors. An obvious initial issue is the fact that the moratorium can be relaxed and secured creditors can enforce their security when the administrator consents or when leave of the court is obtained.⁵⁵ In an indication of the flexible operation of the moratorium, there is a not-so-strict line that the courts has been taking as regards secured creditors lifting the conditions of the moratorium. A starting point would be *Royal Trust Bank v Buchler*,⁵⁶ which occurred only six years after the administration regime was finally consolidated. Although the application of the secured creditor to appoint a receiver was refused because it lacked proper grounds, Peter Gibson J. nevertheless confirmed the general orthodoxy in relation to leave to enforce the security – i.e. it was not necessary to demonstrate any criticism of the administrator's conduct in order for a court to grant a secured creditor leave to enforce their security.⁵⁷ Weighing up the conflicting interests, the following judgment in *Re Atlantic Computer Systems plc (No 1)* further illustrated the tilting of the balance towards secured creditors when their

⁵¹ Schedule B1, para 3 (1).

⁵² See para 3(1), Schedule B1.

⁵³ DTI, "Productivity and Enterprise – Insolvency: A Second Chance" (Cm 5234, 2001), at paras 2.12, 2.2–2.3; B Hannigan, *Company Law*, 2nd ed, (2009, OUP), at 616.

⁵⁴ IA 1986, Schedule B(1), para 43(2).

⁵⁵ See para 43, Schedule B1.

⁵⁶ [1989] BCLC 130.

⁵⁷ [1989] BCLC 130.

legitimate interests and those of the other creditors are in contradiction.⁵⁸ As stipulated by Nicholls L.J., in carrying out the balancing exercise, the underlying principle is always that an administration for the benefit of unsecured creditors should not interfere in the benefits of those who have proprietary rights, save to the extent that this may be unavoidable, and even then this will usually be acceptable only to a strictly limited extent.⁵⁹ To this end, the court, drawing upon Sir Nicolas Browne-Wilkinson V-C's observation in *Bristol Airport plc v Powlit*⁶⁰ in terms of applications for the granting of leave, concluded that the power of the moratorium in administration should be constrained, at least to the extent that its employment would not disturb the full rights of those who are secured creditors.⁶¹ Thus the unfavourable situation of unsecured creditors in administration was again evident when measured against secured creditors: in any case, it was never intended that administration would strengthen the administrator's hand in negotiations with property owners who could not assert their full rights because of the moratorium.⁶²

A central problem in complex administration scenarios is that the hierarchy of purposes of administration can be practically distorted by the claims of secured creditors. The current legislative regime expects that an administrator, in his day-to-day management of the company's affairs, will strive to rescue the company as a going concern and perform his functions for the benefit of the company's creditors as a whole.⁶³ Underlying this structure is the assumption that creditors are to have an important say in administration.⁶⁴ However, observations from practice suggest that unsecured creditors rarely have the opportunity to exert any influence in the conduct of administration, while administrators often seek the support of secured creditors. A reason frequently used to justify the neglect of the voice of unsecured creditors is that the business situation prevents the administrator from doing so. As Collins J. suggested in *Re Transbus International Ltd*,⁶⁵ if a tight timetable does not allow for the holding of a creditors' meeting, the administrators will be justified in not laying any proposals before the creditors. This is the case where the requirements of para. 52 are satisfied, e.g. where unsecured creditors are going to receive no payment.⁶⁶

Even if a meeting of creditors is convened to consider the administrator's proposals, it has very limited powers in practice. The meeting of creditors can accept the administrator's proposal in full, but any modification suggested by the meeting is subject to the

⁵⁸ [1992] Ch 505.

⁵⁹ [1992] Ch 505, per Nicholls L.J., at 542.

⁶⁰ [1990] 2 WLR 1362, 1379.

⁶¹ [1992] Ch 505, per Nicholls L.J., at 542 ; also see discussions in B. Hannigan, *Company Law*, 2nd ed, (2009, OUP), at 634.

⁶² *Ibid.*

⁶³ IA 1986, Sch B1, para 3(1).

⁶⁴ J. Birds, A.J. Boyle, B. Clark, I. MacNeil, G. McCormack, C. Twigg-Flesner & C. Villiers, *Boyle & Birds' Company Law* (8th ed), (2011, Jordans), 897.

⁶⁵ [2004] 2 All ER 911, at 12-13 of the judgment.

⁶⁶ J. Birds, A.J. Boyle, B. Clark, I. MacNeil, G. McCormack, C. Twigg-Flesner & C. Villiers, *Boyle & Birds' Company Law* (8th ed), (2011, Jordans), 898.

administrator's consent.⁶⁷ There is no shortage of examples where creditors' opposition towards the administrator's proposal was ignored, allowing the latter to proceed as he thinks fit.⁶⁸ Furthermore, secured lenders frequently assure their absolute influence over administrators' actions by enforcing their final say on IPs' appointments and fees.⁶⁹ In practice, low attendance rates for unsecured creditors at these meetings are regularly observed,⁷⁰ perhaps not least because they have little actual say in affecting the final decision made by insolvency practitioners.

This bias in favour of secured creditors was not significantly improved by the implementation of the Enterprise Act 2002. Despite the goodwill, the reforming measures introduced by the EA, which were intended to effect a trickle-down of the realisation of insolvent estates to the benefit of unsecured creditors, seem unlikely to affect the overall position to any significant degree.⁷¹ For example, Mokal expressed doubts about the "top-slicing" idea when he tried to estimate the quantity of additional benefits to unsecured creditors resulting from the removal of Crown preference.⁷² From the low average recovery rate for unsecured creditors in the overwhelming majority of formal insolvency proceedings, it seems obvious that unsecured creditors are not appreciably better off.⁷³ Also, the claims held by employee-creditors, which are given preferential status, are vested in the Crown by way of subrogation.⁷⁴ The most important change implemented in the Enterprise Act 2002 was the abolition of administrative receivership in favour of floating charges, but this reform is neither instantaneous nor comprehensive;⁷⁵ the right to appoint an administrative receiver remains in place when floating charges are concerned with certain exempted categories of transaction.⁷⁶ Therefore, the enforcement of the EA 2002 has not significantly improved the disadvantaged position of unsecured creditors. In the recent case of *Uniserve Limited and Others v Croxson and Others*,⁷⁷ the orthodox view in *Re Atlantic Computer Systems plc* was again fully upheld, exhibited by the Court's reluctance to overturn a lien-holder's established security against the use of the moratorium. This legislative reform, whilst disappointing to unsecured creditors, clearly reflects the statement made in the early White Paper, to the effect that "secured creditors ... should not feel at any risk from our proposals."⁷⁸

⁶⁷ Schedule B1, para 52.

⁶⁸ E.g. *Re Maxwell Communications Corp* [1992] BCLC 465, at 467; *Re Structures & Computers Ltd* [1998] BCC 348.

⁶⁹ See comment made by David Stallibrass, director at the Office of Fair Trading, quoted in Anousha Sakoui, "Unsecured Creditors Need Protection, Says OFT", *Financial Times*, June 24, 2010.

⁷⁰ E.g., see S. Frisby, *Report on Insolvency Outcomes*, a paper presented to the Insolvency Service, at 54.

⁷¹ B. Hannigan, *Company Law* 2nd edn., Oxford: Oxford University Press (2009) 683

⁷² R.J. Mokal, 'Priority as Pathology: The *pari passu* Myth' (2001) 6 *The Cambridge Law Journal* 581.

⁷³ *Ibid.* at 617–618.

⁷⁴ *Ibid.*

⁷⁵ *Ibid.* at 56.

⁷⁶ For example: Capital Market and PFI deals. See s 72(A)-(H) of Insolvency Act 1986.

⁷⁷ [2012] EWHC 1190.

⁷⁸ Insolvency Service, White Paper, Productivity and Enterprise: Insolvency – A Second Choice, Cm. 5234 (July 2001), at para 2.6.

3. Company Voluntary Arrangements (CVA)

As a less formal option for companies which are experiencing financial difficulties, voluntary arrangements between a company and its creditors and members were originally introduced with a laudable intention, i.e., providing unsecured creditors with a means of recovering what they were owed without recourse to the more expensive recourse provided by winding up or administration, while also offering the company the continuing opportunity to trade.⁷⁹ However, the laws and practices relevant to this scheme pose serious challenges to the fulfilment of this objective from the following aspects. First of all, although a company entering into a CVA is normally in financial difficulties, there is no formal requirement that the company has to be in a state of insolvency. This leads to a rather unfair practical situation; although the CVAs are for the benefit of unsecured creditors and do not bind secured creditors, support from the latter is crucial to the feasibility of any CVA, as the company is likely to require additional funding from banks, which usually constitute a large proportion of the company's secured creditors.⁸⁰

This practical control over the voluntary arrangements granted to secured creditors is further enhanced by the fact that apart from the limitations stated above on secured creditors and preferential creditors, any proposal can be presented by directors for approval, provided that it is in satisfaction of the company's debts or a scheme of arrangement of its affairs.⁸¹ Evidence suggests that very few proposals at creditors' meetings get modified or rejected, not least because of the fact that very few unsecured creditors attend the creditors' meetings owing to their inadequate knowledge and information about the process, as well as their limited level of influence.⁸² To a certain extent, secured credit is misused to "siphon away insolvency value from certain types of unsecured creditors."⁸³ This is particularly the case when secured creditors are large banks who employ professional legal and financial experts to advise upon and draw up legal arrangements relating to secured lending,⁸⁴ which can lead to a rather startling result in practice: although according to the rules secured creditors in creditors' meetings may not vote on these arrangements other than with respect to any element of their rights which are unsecured,⁸⁵ courts have nevertheless established that it is possible for a creditors' meeting to approve a scheme of arrangement which will only benefit secured creditors, with no realistic prospect of offering any payment to

⁷⁹ *Re NT Gallagher & Son Ltd* [2002] 2 BCLC 133, CA.

⁸⁰ IA 1986, s 4(3). "A meeting ... shall not approve any proposal or modification which affects the right of a secured creditor of the company to enforce his security, except with the concurrence of the creditor concerned." See further discussions in B. Hannigan, *Company Law* (2nd ed, 2009, OUP), at 599.

⁸¹ S 1(1) of IA 1986.

⁸² According to the statistics disclosed by OFT, 80% of creditors' meetings in administrations agree with all the IP's proposals. No unsecured creditors attend in nineteen out of twenty creditors' meetings. See Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 42.

⁸³ R.J. Mokal, 'The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit', (2002) 22 *Oxford Journal of Legal Studies* 687 at 690.

⁸⁴ J. Hudson, 'The Case Against Secured Lending' (1995) *International Review of Law and Economics* 47 at 56.

⁸⁵ Insolvency Rules 1986, r, 1.17(1) & (2),

unsecured creditors.⁸⁶ To add to their pain, the efficacy of the voluntary arrangement follows from the fact that once it is in effect, it binds every creditor who would have been entitled to vote at the meeting.⁸⁷ However, this means that those unsecured creditors for whom the nominee was unaware of their existence will be bound by the proposal, notwithstanding the fact that their opinions have not been taken into account.⁸⁸

C. Redress Methods for Unsecured Creditors – A Narrow and Difficult Path

One cannot deny that the current regulatory framework offers unsecured creditors some means to exercise their influence on IPs, such as mounting a challenge in court, or initiating winding-up proceedings. A typical legislative example is s.6 of IA 1986, under which anyone entitled to vote at the creditors' meetings can make an application on one or both of the following grounds, namely: (1) that a voluntary arrangement unfairly prejudices the interests of a creditor, member or contributor to the company; or (2) that there has been some material irregularity at or in relation to either of the meetings. As will be presented in the next section, the fact that unsecured creditors have very limited practical control over IPs' actions in market places means that they can only rely upon these formal legal mechanisms to exercise their influence and seek redress. However, even this limited ability to challenge is severely undermined by practical factors. As revealed by the OFT, the median value for the average amount owed to unsecured creditors is £3000, which is likely to be negligibly small compared to the amount of money and time they have had to devote to be actively involved in the proceedings.⁸⁹ This inevitably reduces the incentive for unsecured creditors to seek redress.

In the limited number of cases where creditors have tried to rely on s 6, the authorities further noted the difficulty of proving unfair prejudice and succeeding in such a challenge. On the grounds that there is no universal test for judging “prejudice” and “unfairness” in this context,⁹⁰ the current applicable test of fairness creates difficulty for creditors in challenging the CVA proposal on the basis of s 6. Perhaps a good starting point would be to review *Re T & N Ltd.*⁹¹ In this case, through a comparison of the criteria for judging fairness for a scheme of arrangement under s 425 of the Companies Act 1985 (now s. 896 of the Companies Act 2006) and the CVA under discussion, David Richards J. pointed out that in the former circumstance the proponents should satisfy the court that the scheme should be sanctioned, whereas under s 6 the objector (i.e. an unsecured creditor) is under an onus to establish unfair

⁸⁶ Commissioners of Inland Revenue v Adam & Partners [2001] 1 BCLC 222.

⁸⁷ S 5(2)(b) of IA1986.

⁸⁸ S 3(3) and 5(2) of Insolvency Act 1986.

⁸⁹ Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 5, 44–5.

⁹⁰ *Re a debtor (No 101 of 1999)* [2001] 1 BCLC 54, at 63, per Ferris J.

⁹¹ [2005] 2 BCLC 488

prejudice.⁹² Coupled with the usual provision that a CVA is determined by a single vote of all creditors, and differential treatment of creditors is not necessarily sufficient to establish unfair prejudice,⁹³ in practice this onus often works to the detriment of a class of unsecured creditors who are outranked by other creditors with different interests. As asserted in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd*,⁹⁴ there may be circumstances in which a CVA may properly provide for one class of creditors to be paid in full while others receive only a fraction of the company's liability to them. Had this unfair result happened in a scheme of arrangement in the company law context, it could have been prevented since the scheme needs approval from each voting class of creditors. However, this is not achievable under a CVA, for which purpose all creditors form a single class and inevitably the interests of those who were disadvantaged will almost inevitably be trumped.⁹⁵

D. Undue Favours from the Insolvency Practitioners: Access to Information and Interference with the Operation of the Company

Additional to the insufficient regulatory consideration of unsecured creditors and their limited ability to seek redress, the measure of practical control afforded to secured creditors over Insolvency Practitioners (IP) and the business of the debtor company may also cause harm to these vulnerable market participants. The terms of the security agreement commonly provides for the debtor company to report regularly to the secured creditors in case the debtor gets into financial difficulties, and the secured creditors will, in many cases, have direct influence on management decisions.⁹⁶ Robust evidence suggests that although the IP in an administration is usually appointed by the directors of the company, secured creditors, particularly banks, can veto this choice and make the final decision.⁹⁷ This factor, combined with the fact that secured creditors are often repeat players in the insolvency process, means that IPs have a strong incentive to form and maintain strong relationships with secured creditors to ensure a steady income, which consequently results in their tendency to respond to the wishes of secured creditors.⁹⁸ In stark contrast, unsecured creditors have no influence in the appointment of the IP, and nor do they have a steady long-term relationship with IPs, except for a few large

⁹² *Re T & N Ltd*, [2005] 2 BCLC 488, per Richards J, at 81.

⁹³ *Re a debtor (No 101 of 1999)* [2001] 1 BCLC 54, at 63, per Ferris J; *Sisu Capital Fund Ltd v Tucker* [2006] BBC 463, at 134, per Warren J.

⁹⁴ [2008] 1 BCLC 289, at 313, per Etherton J.

⁹⁵ [2008] 1 BCLC 289, at 313, per Etherton J; *Sisu Capital Fund Ltd v Tucker* [2006] BBC 463, at 134, per Warren J. in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd*, the unfair prejudice claim was nevertheless upheld, on the basis of the unusual feature of the claimants as landlords with valuable guarantees. For further discussion, see B Hannigan, *Company Law*, 2nd ed, (2009, OUP), 604–5.

⁹⁶ Paul L. Davies, S. Worthington & E. Micheler, *Gower and Davies' Principles of Modern Company Law*, 8th ed, (2008, Sweet & Maxwell), at 1162.

⁹⁷ As evidence has revealed, most banks would form panels to directly select IP firms for their insolvency cases, particularly where indebtedness to the bank exceeds £200,000. See Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 4–5. Also see academic discussion in J. Armour, A. Hsu & A. Walters, *The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK*, University of Cambridge Centre for Business Research Working Paper No. 332, (March 2009).

⁹⁸ Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 4–5,

ones such as HM Revenue and Customs. The small magnitude of their interests at stake further constrains their ability and incentive to maintain oversight on the IPs.⁹⁹

Given these factors, it is not surprising that IPs have little incentive to correct the disadvantaged position of unsecured creditors. This is particularly demonstrated in the information asymmetry suffered by unsecured creditors. Unsecured creditors are usually ill-informed; normally only general information on insolvency procedures will be provided by IPs, rather than information relevant to the case-specific process.¹⁰⁰ They are usually too small and poor to hire specialists; therefore, the complexity, time and cost of inspecting documents often prevents them from successfully investigating the company.¹⁰¹ In stark contrast, in addition to gaining priority for payment, securities fulfill the purpose of offering secured creditors privileged access to information, as well as a certain amount of control over the conduct of the debtor's business which may not be achieved by exclusive reliance on personal covenant.¹⁰² This is particularly the case when secured creditors are large banks who employ professional legal and financial experts to advise upon and draw up legal arrangements relating to secured lending.¹⁰³ This point was noted by Lindley LJ in the Court of Appeal in the *Salomon* case¹⁰⁴, where it was suggested that in practice it is often inevitable for small business persons to ignore essential information regarding the company's status, including a register of security interests. Otherwise, the trade creditors in this celebrated case would have been placed on notice of Mr Salomon's first priority secured debenture.¹⁰⁵

III. THE ECONOMIC BASES OF SECURED FINANCING: A CHALLENGABLE PERSPECTIVE

As presented in the foregoing sections, the respect for pre-bankruptcy ordering of entitlements has long marked the primary thesis of UK insolvency law, including the tilted balance in favour of creditors holding security. Founded on the premise of contractarianism,¹⁰⁶ which emphasises the sanctity of bargains and parties' contractual power, the basic proposition is that the function of insolvency law is merely to translate pre-bankruptcy assets and liabilities into the bankruptcy forum with minimal

⁹⁹ As revealed by the OFT, the median value for the average amount owed to unsecured creditors is £3000, which is perceived as not outweighing the time and costs associated with using mechanisms to influence IPs. Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 5, 44–5.

¹⁰⁰ Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 5, 47; R.M. Goode, 'Is the Law too Favourable to Secured Creditors?' (1983) 8 *Canadian Business Law Journal* 53 at 56; J. Hudson, 'The Case Against Secured Lending' (1995) *International Review of Law and Economics* 47.

¹⁰¹ V. Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 *Modern Law Review* 633 at 638.

¹⁰² R.M. Goode, 'Is the Law too Favourable to Secured Creditors?' (1983) 8 *Canadian Business Law Journal* 53 at 56.

¹⁰³ J. Hudson, 'The Case Against Secured Lending' (1995) *International Review of Law and Economics* 47 at 56.

¹⁰⁴ *Salomon v Salomon Co* [1897] AC 22.

¹⁰⁵ D Kershaw, *Company Law in Context*, (2009, OUP), at 709.

¹⁰⁶ The term "contractarianism" is used here for its economic implications, and is different from the word "contractarianism" in legal philosophy.

dislocation.¹⁰⁷ Regardless of the level of risk he faces, it is argued that any creditor is at liberty to insert risk-reducing devices in his private arrangements with the debtor, e.g. insisting on a premium interest rate for lending, or asking for a security interest. “Every man is the master of the contract he may choose to make, and it is of the highest importance that every contract should be construed according to the intention of the contracting parties”.¹⁰⁸ Putting this in the insolvency context, contractarian theorists hold that only those with consensual claims against the debtor’s assets at the time of the opening of the insolvency proceedings qualify for consideration as parties to the agreement.¹⁰⁹ If one were to extend this thesis to the conflict between the interests of secured and unsecured creditors, secured financing becomes a mere reflection of the diverse choices of risk-reducing strategies made by different creditors. The substantive priority rights in bargains acquired by secured creditors *ex ante* should be at the forefront of values to be protected, ahead of those who have bargained otherwise, i.e. creditors who choose to forego security and assume greater risk in exchange for quicker and better lending interests, more efficient contract processes or less formal credit investigations.

While this contractarian argument clearly articulates the legitimacy of the priority order between secured and voluntary unsecured creditors, it falls short of taking proper account of interests other than these so-called contract creditors. At the very least, a number of creditors are truly involuntary,¹¹⁰ e.g. unpaid employees and disgruntled trade creditors, and the reason they cannot take security arrangements is not because they did not bargain for that right, but because they become creditors without their volition, who almost always have little knowledge of security arrangements and of how to protect their own interests. If we follow the contractarian argument, distribution of the assets to these non-consensual interest holders, including tort creditors and unpaid suppliers, might be desirable, but this premise is fundamentally different from distributions based on the *ex ante* bargain, and these entitlements should be provided in other systems of law.¹¹¹ This argument utterly overlooks the fact that it is only on insolvency that the ranking issue of these unsecured claims arises, and there is no scope within the general law to prescribe priority and protection for these involuntary creditors.¹¹² As succinctly commented by Lynn LoPucki, security is an institution “in need of basic reform” because it tends to misallocate resources by imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent.¹¹³

¹⁰⁷ E.g. see Thomas H. Jackson, “Bankruptcy, Nonbankruptcy and the Creditors’ Bargain” (1982) 91 *Yale Law Journal* 857; T. Jackson & R. Scott, “On the Nature of Bankruptcy: an Essay on Bankruptcy Sharing and the Creditors’ Bargain” (1989) 75 *Virginia Law Review* 155; Thomas H. Jackson, “Translating Assets and Liabilities to the Bankruptcy Forum” (1985) 14 *Journal of Legal Studies* 73; R. Goode, *Principles of Corporate Insolvency Law* (2011, Sweet & Maxwell), at 70–2.

¹⁰⁸ *Clarke v. Watson* (1865) 17 C.B.R., U.S. 278.

¹⁰⁹ See R. Goode, *Principles of Corporate Insolvency Law* (2011, Sweet & Maxwell), at 70–2; Thomas H. Jackson & R. Scott, “On the Nature of Bankruptcy: an Essay on Bankruptcy Sharing and the Creditors’ Bargain” (1989) 75 *Virginia Law Review* 155, at 177.

¹¹⁰ V. Finch, ‘Security, Insolvency and Risk: Who pays the price?’ (1999) 62 *Modern Law Review* 660.

¹¹¹ E.g. Thomas Jackson, *The Logic and Limits of Bankruptcy Law*, (1986), at 31–32.

¹¹² R. Goode, *Principles of Corporate Insolvency Law* (2011, Sweet & Maxwell), 74.

¹¹³ L.M. LoPucki, ‘The Unsecured Creditors Bargain’ (1994) *Virginia Law Review* 1887 at 1891.

Furthermore, this contractual argument establishes itself on the basis of a hypothetical bargain made by rational parties for the purpose of maximising the collective value of the proceedings, and it assumes equal bargaining positions between the debtor company and every voluntary creditor. This is not connecting to reality. Additional to those who are completely involuntary, the identity of unsecured creditors could also be owing to the fact that they are not able to require the debtor to provide security; the debtor company may already have charged its assets to other creditors, or it wish to keep its assets unencumbered so it can utilise them at a later time.¹¹⁴ Small trade creditors, for instance, often have no opportunity to collect information which would make them equal bargainers, and they might lack the resources, expertise and time to evaluate risks accurately.¹¹⁵

In practice the collective rights of unsecured creditors as a group also tend to be trumped by IPs' favour towards secured creditors. In a hypothetical bargaining process, when a debtor grants a security interest to one of his creditors, he increases the riskiness for other creditors by reducing their expected value in insolvency.¹¹⁶ Thus, it is a fair assumption that the interests charged by unsecured creditors to compensate for that risk are naturally higher in comparison to the interests charged by secured creditors. However, robust evidence has proved that practice has moved in the opposite direction; in many cases, banks' interest rates for secured loans have not gone down, as would be anticipated in theory.¹¹⁷ The reason is succinctly stated by Professor Armour: "Of course, in the real world, all ... things are seldom equal."¹¹⁸ The contractarian argument not only fails to consider the interests of involuntary unsecured creditors, but falls short of correcting the unfair treatment suffered in practice by the general group of unsecured creditors. It does not come as a surprise that the concept of freedom of contract has since attracted stern criticism, led by Patrick Atiyah who described the rise to prominence of freedom of contract as a political, economic and legal ideal with a high point in the 1870s and a subsequent gradual decline:¹¹⁹ while "freedom of choice was whittled down in many directions, government regulations replaced free contract, ... and paternalism once again was the order of the day".¹²⁰ It is thus necessary to interfere with freedom of contract and restricted it in a number of ways,¹²¹ with legal intervention and redistribution mainly in the favour of parties who are in relatively weaker, and vulnerable contracting parties such as consumers, employees or tenants.¹²²

¹¹⁴ S. Schwarcz, 'The Easy Case for the Priority of Secured Claims in Bankruptcy' (1997) 47 *Duke Law Journal* 425 at 447.

¹¹⁵ Justice, *Insolvency Law: An Agenda for Reform* London (1994) 6.

¹¹⁶ See Thomas H. Jackson & Anthony T. Kronman, "Secured Financing and Priorities among Creditors", (1979) 88(6) *The Yale Law Journal* 1143, at 1147.

¹¹⁷R. Goode, *Principles of Corporate Insolvency Law* (2011, Sweet & Maxwell), 76-7; also see J. Armour, "The Law and Economics Debate about Secured Lending: Lessons for European Lawmaking?" (2008) *European Company and Financial Law Review* 3, at 10-11.

¹¹⁸ See J. Armour, "The Law and Economics Debate about Secured Lending: Lessons for European Lawmaking?" (2008) *European Company and Financial Law Review* 3, at 13.

¹¹⁹ P.S. Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford: Oxford University Press 1985).

¹²⁰ P.S. Atiyah, *Essays on Contract* (Oxford: Oxford University Press 1988) Essay 12: 'Freedom of Contract and the New Right' 355 at 356.

¹²¹ P.S. Atiyah, *Essays on Contract* (Oxford: Oxford University Press 1988) Essay 6: 'Freedom of Contract and the New Right' 355.

¹²² D. Kimel, 'Neutrality, Autonomy, and Freedom of Contract' (2001) 21 *Oxford Journal of Legal Studies* 473 at 474; see also Unfair Contract Term Act 1977, Employment Protection Act 1978, Employment Act 1989, Trade Union and Labour Relations Act 1992, Landlord and Tenant Act 1985.

The other economic justification of secured financing rests on its positive value in reducing transaction costs, primarily monitoring costs. As suggested, in order to discourage potential misbehaviour on the part of the debtor, as well as increasing the interest rate of the loan, a creditor may also reduce the risk by monitoring the debtor's conduct. The creation of a security in such circumstances will benefit the relevant creditor in two ways: reducing the riskiness of the loan in the event of the debtor's insolvency, and the reduction of the monitoring cost required to guard against the debtor.¹²³ The creditor will be immune from the debtor's misbehaviour and the risk of loss, as long as he focuses his attention on the particular items of property securing his loan. This results in substantive savings of money and effort in comparison with his counterparts without security, who have to bear the complex task of overseeing the debtor's performance.¹²⁴

Compared to the contractarian argument, which is made in connection only with consensual securities, this transaction cost view offers a convincing justification for non-consensual securities, e.g. the common law lien and the equitable lien arising from the operation of law.¹²⁵ However, it rests on two questionable premises: first, that unsecured creditors have the ability and will in practice to spend more time and effort in monitoring the debtor company after their counterparts take security. Secondly, compared to a situation where all creditors are unsecured, unsecured creditors will now charge higher interest and secured creditors will charge a lower rate, to reflect the varied risks of loans and the different monitoring costs they must now incur. While the latter assumption has already been practically refuted in the context of contractarianism, equally the former cannot stand the reality test, which involves interactions of wider considerations than mere economic rationality. Many unsecured creditors in practice are small and involuntary, such as unpaid suppliers and tort claimants. These unsecured creditors, before they become so, had neither the incentive nor the resources to monitor the status of securities. When they become unsecured creditors, they have no ability to adjust their position either by bargaining for security *ex ante* or by bearing the cost of monitoring the debtor.¹²⁶ Statistics have revealed that unsecured creditors have little say in processes of insolvency as their formal methods of oversight are rarely used: a committee is formed in only 3% of administrations, and even fewer in cases of CVA.¹²⁷

¹²³ Thomas H. Jackson & Anthony T. Kronman, "Secured Financing and Priorities Among Creditors" (1979) 88(6) *The Yale Law Journal* 1143, at 1149–57.

¹²⁴ *Ibid.*, at 1153.

¹²⁵ For further discussions on non-consensual securities, see Bell, *Modern Law of Personal Property in England and Ireland*, (London, 1989), at 138–141; Paul L. Davies, S. Worthington & E. Micheler, *Gover and Davies' Principles of Modern Company Law*, 8th ed, (2008, Sweet & Maxwell), at 1150.

¹²⁶ The median value for the average amount owed to unsecured creditors is £3000, which is likely to be very negligibly small compared to the amount of money and the time necessary to challenge a proposal on the grounds of unfair prejudice. Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 43–4; H. Anderson, 'Corporate Social Responsibility – The Case for Unsecured Creditors' (2007) *Oxford University Commonwealth Law Journal* 93. Strictly speaking, a preferential creditor who does not own security is also an unsecured creditor. However, in this article, the definition of unsecured creditors will exclude preferential creditors.

¹²⁷ Office of Fair Trading, *The Market for Corporate Insolvency Practitioners – A Market Study*, (2010) OFT 1245, at 43–4.

One also needs to be aware that the legitimacy of secured financing is based on the premise of proper notice. The grant of security does not involve an unfair preference while other creditors also have proper notice of the security interest, as they have not been misled into thinking that the assets comprising the security are the unencumbered property of the debtor.¹²⁸ For unsecured creditors, requiring a company to register particular details of charges is their only means of knowing about any earlier secured lending that ranks ahead of their own claims. However, the law currently fails to achieve this premise: while s 860(7) of CA2006 provides an exhaustive list of charges to be registered, quasi-securities that rank ahead of unsecured creditors' claims are not all included.¹²⁹ Further complexity arises with regard to registered charges with inaccuracies. English law states that inaccurate particulars will not destroy the validity of security.¹³⁰ However, this creates difficulties for unsecured creditors, as they may be misled by incorrect particulars available from the Registrar, while the parties to the security agreement will operate on the basis of the correct terms.¹³¹

Although the current insolvency regime underpinned by contractarianism and transaction costs has its defects, substantive changes in favour of the protection of unsecured creditors are unlikely to occur within the system. For the courts, if the fundamental tenet in commercial law, i.e. the exclusive and inviolable rights of secured creditors, had been disturbed, there would be significant repercussions for the community. Significantly, as pointed out by the London Investment Banking Association (LIBA), the sanction of the scheme would have had “unfortunate implications for London as a world financial centre”.¹³² As a global financial centre, London has a large share of the international financial markets and has always taken a lead in conducting investment business.¹³³ A factor of particular importance in relation to London's strength in financial activities is the existence of a reliable and robust legal insolvency regime.¹³⁴ It is not difficult to predict that if the sanctity of the rights attached to security became distorted, many clients and creditors would become concerned as to the future safety of their assets, which would have repercussions for investment activity and the reputation of London as the heart of financial business.¹³⁵ Previous practice also proves the difficulty of substantive reform in this field. Receivership was replaced in 2003 by administration with the intent of enhancing accountability to unsecured creditors in the governance of bankrupt firms, but robust evidence has since proved that the change in the law tended to

¹²⁸ R.M. Goode, ‘Is the Law too Favourable to Secured Creditors?’ (1983) 8 *Canadian Business Law Journal* 53 at 57.

¹²⁹ For instance, the retention of title agreement is not within the list and does not need to be registered.

¹³⁰ For instance, *National Provincial and Union Bank v Charnley* [1924] 1 KB 431 (contained misstatement of the property charged).

¹³¹ For instance, *Davis v Radcliffe* [1990] 1 WLR 821; for further discussions, see Paul L. Davies, S. Worthington & E. Micheler, *Gower and Davies' Principles of Modern Company Law*, 8th ed, (2008, Sweet & Maxwell), at 1183–91.

¹³² *Ibid.*

¹³³ The financial sector is the largest contributor to the UK balance of payments, and is a major contributor to GDP and employment. Taking multiple performance perspectives into consideration, including banking, insurance, equity markets, derivatives, foreign exchanges, etc., London has been constantly ranked first in the Global Financial Centres Index over the past three years. IFSL, *International Financial Markets in the UK*, May 2010, available at <http://www.thecityuk.com/media/154873/ifm%20in%20the%20uk%2005%202010.pdf>, last accessed on 01/07/10, at 3.

¹³⁴ HM Treasury, *Establishing Resolution Arrangements for Investment Banks*, (2009, London: OPSI), at 3.

¹³⁵ Also see S. Wen & J. Zhao, (2010) “Revisiting the Scope of a Scheme of Arrangement - Insights Derived from Lehman”, vol 3(3) *Bankers Law* 20, 26.

be counterbalanced by IPs' practice favouring secured creditors, as well as other practical factors such as the concomitantly increased bankruptcy costs.¹³⁶ Therefore, it is worthwhile and desirable to acquire and establish protection measures or systems outside the insolvency law regimes to promote the interests of unsecured creditors, with CSR being a serious option.

IV. PROTECTING THE INTERESTS OF UNSECURED CREDITORS BY THE USE OF CSR

A. Implications of CSR Factors for Unsecured Creditors

So far a consensus regarding the definition of CSR has yet to be reached, which is not least owing to the constantly adjusting expectations and demands of stakeholders in rapid-changing corporate practices. The following definitions from different sources adequately demonstrate the divergences among these variable constructions. Accordingly to Davis, CSR is the firm's consideration of, and response to, issues beyond the narrow economic, technical, and legal requirements of the firm ... to accomplish social benefits along with the traditional economic gains which the firm seeks.¹³⁷ Elkington holds that CSR is taking care of societal, ecological and economical concerns.¹³⁸ Carroll and Buchholtz further expand on the scale of CSR, advocating that it encompasses the economic, legal, ethical, and philanthropic expectations placed on organisations by society at a given point in time.¹³⁹

As to the substance of CSR, Williams and Siegal describe it as a situation where companies participate in public welfare issues more than is required for their interests by legal regulations.¹⁴⁰ On the other hand, Baker delineates CSR as a business administration procedure for a general good effect on society.¹⁴¹ Nakajima focuses on directors' responsibility that lead to corporations' voluntary actions which are over and above legal requirements, and which contribute to sustainable economic development so that the business can address both its own competitive interests and the interests of wider society.¹⁴² Additional to these scholars from various disciplines, a variety of definitions are also provided by international organizations. For instance, United Nations considers CSR as directors' responsibility which aims both to examine the role of business in society, and to maximise the positive societal outcomes of business activity,¹⁴³ while World Business Council for Sustainable Development describes CSR as the continuing

¹³⁶ J. Armour, A. Hsu & A. Walters, *The Cost and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK* (March, 2009), available at papers.ssrn.com/sol3/papers.cfm?abstract_id=912302

¹³⁷ K. Davis, 'The Case for and against Business Assumption of Social Responsibilities' (1973) *The Academy of Management Journal* 312.

¹³⁸ J. Elkington, *Cannibals with Forks: The Triple Bottom Line of 21st Century Business*, Oxford: Capstone Publishing (1997).

¹³⁹ A.B. Carroll & A.K. Buchholtz, *Business and Society: Ethics and Stakeholder Management*. 5th edn. Australia: Thomson South-Western, 2003.

¹⁴⁰ A. McWilliams & D.S. Siegel, 'Corporate Social Responsibility: A Theory of the Firm Perspective' (2001) 26 *The Academy of Management Review* 117.

¹⁴¹ M. Baker, 'Corporate Social Responsibility: What Does It Mean?' available from blog of Mallen Barker via <http://www.mallenbaker.net/csr/definition.php>

¹⁴² C. Nakajima, 'The Importance of Legally Embedding Corporate Social Reasonability' (2011) *Company Lawyer* 257.

¹⁴³ H.E. Ward, E. Wilson, L. Zarsky & T. Fox, 'CSR and Developing Countries: What Scope for Government Action?', United Nations Sustainable Development Innovation Briefs, Issue 1; available via <http://www.un.org/esa/sustdev/publications/innovationbriefs/no1.pdf>

commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large.¹⁴⁴

Despite the fact that the term CSR has been defined in various ways, a few common characteristics can be drawn. First of all, CSR emphasises that responsible behaviour on the part of corporations can help them achieve wider goals, in particular the general good of society. The promotion of these wider goals involves making the case for corporate responsibility, respected corporate citizenship, environmental stewardship, pollution control and sustainable development by considering disadvantaged and vulnerable stakeholders. Secondly, the scope of CSR mainly focuses on social and environmental concerns, in addition to the traditional economic goals of corporations. It aims to improve quality of life and community harmonisation, working towards a more sustainable society as a whole via the performance of corporations. Last but not least, despite the fact that many definitions emphasise the voluntary characteristics of CSR beyond enforceable legal requirements, the practice of CSR is established on the basis of the fulfilment of traditional economic and legal responsibilities, which are normally achieved via directors' duties and corporate reports on social and environmental issues.¹⁴⁵ CSR as a concept covers many issues, encompassing sustainability development, corporate governance development and corporate objectives, employment rights, consumer protection rights, occupational health and safety, local taxation law and socially responsible investments from shareholders, especially institutional shareholders. Working together with the enforcement measures through legal requirements, the motivation to embrace CSR can also be expressed as standard-setting practice through non-legal means such as adverse publicity, protests and boycotts by NGOs and the market.¹⁴⁶

In the legal domain, corporate practices are typically influenced by a variety of instruments, such as securities regulations, taxation law, contract law, employment law, environmental law, consumer protection law and insolvency law.¹⁴⁷ When they manage their businesses, directors will find “their decision tree considerably trimmed and their discretion decidedly diminished by mandatory legal rules enacted in the name of protecting stakeholders.”¹⁴⁸ While CSR is fundamentally affected by how law and other forms of

¹⁴⁴ See <http://www.wbcsd.org>

¹⁴⁵ See W. Vandekerckhove & M.S.R. Commers, 'Beyond Voluntary/Mandatory Juxtaposition: Towards a European Framework on CSR as Network Governance' (2005) 1 *Social Responsibility Journal* 98; M. Blowfield, 'Corporate Social Responsibility: Reinventing the Meaning of Development' (2005) 81 *International Affairs* 515; A.B. Carroll, 'The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders' (1991) 34 *Business Horizons* 39; O. Aiyegbayo & C. Villers, 'The Enhanced Business Review: Has it Made Corporate Governance More Effective' (2011) *Journal of Business Law* 699; K. Campbell & D. Vick, 'Disclosures Law and the Market for Corporate Social Responsibility' in D. McBarnet, A. Voiculescu & T. Campbell, *The New Corporate Accountability: Corporate Social Responsibility and the Law*, Cambridge: Cambridge University Press (2007) p. 241; A. Johnson, 'After the OFR: Can UK Shareholder Value Still Be Enlightened?' (2006) 7 *European Business Organization Law Review* 817.

¹⁴⁶ D. McBarnet, 'Corporate Social Responsibility beyond Law, through Law, for Law: The New Corporate Accountability' in D. McBarnet, A. Voiculescu, & T. Campbell (Eds.), *The New Corporate Accountability: Corporate Social Responsibility and the Law*, Cambridge: Cambridge University Press (2007) p.21.

¹⁴⁷ OECD, *OECD Principles of Corporate Governance* (2004) available via OECD website www.oecd.org, 2.

¹⁴⁸ A. Winkler, 'Corporate Law or the Law of Business? Stakeholders and Corporate Governance at the End of History' (2004) 67 *Law & Contemporary Problems* 21

regulation delineate,¹⁴⁹ it by no means is limited to legal prescriptions or prohibitions; it also embraces what is morally and philanthropically permissible.¹⁵⁰ In practice, CSR is expected to begin where the primary laws end, and in the immediate future it will find the most use where there is no definite consensus regarding the ethics of particular business practices. The interaction between law and CSR will therefore embrace a minimum position of legal compliance, as well as societal considerations where the law is lacking, and will lean towards facilitating corporate contributions to sustainable development and other forms of community investment where the business case warrants it.¹⁵¹

CSR is an issue of potential significance not only to companies but also to wider society in terms of both welfare and development,¹⁵² in the sense that CSR may “assist a government in fulfilling welfare state goals of political character or based in law as obligations”.¹⁵³ In America, President Obama has called for a new concept of responsibility as the only proportional remedy for a crisis of infinite magnitude, the result of the US recession.¹⁵⁴ In the EU, a Socialist and Green Member of the European Parliament argued against a purely voluntary policy for CSR and urged the European Commission to impose binding rules to regulate corporate behaviours.¹⁵⁵ Effective CSR requires dialogue and partnership with stakeholders such as trade unions, public authorities, non-governmental organisations, and business representative organisations.¹⁵⁶ Support for CSR also comes from the United Nations. According to the Ruggie Report 2011 produced by John Ruggie, the UN Special Representative for Business and Human Rights,¹⁵⁷ member states are required to ensure that “their current policies, legislation, regulation and enforcement measures are effective in addressing the risk of business involvement in gross human rights abuses”.¹⁵⁸ Besides human rights, when discussing issues concerning supply chains and CSR, John Ruggie also emphasised the “urgency of bringing government back in to the equation”.¹⁵⁹ This is consistent with the findings from Vogel, who noted the limited function of NGOs and the market in promoting the ethics of firms, underlining the necessity for effective regulation from government.¹⁶⁰

109 at 111.

¹⁴⁹ B. Horrigan, *Corporate Social Responsibility in the 21st Century: Debates, Models and Practices Across Government, Law and Business*, Cheltenham: Edward Elgar, p. 26.

¹⁵⁰ For the four-tier model of CSR, see the celebrated work of A.B. Carroll, “A Three-dimensional Conceptual Model of Corporate Social Performance”, (1979) 4 *Academy of Management Review* 497, at 500.

¹⁵¹ B. Horrigan, *Corporate Social Responsibility in the 21st Century: Debates, Models and Practices Across Government, Law and Business*, Cheltenham: Edward Elgar, p. 26; H.E. Ward, E. Wilson, L. Zarsky & T. Fox, ‘CSR and Developing Countries: What Scope for Government Action?’, United Nations Sustainable Development Innovation Briefs, Issue 1; available via <http://www.un.org/esa/sustdev/publications/innovationbriefs/no1.pdf>

¹⁵² K. Buhmann, ‘Corporate Social Responsibility: What Role for Law? Some Aspects of Law and CSR’ (2006) *Corporate Governance* 188 at 189.

¹⁵³ K. Buhmann, ‘Corporate Social Responsibility: What Role for Law? Some Aspects of Law and CSR’ (2006) *Corporate Governance* 188 at 189.

¹⁵⁴ Barack H. Obama, President of the U.S., Inaugural Address.

¹⁵⁵ <http://www.euractiv.com>, 14 July 2005.

¹⁵⁶ European Commission, *European Competitiveness Report 2008*, Luxembourg (2009) p.107.

¹⁵⁷ See Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprise, General Principles on Business and Human Rights: Implementing the United Nations “Protect, Respect and Remedy” Framework (2011).

¹⁵⁸ *Ibid.*, see page 11.

¹⁵⁹ See John. G. Ruggie, ‘Forum on Corporate Social Responsibility’, Fair Labour Association and the German Network of Business Ethics, (Bamberg, Germany June 14, 2006).

¹⁶⁰ D. Vogel, *Market for Virtue: Potential and Limits of CSR* (Washington, DC: Brookings 2005); see also D. Vogel, ‘The Limits of the Market for Virtue’, (2006, 14th June) *Ethical Corporations*, 46.

Because of various types of CSR-related performance, the regulations governing CSR are also in a variety of forms and are drafted and enforced by regulatory bodies at different levels. At the most fundamental level, government regulations are normally formal and binding in law, above which there are recommendations that have guiding effects but no legal standing. Meanwhile, globalisation has further increased the complexity of the legal environment by exposing corporations to international law and the laws of foreign nations.¹⁶¹ Under the banner of CSR, many local and international institutions also seek to raise public awareness of the necessity for transnational corporations to abide by certain health, environmental and social standards. Progressive advocates who are engaged in promoting more sustainable businesses, more environmentally-friendly companies and firms focused on human rights will also drive corporations to adopt more socially responsible ethical codes and guidelines for conduct, the adoption of which is largely on a voluntary basis. In reality companies are regulated and closely monitored by various groups, who include shareholders, public authorities, intergovernmental bodies, trade unions, NGOs, insurers and consumer groups.¹⁶² All these positive and responsible actions will in turn have a collective societal-friendly impact on the government's subsequent policies and legislative direction. CSR-related actions are thus based on a good mix of social and legal norms, and legal requirements to report non-financial issues are becoming increasingly common in countries in the EU and elsewhere.¹⁶³

B. Applying CSR in the Favour of Unsecured Creditors in Order to Rebalance the Insolvency System

The development of CSR is almost invariably stimulated by failures of legal regulation and compliance. In the case of unsecured creditor protection, the legal vacuum discussed above needs to be filled through the enforcement of CSR-related obligations and favourable treatments, a possible remedy being setting out control over errant directors' performance. The purpose underlying such treatment, which clearly indicated the interrelation between unsecured creditor protection and elements of CSR, can be traced back to the Cork Report. Besides distributing the insolvent estate to creditors, it is stated that insolvency law should function as a "means by which the demands of commercial morality can be met, through the investigation and the disciplinary measures and restrictions imposed on the bankrupt".¹⁶⁴ Such control was not merely towards punishing the errant, but towards exposing affairs to creditors

¹⁶¹ J.F. Steiner & G.A. Steiner, *Business, Government, and Society: A Managerial Perspective, Text and Cases*, 13th edn., New York: McGraw-Hill (2012) 42.

¹⁶² J.A. Zerk, *Multinationals and Corporate Social Responsibility: Limitations and Opportunities in International Law*, Cambridge: Cambridge University Press (2006) 41.

¹⁶³ For example, the Business Review, in line with the minimum requirements of the EU Accounts Modernisation Directive 2003, which called for companies' annual reports to include "both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters (when necessary)" (Article 14 amending Article 46 of the Accounts Directive); see also Section 417 (3) Companies Act 2006; this is a replacement for Operating and Financial Review; for discussions on Business Review and Operating and Financial Review, see A. Johnson, 'After the OFR: Can UK Shareholder Value Still Be Enlightened?' (2006) 7 *European Business Organization Law Review* 817.

¹⁶⁴ Cork Report, para.235.

and encouraging public security,¹⁶⁵ so as to promote the “highest standards of business probity and competence”.¹⁶⁶ This objective of commercial morality fits with the purpose of CSR in terms of promoting the long-term competitiveness of companies and encouraging the consideration of wider interests.

Society has an interest in insolvency processes. As pointed out by Professor Goode, by closing businesses, corporate insolvency has a negative impact on customers and suppliers; by causing job losses, it tears the heart out of the employees and the local community; in cases involving large-scale companies, even the national economy may be threatened.¹⁶⁷ In this process, the welfare of vulnerable parties, particularly unsecured creditors who are not able to fully protect their interests against secured ones in insolvency,¹⁶⁸ deserves to be safeguarded. Unsecured creditors always have a positive view of the company when they become loan providers, in the absence of information or doubts about the successful running of the company. Under circumstances where corporations are in financial trouble, the fact that secured creditors appoint the insolvency professionals means that these practitioners have less incentive to act in the interests of unsecured creditors. In these cases, secured creditors are better able to cope and withstand the insolvency situations of the debtor than are the unsecured creditors, and they should suffer some diminution in their distributional rights in order to balance the equality of distribution among various creditors.¹⁶⁹ According to recent statistics published by the Office of Fair Trading, in around 63% of cases in the field, secured creditors exert control over the fees and activities of insolvency practitioners. Even in the other 37% of cases, unsecured creditors are still unable to influence the professionals.¹⁷⁰ The fact that in the majority of cases unsecured creditors are insufficiently represented and defended makes the need for increased protection even more self-evident.¹⁷¹ Therefore, the reform of the current corporate regulatory system so as to strengthen the ability and opportunity for unsecured creditors to recover their debts seems necessary in terms of enhancing the practice of fair trading and maintaining a competitive economy. It may also help achieve other objectives, such as raising standards of business conduct and entrepreneurship.¹⁷²

In jurisdictions where the insolvency system is not able to make radical and efficient changes to completely transform the disadvantaged position of unsecured creditors, such as the UK, CSR-related measures in other fields of law are also called for as a serious alternative to enhance the interests of unsecured creditors and achieve fairness among all stakeholders. The consideration of

¹⁶⁵ Cork Report, para. 239.

¹⁶⁶ Cork Report, para. 1735

¹⁶⁷ R. Goode, *Principles of Corporate Insolvency Law*, 4th ed, (2011, Sweet & Maswell), at 68.

¹⁶⁸ K.J. Crossland, ‘Unsecured Creditors and the ‘Uncorporation’: Issues and Trading Trust Post Global Financial Crisis’ (2011) 17 *Trust and Trustees* 185.

¹⁷⁰ A Sakoui, “Unsecured Creditors Need Protection, Says OFT” *Financial Times*, June 24, 2010.

¹⁷¹ A Sakoui, “Unsecured Creditors Need Protection, Says OFT” *Financial Times*, June 24, 2010.

unsecured creditors in the name of CSR is also consistent with the objective of a well-organised corporate governance system, which is to ensure that companies are run in a way that uses society's resources efficiently, including a balanced and sustainable capital resources distribution. Favourable treatment is thus justifiable on the basis of building a better corporate governance framework that benefits companies through greater access to finance, lower cost of capital and more favourable treatment of all stakeholders.¹⁷³

Unsecured creditors, as a class of key external economic stakeholders, play an integral role in the stakeholder group network. Despite the fact that the unsecured creditors are not the main loan capital providers in comparison with secured creditors, their satisfaction and the image of corporations from the point of view of unsecured creditors is very important in building an efficient and well balanced capital market. As a consequence, they should be viewed as worthy beneficiaries of CSR if one views the company as an "organic community" in the broader sense, having economic, legal, social and philanthropic responsibility in the corporate responsibility pyramid.¹⁷⁴ At the same time, there are certain limits that should be placed on the contractual powers of stronger parties where the agreements made are "socially undesirable for reasons of inefficiency, inequity and other substantive objections."¹⁷⁵

Improving the social responsibility records is always a good business strategy to promote corporate image and the long-term interests of the company. The benefits of CSR for a company, such as higher employee morale, a positive corporate reputation and more efficient and reliable relationships with creditors (including unsecured creditors), will not appear immediately on balance sheets; rather, it will be demonstrate in the long run.¹⁷⁶ Companies endorsing CSR strategies will face fewer business risks in comparison with their competitors, and will be in a better position to attract and retain creditors. Therefore, corporations with respected and sustainable records see CSR enforcement as an opportunity to be seized in order to pursue competitive advantages, rather than as a problem to deal with or a task to accomplish.¹⁷⁷ The protection of unsecured creditors will be of particular importance for corporations' reputation and image, as it will enable companies, as responsible and sophisticated borrowers, to be in a better position to obtain capital quickly and at a lower cost. CSR activities towards unsecured creditors might seemingly have no immediate

¹⁷³ S. Claessens & B.B. Yurtoglu, 'Corporate Governance in Emerging Market: A Survey' (2012) *Emerging Market Review* (first available online); available via <http://www.sciencedirect.com/science/article/pii/S1566014112000131>

¹⁷⁴ A.B. Carroll, 'The Pyramid of CSR: Toward the Moral Management of Organizational Stakeholders' (1991) 34 *Business Horizons* 39 at 40–41; for more discussion of models of CSR, including the pyramid model, see A. Geva, 'Three Models of CSR: Interrelationships between Theory, Research and Practice' (2008) 113 *Business and Society Review* at 1.

¹⁷⁵ B.E. Hermalin, A.W. Katz & R. Craswell, 'Contract Law' in A. M. Polinsky & S. Shavell (eds) *The Handbook of Law and Economics* Vol1 (1st edn., London: North Holland 2008) p.19.

¹⁷⁶ D. Vogel. 'Is There a Market for Virtue? The Business Case for Corporate Social Responsibility' in D. Vogel (edn) *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (Brookings Institute Press 2005) 16 at 17.

¹⁷⁷ D. McBarnet, 'Corporate Social Responsibility beyond Law, through Law, for Law: The New Corporate Accountability' in D. McBarnet, A. Voiculescu, & T. Campbell (Eds.), *The New Corporate Accountability: Corporate Social Responsibility and the Law*, Cambridge: Cambridge University Press (2007) p.21.

financial reward, but they are *de facto* rational for companies to achieve a desirable “win-win” situation for both business and unsecured creditors in a long-term sustainable business environment.

The protection of unsecured creditors also fits into the logic of the business case for CSR. The business case emphasizes the link between CSR and sustainable development, and offers corporations guidance in becoming both responsible and profitable entities.¹⁷⁸ The CSR case for considering unsecured creditors will act as a good component of a sustainable company system, described by Chris Laszlo as “an integrated economic, social, and environmental approach leading to more enduring shareholder value ... [as] a source of innovation and profitable rather than added cost”.¹⁷⁹ Unsecured creditors, as a stakeholders group with dual identities – an economic identity as capital providers, and as social identity as parties who are in a disadvantaged position – should be put on the protection list in order to establish a sustainable company. More care should be offered to this stakeholder group to create corporate strategies for integrity and fair play – and, from the experience of twelve companies, “caring capitalism is not only decent, it is also profitable”.¹⁸⁰ Despite the fact that these cares and responsibilities might entail short-term costs, they will pay off for the companies in the long term, since they benefit from greater social legitimacy, fewer less government regulations and increased long-term profitability.¹⁸¹

It is important to recognise here that CSR is not philanthropy, donations or gifting giving from profits, but involves the exercise of socially responsibility in how profits are made. This can be achieved more efficiently in a long-term manner by giving unsecured creditors the share of consideration they deserve.¹⁸² This approach will not only help to persuade companies to adopt CSR for the interests of various stakeholders who are in need of extra care beyond contractual rights, such as unsecured creditors, but will also be adopted by lawyers to justify a broader legal interpretation and wider legitimacy of directors’ responsibilities.

V. PROPOSALS TO PROMOTE THE INTERESTS OF UNSECURED CREDITORS THROUGH THE MEANS OF CSR

Based on the arguments for embracing CSR on a mandatory footing as well as on a voluntary basis, the law should be employed

¹⁷⁸ B. Wilard, *The Sustainability Advantage: Seven Business Case Benefits of a Triple Bottom Line* (New Society Publishers 2002); M. Porter & M. Kramer, ‘The Competitive Advantages of Corporate Philanthropy’ (2002 December) *Harvard Business Review* 67.

¹⁷⁹ C. Laszlo, *The Sustainable Company: How to Create Lasting Value through Social and Environmental Performance* (Washington: Island Press 2003) p.23.

¹⁸⁰ M. Scott & H. Rotherman, *Companies with a Conscience: In-depth Profits of Business That are Making A Difference* (2nd edn., Career Press 2002).

¹⁸¹ K. Davis, ‘The Case for and against Business Assumption of Social Responsibilities’ in A. Carroll (ed.), *Mapping Corporate Social Responsibility* (Boston, Little, Brown & Co. 1977); see also L. Burke & J. Logsdon, ‘How Corporate Social Responsibility Pays Off?’ (1996) *Long Range Planning* 495.

¹⁸² D. McBarnet, ‘Corporate Social Responsibility beyond Law, through Law, for Law: The New Corporate Accountability’ in D. McBarnet, A. Voiculescu, & T. Campbell (Eds.), *The New Corporate Accountability: Corporate Social Responsibility and the Law*, Cambridge: Cambridge University Press (2007) p.9.

positively to ensure that companies act responsibly with regard to stakeholders, especially vulnerable stakeholders under certain circumstances.¹⁸³ Apart from the inadequate insolvency legislations discussed above, current UK corporate law and governance regimes, within which the focus has been on the balance between the interests of shareholders and stakeholders on a broad spectrum, also demand more protection for unsecured creditors.

Despite the fact that the Companies Act 2006 is over seven hundred pages long, the way that directors should take account of the conflicting interests between secured and unsecured creditors in the process of running the company, particularly, how to make directors take responsibility for considering and acting appropriately in the interests of unsecured creditors, is not prescribed. Under current UK law, directors are still under an obligation to act in favour of the aim of maximising shareholders' benefits, or, in the words of s 172 (1), to "promote the success of the company for the benefit of its members as a whole." Their obligation towards creditors as a general group is provided in s 172(3), which will come into play if "certain circumstances" occur, i.e. the company entering financial difficulty and being on the edge of insolvency. Further clarification regarding the consideration of unsecured creditors' interests seems desirable in this section. In the same way that directors are required to "have regard to the need to act fairly between the members of the company", an additional factor could be inserted into s 172(3), asking directors to "have regard to the need to balance secured and unsecured creditors' interests wherever possible". All that would be required here is that directors take these interests into account in good faith. This will not contradict the overriding objective of a company's directors to act "for the benefit of its members as a whole",¹⁸⁴ and neither would it interfere with directors acting for creditors' interests as a whole when the company encounters difficulties. However, for directors who have the opportunity to give more consideration to unsecured creditors, this insertion would provide them with legitimate grounds to do so.

Additional legislative changes to improve the situation of unsecured creditors have also been proposed by a number of scholars, many of whom are of the view that mandatory provisions should be put in place to provide a means of redress for unsecured creditors if their interests are unfairly prejudiced. For instance, as argued by Riley, "the duty (of directors to consider creditor interests) must demand something more than a mere statement after the event that the directors gave a thought to the creditors, but then decided to act in a way contrary to their interests."¹⁸⁵ In her celebrated work Andersen suggests an even more radical approach, which is that personal responsibility should be imposed on directors in solvent companies for behaviour that may damage the

¹⁸³ H. Anderson, 'Corporate Social Responsibility – The Case for Unsecured Creditors' (2007) *Oxford University Commonwealth Law Journal* 93 at 98–99.

¹⁸⁴ See s 172(1) of CA 2006.

¹⁸⁵ C Riley, "Directors' Duty and the Interests of Creditors" (1989) 10 *Company Lawyer* 87.

interests of non-shareholder stakeholders, particularly unsecured creditors.¹⁸⁶ The grounds for such a suggestion lie in the claim that directors are “in the best position to assess what is required for external stakeholder protection and should have the incentive to do so.”¹⁸⁷ Alternatively, as suggested by Rao, Sokolow and White, if creditors are presented with the ability to threaten directors with a lawsuit to hold them personally liable for their actions, this should effectively “limit shareholder expropriation of remaining firm value.”¹⁸⁸

Effectively, providing redress for unsecured creditors in the form of threatening directors with a lawsuit requires directors to act not only in the interests of shareholders, as presently required by s 172(1), but also in the interests of unsecured creditors. Theoretically, the above arguments fall within the scope of stakeholder theory, which suggests that in corporate governance the interests of a number of stakeholder groups should be advanced by virtue of directors’ discretion, without the interests of a single group (the shareholders) being allowed to override the others.¹⁸⁹ However, a number of practical difficulties regarding the implementation of a complete stakeholder model have been encountered in the UK corporate governance environment. For instance, changes in company law to offer redress to non-shareholder stakeholders would require a fundamental change to the current company law framework, and might lead to “unpredictable and damaging effects.”¹⁹⁰ In addition, acting for concerns other than shareholders’ interests would increase managerial powers, which would in turn increase the risk of managerial manipulation and “dangerously distracted management ... at the expense of economic growth and international competitiveness.”¹⁹¹ On the basis of these practical concerns, s 172(1) only requires directors to take account of stakeholders’ interests in good faith, but it does not require them to act for these interests. For the same reason, we have grounds to believe that a legislative change allowing directors to care for the interests of unsecured creditors, but not requiring them to do so, will be in line with the current company law framework in the UK.

In addition to reforms on directors duties, there are other possible legislative means to protect stakeholder groups, with information disclosure at a mandatory as primary one. Despite the fact that companies are increasingly disclosing CSR information, it is questionable whether the current annual, stand-alone CSR reports on social and environmental factors can satisfy the increasing demand for corporate accountability.¹⁹² The necessity of mandatory reporting could thus be perceived in a number of aspects, to

¹⁸⁶ H. Anderson, ‘Corporate Social Responsibility – The Case for Unsecured Creditors’ (2007) *Oxford University Commonwealth Law Journal* 93, at p. 113.

¹⁸⁷ H. Anderson, ‘Corporate Social Responsibility – The Case for Unsecured Creditors’ (2007) *Oxford University Commonwealth Law Journal* 93, at p. 113.

¹⁸⁸ R Rao, D Sokolow & D White, “Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm” (1996) *Journal of Corporation Law* 53, at 73.

¹⁸⁹ CLRS, *Modern Company Law for a Competitive Economy: the Strategic Framework*, (1999, London: DTI), at para 5.1.13.

¹⁹⁰ CLRS, *Modern Company Law for a Competitive Economy: the Strategic Framework*, (1999, London: DTI), para 5.1.27.

¹⁹¹ CLRS, *Modern Company Law for a Competitive Economy: the Strategic Framework*, (1999, London: DTI), para 5.1.28.

¹⁹² See C.A. Adams, ‘The Ethical, Social and Environmental Reporting-Performance Portrayal Gap’ (2004) 17 *Accounting, Auditing & Accountability Journal* 731; M.J.

Milne & R. Gray, ‘Future Prospectus for Corporate Sustainability Report’ in J. Unerman, J. Bebbington & B. O’Dwyer, (eds.), *Sustainability Accounting and*

name but a few, “changing the corporate culture, incompleteness of voluntary reports, comparability, non-disclosure of negative performance, legal certainty, market failures, cost savings, standardisation and equal treatment of investors”.¹⁹³ Furthermore, as presented by Beattie and McInnes, legal mandates in this field will help to produce narrative disclosures of a higher quality, which in turn will lead to an increase in the amount of disclosure and reduce variability by an absolute amount attributable to the size of the company.¹⁹⁴ A possible way of change is to introduce two-way communication, via a system under which information can be transferred between the company and its stakeholders in a bidirectional manner, so as to make the CSR information disclosure system more efficient.¹⁹⁵ Under such a scheme, the “informing” direction will transmit messages to unsecured creditors about both CSR and financial performance via reports and other media, in order to involve them in the sustainable development of the company. This involvement will enable them to provide voluntary sustainable support for socially responsible corporate behaviours and help them become more informed about the financial performance of the company. On the other hand, the “listening” direction will also help the company to adapt to the needs of unsecured creditors by listening to their voices through questionnaires, surveys, consulting sessions and collective opinion pools. Therefore, in line with directors’ duties to unsecured creditors, two-way information disclosure requirements for the interests of unsecured creditors would seem to be necessary

Another area that merits further reform is in the context of a group of companies, where the interests of unsecured creditors are the most easily prejudiced. This is also an area of great practical significance, because in reality even relatively modest businesses customarily operate through group companies, and multinational companies invariably do so.¹⁹⁶ In terms of business strategies and operations, the interrelationship between the parent company and its subsidiaries is generally inseparable – normally the subsidiaries will be wholly or mainly controlled by the parent or holding company in their business operations. Nevertheless, in the legal sense, given the rigidity of UK law in applying the separate legal entity principle that was established in the celebrated case *Salomon v A Salomon Ltd*¹⁹⁷, a subsidiary company will, in most circumstances, be regarded as a legal reality with a separate existence from the parent or holding company.¹⁹⁸ Thus, in practice the operations of subsidiary companies commonly become risk-diverters for the parent; business decisions are often made by the parent not to benefit the subsidiary, but rather to serve the best interests of the

Accountability (London: Routledge London) p.184.

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¹⁹⁴ V. Beattie & B. McInnes, ‘Narrative Reporting in the UK and the US – Which System Works Best?’ Institute of Chartered Accountants in England and Wales Briefing, Centre for Business Performance for ICAEW (London: 2006) p.15.

¹⁹⁵ H. Chen & H. Zhang, ‘Two-way Communication Strategy on CSR Information in China’ (2009) 5 *Social Responsibility Journal* 440 at 442.

¹⁹⁶ E.g. P. Davies, *Principles of Modern Company Law* (2008, OUP); C. Schmitthoff, ‘The Wholly Owned and the Controlled Subsidiary’ (1978) *Journal of Business Law* 218; V. Priskich, ‘Corporate Groups: Current Proposals for Reform in Australia and the United Kingdom and a Comparative Analysis of the Regime in Germany’ (2002) 4 *International Company and Comparative Law Journal* 37.

¹⁹⁷ [1897] AC 22; see also *Macaura v Northern Assurance Co.* [1925] AC 619; *Lee v Lee’s Air Farming Ltd* [1961] AC 12.

¹⁹⁸ “It is long established and now unchallengeable by judicial decision ... that each company in a group of companies ... is a separate legal entity possessed of separate legal rights and liabilities so that the rights of one company ... cannot be exercised by another company in that group.” *The Albarzero*, [1975] WLR 491, at p 521, *per* Roskill LJ.

parent and the group of companies as a whole.¹⁹⁹ This places creditor groups of the subsidiary, particularly unsecured creditor groups, in an extremely disadvantageous position – if the subsidiary enters financial difficulty as a result of these unfavourable decisions, creditors of the subsidiary will not be able to enforce their claims against the parent or the holding company’s assets if the subsidiary has insufficient assets to meet its liabilities, because of the strict operation of the *Salomon* rule.

Although there have been some courageous judicial attempts to lift this corporate veil in English law, the most well-known being the “single economic entity” argument advocated by Lord Denning,²⁰⁰ subsequent cases have largely refuted this by stating that the *Salomon* principle should normally be applied in a strict way, and that the veil should be only lifted when the company was used as a façade²⁰¹ or when the subsidiary was acting as an agent of the parent.²⁰² This agency relationship is hard to establish in practice: it must be clearly demonstrated, and cannot be inferred from control or ownership of shares.²⁰³ This further increases the difficulty for creditors who have claims against the parent, particularly after the reaffirmation of the separate legal entity principle in *Adams v Cape Industries Plc*.²⁰⁴

Nevertheless, Lord Denning’s argument, though rarely followed, has found sympathy from many judges. One example is Staughton LJ’s statement in *Atlas Maritime v Avalon Maritime (No.1)*:²⁰⁵ “The creation or purchase of a subsidiary company with minimal liability, which will operate with the parent’s funds and on the parent’s directions but not expose the parent to liability, may not seem to some the most honest way of trading.” Taking into consideration the injustice that the structure of group companies can bring to creditors, group liability has been accepted to some extent in certain common law countries with the introduction of contribution orders and the pooling of assets on liquidation. For instance, it is provided in s 271 of the New Zealand Companies Act 1993 that:

- (1) On the application of the liquidator, or a creditor or shareholder, the court, if satisfied that it is just and equitable to do so, may order that—
 - (a) a company that is, or has been, related to the company in liquidation must pay to the liquidator the whole or part of any or

¹⁹⁹ PL. Davies, *Principles of Modern Company Law* (8th edn., 2008, Sweet & Maxwell), p 228–235; C. Schmitthoff, “The Wholly Owned and the Controlled Subsidiary” (1978) *Journal of Business Law* 218; V. Priskich, “Corporate Groups: Current Proposals for Reform in Australia and the United Kingdom and a Comparative Analysis of the Regime in Germany” (2002) 4 *ICCLJ* 37.

²⁰⁰ *DHN Food Distributors Ltd v Tower Hamlets London Borough Council* ([1976] 3 All ER 462.

²⁰¹ *Woolfsjon v Strathclyde Regional Council* (1978 5C (HL) 90; *Bank of Tokyo v Karoon* ([1987] AC 45. Regarding grounds for piercing the veil of corporations, in the recent *Kensington International Ltd v Congo* [2006] 2 BCLC 296 it was held that transactions or structures that had no legal substance, and which were set up with a view to defeating existing claims of creditors against the entity responsible for setting up those transactions or structures and lying behind them, could, if they were purely a sham and a façade, be treated by the court as lacking validity.

²⁰² *JH Rayner (Mining Lane) Ltd v Department of Trade and Industry* ([1989] Ch 72.

²⁰³ *JH Rayner (Mining Lane) Ltd v Department of Trade and Industry* ([1989] Ch 72; *Adams v Cape Industries Plc* [1991] 1 All ER 929; *Re FG (Film) Ltd* (1953) 1 WLR 483; *Trebanog Working Men’s Club and Institute Ltd v MacDonald* (1940) 1 KB 576.

²⁰⁴ [1991] 1 All ER 929.

²⁰⁵ [1991] 4 All ER 769.

all of the claims made in the liquidation.

(b) where two or more related companies are in liquidation, the liquidations in respect of each company must proceed together as if they were one company to the extent that the court so orders and subject to such terms and conditions as the court may impose.

As can be seen from the provision above, a pooling order in the group company context has the potential to affect the rights of a creditor in the event of the insolvency of a related company. Although the original legislative intent of the New Zealand Companies Act 1993 does not concern the enhancement of CSR, these provisions practically achieve similar ends, by increasing the opportunity for unsecured creditors to get at least partial recovery. As Justice Baragwanath commented in *Mountfort v Tasman Pacific Airlines of NZ Limited*,²⁰⁶ “such an order ... would reduce the parent’s return by only half a cent in the dollar but bring the regional creditors to equality.” A similar provision in the UK insolvency context, requiring parent companies to pay to the liquidator the whole or part of any or all claims made by creditors on its subsidiaries in liquidation, might also offer a good additional recourse to these weak creditors of firms experiencing financial distress.

As well as potential statutory modifications, the enforcement and protection of the interests of unsecured creditors through the discretion of directors could also be achieved by virtue of voluntary methods that come under the aegis of CSR. Directors could enhance the position of unsecured creditors, as the least favoured group of stakeholders, by including their interests in their strategic management policies and the ethical code of the company and by giving directors the legitimacy to do so.

The purpose of a CSR policy is to describe the demeanour of any organisation in a financially, socially and environmentally responsible way. The basic principles of the concept are sustainability, accountability and transparency.²⁰⁷ Based on a meta-analysis of fifty-two studies, encompassing 33,878 different observations carried out with the purpose of demonstrating a relationship between corporate social performance and financial performance, it was found that “market forces generally do not penalize companies that are high in corporate social performance; thus, managers and directors can afford for their companies to be socially responsible”.²⁰⁸

²⁰⁶ (2005) 9 NZCLC 263.

²⁰⁷ D. Crowther & G. Aras David, *Corporate Social Responsibility*, (2008) 30 <http://bookboon.com/uk/student/organisation/defining-corporate-social-responsibility> accessed 29th May, 2011.

²⁰⁸ M. Orlitzky, F.L. Schmidt & S.L. Rynes, ‘Corporate Social and Financial Performance: A Meta-Analysis’ (2003) 24 *Organisation Studies* 403 at 426.

By embracing the theme of CSR in their business strategies, directors will be able to achieve business objectives with smoother cooperation from all constituencies, including unsecured creditors. Furthermore, companies that practice CSR accumulate benefits in terms of better public relations, better economic results and the creation of new opportunities, innovation and competitive advantages, and by being more attractive to potential investors who may, possibly, become unsecured creditors.²⁰⁹ CSR is more than just a cost, a constraint, or a charitable deed.²¹⁰ Unsecured creditors who feel that they are treated fairly will be more willing to offer constant loans, and will be more loyal to the firm. These considerations may lead to considerable long-term corporate profitability and shareholder gain.²¹¹

This so-called “stakeholder governance”, in which managers act honestly for the benefits of other stakeholders including unsecured creditors, offers a better way to moderate and mitigate the pathological failure of corporate firms, and offers the potential to use distinctive corporate attributes to serve society more efficiently.²¹² In the case of unsecured creditors, they are at the bottom of the priority ladder, and are merely given the right to an equal and proportional claim to any company funds that remain after the secured and preferential creditors have been satisfied.²¹³ They are the ones who always lose the most when companies go into insolvency. However, funds from unsecured creditors have always been an important financial resource for companies. The unfavourable treatment of this stakeholder group will prevent unsecured creditors from voluntarily putting their money at risk. With more active consideration of their interests from directors, a more desirable result for the progress of business can be achieved.²¹⁴

VI. CONCLUSION

Analyses of the practical position and legal treatment of secured and unsecured creditors in an insolvency context clearly demonstrates the high level of priority and benefits enjoyed by secured creditors. In stark contrast, unsecured creditors find themselves in a worrying position. They are a group of extremely vulnerable market participants who systematically underestimate the risk of the debtors’ business and charge less than they should, owing to their limited information and lack of bargaining

²⁰⁹ M.E. Porter & M.R. Kramer, ‘Strategy and Society: The Link between Competitive Advantage and Corporate Social Reasonability’ (2006) 84 *Harvard Business Review* 78 at 79.

²¹⁰ *Ibid.*

²¹¹ M.M. Magaro, ‘Two Birds, One Stone: Achieving Corporate Social Responsibility through the Shareholder Primacy Norm’ (2010) 85 *Indiana Law Journal* 1149 at 1161.

²¹² K. Greenfield & D.G. Smith, ‘Debate: Saving the World with Corporate Law?’ (2008) 57 *Emory Law Journal* 947 at 961.

²¹³ A. Keay, ‘Formulating a Framework for Directors’ Duties to Creditors: An Entity Maximisation Approach’ (2005) 64 *Cambridge Law Journal* 614 at 631.

²¹⁴ It was also argued by Grantham that the self-interest of directors, which might normally compel them to act responsibly and in the best interests of creditors, dissolves when a company is approaching insolvency. See R. Grantham, ‘The Judicial Extension of Directors’ Duties to Creditors’ (1991) *Journal of Business Law* 1 at 1.

power.²¹⁵ The unfavourable situation of unsecured creditors has been slightly enhanced in law since the enforcement of the Enterprise Act 2002, but there was little practical improvement, owing to the lack of information available to unsecured creditors, their limited ability to seek redress, and the management powers granted to secured creditors over the debtor company and IPs.

Although the priority given to secured creditors has been commonly justified on basis of various economic perspectives, including bargains, transaction cost and proper notice principles, a glance into the reality nonetheless suggests otherwise. The operation of secured financing generates practical results that severely prejudice unsecured creditors, especially involuntary creditors and trade creditors. Coupled with the additional fact that radical changes will unlikely be offered to promote the position of unsecured creditors' interests purely from within the insolvency law regime, CSR-related reform seems both necessary and desirable to ease the situation of unsecured creditors.

This paper presents reform suggestions at both statutory and voluntary levels with the aims of ameliorating the unfavourable position of unsecured creditors, and of placing limits on the unbalancing power of secured creditors in managing the debtor without being liable for misconduct. Significantly, suggestions were offered regarding the duties of directors in terms of promoting the success of companies, as well as two-way information disclosure requirements in the long term. Alternatively, the protection of unsecured creditors could be achieved by including their interests in management policies aimed at promoting more socially responsible corporations and establishing more coherent stakeholder networks for a sound corporate governance framework. It is logical to conclude that as CSR is desirable and is becoming an acceptable norm in external strategic management policy, the interests of unsecured creditors, who are in an inequitable and adverse position, should be given more serious consideration in order to create a more sustainable and long-term investment environment.

²¹⁵ A. Schwartz, 'Securities Interests and Bankruptcy Priorities: A Review of Current Theories' (1981) 10 *The Journal of Legal Studies* 1 at 36.