External administration in corporate insolvency and reorganisation: The insider alternative

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This article considers the merits of alternative policy approaches to management of companies in insolvency administration, in particular from an identity economics theoretical perspective. The use of this perspective provides a novel assessment of the policy alternatives for insolvency administration, which can be characterised as either following the more flexible United States Chapter 11-style debtor-in-possession arrangement, or relying on the appointment of an external administrator or trustee to manage the insolvent company, who automatically displaces incumbent management. This analysis indicates that stigma and reputational damage from automatic removal of managers in voluntary administration leads to “identity loss” and that an insider alternative to the current external administration approach could be a beneficial policy change.

INTRODUCTION

Exploring the dynamics of decision-making by company managers when they are faced with severe financial distress or insolvency is an area of continuing importance for insolvency research. A critical decision that confronts managers is whether to enter insolvency administration. The ramifications of the decision are significant in that, upon entry, the legal processes of the administration procedure will intervene significantly in the day-to-day operations, governance and contracts of the company. Unsurprisingly, prior research has shown that the nature of the insolvency process and the extent of its intervention in the company’s affairs have a substantial influence on the decision by managers to enter administration.1

This article focuses on the decision by company directors to enter voluntary administration (VA), which is the reorganisation option for insolvent companies in the Australian Corporations Act 2001 (Cth). In particular, it considers how the VA legislation’s requirement for automatic replacement of incumbent management with an external administrator2 impacts on the decision to enter VA. The authors address the question whether this policy approach promotes optimal decision-making around the circumstances of insolvency. This is an important question because other jurisdictions have successfully implemented insolvency administration laws that allow incumbent managers to continue in their managerial roles during insolvency administration. This alternative approach is often referred to as “debtor-in-possession” administration, and is a well-known feature of reorganisation law in Chapter 11 of the United States Bankruptcy Code (US Chapter 11). The comparison between the two broad approaches is not new – the Companies and Markets Advisory Committee (CAMAC) in its 2003 Report, “Rehabilitating Large and Complex Enterprises in Financial Difficulties”3 examined the

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2Corporations Act 2001 (Cth), s 437A.

US Chapter 11 but largely decided against adopting any of its features. This shows that there are “elements of dissatisfaction” with both approaches but this article will re-examine the incentives that directors operate under in making the administration decision, from a theory perspective rather than a legislative imperative. Of interest is that a recent comprehensive review by the American Bankruptcy Institute Commission affirmed the debtor-in-possession approach in Chapter 11 as providing an appropriate balance and that it should continue as the default rule.

This article considers the effect that removal of incumbent managers has on decision-making and governance prior to the insolvency administration commencing. It suggests the automatic removal of incumbent managers creates adverse incentives in the pre-administration period, and can undermine corporate governance as financial distress takes hold. It argues there is an incentive for managers to sub-optimally delay the decision to enter VA because automatic removal is damaging to their reputation and has a stigmatising effect. This viewpoint is supported by application of theory developed by Akerlof and Kranton, which highlights the importance of identity to decision-making. The conclusion drawn from this analysis is that consideration should be given to relaxing the VA requirement for removal of incumbent managers. This article also suggests that reshaping VA policy from a purely “external” administration process, to a regime that permits “insider” involvement could improve efficiency.

Prior literature has discussed the differences between the external administration approach in the VA legislation and the debtor-in-possession approach. In addition, suggestions have been made about how the policy settings embodied in these approaches could be adjusted to improve governance in the context of insolvency administration. This article adds to the extant work by focusing on the effects of insolvency administration policy on the decision-making of company managers in the period leading up to insolvency. In doing so, the authors draw upon a range of research from across business and law disciplines to present evidence as to the deleterious effects of the “stigma of bankruptcy” on the individuals involved in corporate distress. The decisions made in this lead-in period are of equal significance to those made during the insolvency administration. In particular, whether managers decide to make a timely entry into insolvency administration has been shown to have a substantial correlation with the probability of company rescue and rehabilitation of the company. Thus, the overall quality of governance in the pre-administration period will have implications for the company’s future prospects, and the effects of poor governance often cannot be undone in administration regardless of its form. Therefore, the authors’ aim is to highlight and discuss whether insolvency policy enhances governance and decision-making in the pre-administration period rather than create adverse incentives.

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5 American Bankruptcy Institute, “Commission to Study the Reform of Chapter 11 Final Report and Recommendations” (2014) available at http://www.commission.abi.org. The report, at p 21, recommends the continuation of the debtor-in-possession approach, which “allows the debtor to continue operations with minimal disruptions while still serving the interests of the debtor’s creditors”.
EXTERNAL ADMINISTRATION VERSUS DEBTOR-IN-POSSESSION

While insolvency reorganisation arrangements are found in the law of most jurisdictions, there is considerable variation in the policy approach to framing the law. One important difference is how the legal mechanism treats company management once the insolvency procedure commences. The two main approaches can be identified as:

1) debtor-in-possession arrangements similar to the US Chapter 11 scheme where incumbent managers may remain in office; or,

2) the mandate for appointment of an external administrator or trustee to take over management of the insolvent company, for example, the administration provisions of the United Kingdom’s Insolvency Act 1986, and the Australian voluntary administration procedure in Pt 5.3A of the Corporations Act 2001 (Cth).

Accordingly, the key distinction between both relates to the position, or identity, of management once the company enters insolvency administration. Under the debtor-in-possession approach the debtor company retains control and incumbent management is not automatically removed. Existing management may continue, subject to creditor and court supervision. In the external administration model, the administrator is a professional insolvency practitioner, who has never been a manager of the company, but who is also under direct supervision of creditors and indirect supervision of the court. The powers of other officers are automatically suspended while the company is in administration. In relation to the treatment of incumbent managers, the two approaches are described as holding to an “all-or-nothing” approach in relation to incumbent management.

Prior literature has considered these different policy approaches and has applied an agency theoretical lens to assess their efficacy. For example, Hahn discusses how the interests of managers, creditors and shareholders might affect decision-making in the context of financial distress and impending entry into insolvency administration. His paper provides an account of management decision-making based on the propensity of managers as agents to maximise their own economic interests. Hahn shows the suitability of debtor-in-possession and external administration arrangements depend on the level of ownership concentration, with the former suited to widely dispersed ownership and the latter suited to concentrated ownership. The basis for Hahn’s conclusion is that a greater separation of management and ownership means existing management is in a better position to “exercise its own business judgement” rather than making decisions that favour shareholders’ interests. This is because the lack of ownership concentration reduces the likelihood that shareholders will be in a position to influence management decisions to the detriment of creditors.

Regarding external administration, commentary from the early stages predicted abuse of process by self-interested incumbent management as potential criticism of the regime. Fridman in 2003 provided extensive critique. The potential for abuse of process stems primarily from the low threshold
test required for directors to select external administration – a belief that the company is unable to pay its debts.\(^{19}\) From this point, he asserted that management could manipulate the process to appoint an administrator, either for example to avoid an impending investigation by another authority,\(^{20}\) or to bring about a restructuring of capital or governance\(^{21}\) under the veil of insolvency that avoids shareholder approval in normal circumstances, such as under a scheme of arrangement. Similarly, Eow\(^{22}\) documented other types of abuse of process open to incumbent management under the external administration procedure, such as stalling of pre-existing litigation,\(^{23}\) or to disrupt claims by employees against the company.\(^{24}\)

While analysis of insolvency decision-making based on agency theory is intuitive and helpful, there is empirical evidence that indicates careful thought should be given to the motivations of managers. For example, Donoher\(^{25}\) investigated the entry by US firms into the Chapter 11 reorganisation scheme. The expectation was that higher levels of management equity ownership reduce agency conflicts, thereby resulting in managers having the firm enter Chapter 11 earlier rather than later. Contrary to expectations based on agency analysis, he found that firms with managers holding more equity entered into Chapter 11 in worse financial condition than those with managers holding less equity. Donoher suggested the result was consistent with managers being willing to forego the value of their equity holding to avoid the reputational damage and loss of employment capital that could arise from delaying entry into Chapter 11. Consistent with this, the authors argue that analysis of how policy impacts management decision-making in the insolvency context should include consideration of economic interests as per the traditional agency approach, but that it should also take account of reputational effects. The economics of identity which is discussed in this article provides a suitable framework for this analysis.

Various papers have addressed the issue of management treatment in insolvency administration. They demonstrate the inherent difficulty with designing policy that ensures good governance and results in managerial decisions that maximises insolvent company value.\(^{26}\) What has emerged is a view that automatic removal of incumbent managers is unnecessary, if the continuation of incumbent management is combined with appropriate independent monitoring to minimise agency problems. Adams, in his analysis of the Chapter 11 reorganisation provisions, suggests a bifurcated debtor-in-possession approach would overcome problems of self-interested decision-making by managers in Chapter 11.\(^{27}\) His model suggests monitoring should be provided by an appointed trustee who works along with knowledgeable incumbent managers during the insolvency administration. Rotem\(^{28}\) offers a thorough comparison of the debtor-in-possession and external administration approaches. He points out that neither offers a robust solution to the complexities of ensuring good governance for insolvent companies, and recommends a hybrid version of the type discussed by

\(^{19}\) Corporations Act 2001 (Cth), s 436A.


\(^{21}\) Cadwallader v Bajco Pty Ltd [2002] NSWCA 328. See also Anderson C and Morrison D. “Seen but not Heard? The Significance of Shareholders under Pt 5.3A of the Corporations Act” (2008) 16 Insolv LJ 222 at 225-256.

\(^{22}\) Eow, n 8.


\(^{25}\) Donoher, n 1.

\(^{26}\) Frost, n 8.

\(^{27}\) Adams, n 8.

\(^{28}\) Rotem, n 7.
Adams, Rotem provides a critique of the Canadian Companies’ Creditors Arrangement Act 1985, which allows for a court appointed monitor to work with incumbent management, and suggests this hybrid approach is a useful policy model. The following analysis suggests a significant detrimental effect from the automatic removal of incumbent managers upon entry into insolvency. Therefore, the insider arrangements suggested by Adams and Rotem could be a suitable alternative policy approach.

Overall, the prior literature highlights that neither the debtor-in-possession or administration approach offers a complete solution to ensuring optimal governance of insolvent companies. This article adds to the existing analysis and understanding of the two policy approaches by highlighting the adverse incentives in the pre-administration period created by the removal of incumbent managers. The authors also introduce the economics of identity as an alternative theoretical lens through which the two approaches can be analysed.

**The relevance of identity**

Corporate law traditionally relies on the agency argument to explain the motivations of directors, particularly non-executive or independent directors, to act in the interests of the company. This can be traced back to Fama and Jensen, who argued that personal reputation provides a powerful motivating force for director conduct. Despite the appealing intuition of using agency theory to understand decision-making by managers, there is emerging inconsistency in its ability to predict behaviour. It is apparent that the standard agency analysis is only useful when people’s preferences are consistent with the typical prescriptions that are assigned to them by economists. For this reason, the authors suggest it is useful to adopt a broader perspective when considering the issue of management decision-making in the insolvency context. Sunstein suggests that advances in understanding of how people actually make decisions through social science research provide a useful basis for legal analysis. Jolls, Sunstein and Thaler argue that by “drawing attention to cognitive and motivational problems … behavioural law and economics offers answers distinct from those offered by the standard analysis”. Accordingly, the authors consider theory from behavioural economics to enhance their understanding of management decisions for insolvent companies. Specifically, this article considers the economics of identity, which shows a person’s sense of self is an important aspect of economic behaviour.

It should also be emphasised that this expanded perspective of economic behaviour does not supplant the traditional agency model. The economics of identity is founded on the view that the sense of self is an important aspect of a person’s utility function. Agency theory is linked to economic utilitarianism – that individuals can be expected to behave in a way that enhances their utility.
Identity economics adds consideration of identity into the utility function, and the authors demonstrate that issues of identity can loom large for managers of insolvent companies. As discussed, evidence suggests that financial incentives are not a strong enough explanation for director conduct and directors will trade-off other factors, such as the ability to develop a reputation and the opportunity to acquire other board positions, against low cash payment and remuneration. That reputation is a strong motivator for director behaviour was confirmed in a recent empirical study by Masulis and Mobbs that examined the market for directorships. Their results showed that reputation is a valuable commodity, and that preserving and enhancing reputation is a primary motivation of directors. Managers of financially distressed companies face a new set of circumstances, and the authors speculate, face a new set of trade-offs for their reputation. As stated by Bernstein:

Corporate restructuring represents a multi-stage balancing act. Unlike a healthy firm, where there is more than enough value to go around, a financially distressed firm comes up short by definition. It is at that point when divergent interests are most apparent, including shareholder-creditor conflicts, creditor-creditor conflicts, management-stakeholder conflicts, and individual-organizational conflicts.

The conflicted position of managers and the threat to their reputation is evident from prior analysis. The potential impact of an insolvency event on managerial positions is demonstrated in an early study by Gilson. The analysis showed that for a sample of companies that experienced a period of financial distress (default, bankruptcy, or debt restructuring outside bankruptcy), 52% made a senior-level management change during the distress period. Moreover, senior managers (CEO, Chairman and president) who lost their board positions did not hold a senior management position in another listed company in the subsequent three years. This early study on the senior management labour market suggests that insolvency can have profound implications for the personal reputation of managers.

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41 Masulis and Mobbs, n 40 at 426.
42 Bernstein E, “All’s Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress” (2006) 11 Stanford Journal of Law, Business & Finance 289 at 324. Our focus is on how insolvency law addresses the issue of who should manage the company once administration commences and how this influences management behaviour in the period prior to insolvency administration. It is acknowledged that other legal provisions can influence manager behaviour. For example, most jurisdictions hold managers accountable to creditors if they continue to carry on business when insolvent. Successful prosecution for breach of an insolvent or wrongful trading provision can also open managers to significant penalties. The consequences of breaching these provisions also becomes one of the trade-offs considered by managers. A substantive discussion of the economic incentives created by the U.K. wrongful trading provisions is found in Mokal RJ, “An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors’ Bargain” (2000) 59 Cambridge Law Journal 335. In the Australian setting, James, Ramsay and Polat conducted an empirical study of insolvent trading cases from 1970 to 2004. They located 103 cases during that time, with 77 resulting in the defendant found liable for insolvent trading. The median compensation order was $110,598 and only seven cases resulted in pecuniary penalties or disqualification orders being made against the defendants. The low incidence of actions for insolvent trading and the limited extent of compensation orders and penalties is not suggestive of a substantial influence on management behaviour in the Australian context (see James P, Ramsay I and Siva P, “Insolvent Trading – An Empirical Study” (2004) 12 Insolv LJ 210). See also MacFarlane A, “Safe Harbour Reforms – Should Insolvent Trading Provisions Be Reformed” (2010) 18 Insolv LJ 138; Purslowe R, “Decisions in the Twilight Zone of Insolvency – Should Directors be Afforded a New Safe Harbour?” (2011) 13 University of Notre Dame Law Review 113, for further discussion of the incentives of insolvent trading provisions in the Australian setting.
43 Gilson n 11.
44 The analysis by Gilson, n 11 was for larger companies. For managers of smaller firms, the implications of insolvency for the future value of their labour market capital are not so pronounced because they are less likely to be concerned about competing for management positions. However, we suggest the substantial management turnover for distressed companies is an indication of the overall negative reputational effect of being identified as a manager of a company that enters insolvency administration regardless of company size. As indicated by Jackson and Scott, managers of smaller closely-held firms are more likely have made a substantial non-monetary idiosyncratic or firm-specific investment in the company, which is reflected in expressions such as “it’s my life’s work” and “my name is over the door” (see Jackson TH and Scott RE, “The Nature of Bankruptcy: An Essay
In explaining the link between the economics of identity, reputation and the law, Hill observes that bankruptcy is a status or identity, and that “the rhetoric of bankruptcy law has been to emphasize that the identity is only transient – one can ‘make a fresh start’.” However, Hill speaks of a tension between the fresh start perspective of bankruptcy and “a general ‘future is like the past view’” where the bankrupt’s identity is immutable. This indicates the substantial consequences of an insolvency event on identity.

Empirical analysis by Bernstein shows that, since the introduction of the Chapter 11 reorganisation law in the United States, the difference in the rate of CEO turnover between bankrupt and non-bankrupt company restructuring has become insignificant. This suggests an increasing willingness to use the legal bankruptcy process as governance tool as “the stigma associated with corporations filing for bankruptcy has been deteriorating”. This analysis shows the need for careful analysis of legal policy due to potential impacts on governance systems and related decision-making.

It is evident that broader analysis than that offered by agency theory is warranted. Overall, it can be concluded that in addition to financial concerns managers are motivated by concern for their reputation. Insolvency can cause significant harm to reputation. However, the structure of insolvency law and whether it adds to reputational damage can affect decision-making by managers. Examination of this concern for reputation can be formalised by considering the economics of identity, which is discussed in the next section.

**THE ECONOMICS OF IDENTITY**

The notion that identity, or a person’s sense of self, is an important aspect of economic behaviour was presented in the seminal paper by Akerlof and Kranton. Their paper demonstrated how identity can influence economic outcomes, and demonstrated this in the areas of gender discrimination, labour markets, household division of labor, social exclusion and poverty. There is an emerging literature that has considered how identity preferences operate in a business setting, including in the management discipline, behavioural economics discipline, accounting and law. In this article, the Akerlof and Kranton (hereafter referred to as AK) concept of identity is applied to explain economic outcomes in the area of insolvency.

AK outline the importance of identity to economic behaviour by demonstrating that a person’s utility function incorporates identity. Identity is based on social categories, with each category enjoying different social status and self-image. Utility is dependent on how well a person’s own characteristics match those considered to be the ideal of their identity category. It is also dependent on whether others within a social category behave in a manner that corresponds with the prescribed.
behaviour of the category. Thus, utility maximisation can be achieved by a person electing to be part of a social category (where this is possible) and by their making choices that are consistent with the ideal of the category. In addition, utility can be affected by whether the choices of others in the category are consistent with the ideal of the category. Violation of the internalised standards of an identity can result in strong negative emotions, with a resulting loss of utility for an individual. AK refer to “gains or losses in identity” resulting from whether they or others fail live up to beliefs regarding what people of the category should do.54

Of relevance to this article is that AK offer examples showing that people are sometimes able to choose their identity. Hill provides specific examples of this in the corporate context.55 For example, she asserts that “corporate executive”, is a category of identity. She discusses two aspects of this identity – those who get their identity pay-off from “pushing the envelope”56 (that is, playing close to the rules, but not by the rules) and those who are motivated by “something quite different” – sacrificing material rewards for something else. The economics of identity can assist with understanding these two perceived categories of managers because the authors see their actions as being consistent with different group ideals provide identity gains or losses. In the corporate law setting, the authors may see this described as the inherent tension between those corporate managers who build their reputation as financial managers by acting, not as a trustee, but exhibiting entrepreneurial flair in managing company funds;57 and those who seek to protect their personal reputations through general monitoring and managing the company’s decisions.

Also of relevance is that social identity categories and internalised behaviour can be manipulated.58 Hill observes that because people’s choice is related to identity, it is possible for policy-makers to “create, encourage, discourage, or otherwise recognize and address identity oriented efforts that may result in behaviour that society finds problematic”.59 Thus, identity can be used to encourage desirable behaviour and discourage undesirable behaviour. This is important because it suggests recognition of identity in the development of insolvency law can influence economic outcomes.

INSOLVENCY AND IDENTITY

It is evident that corporate insolvency, and particularly the entry by companies into insolvency administration, has an unfavourable stigmatising effect on the credibility of top managers.

There is a substantial literature that has addressed the significant stigma associated with insolvency. For example, Sutton and Callahan present analysis of firms that enter Chapter 11 of the US Federal Bankruptcy Code and show that stakeholders of these firms viewed senior managers as tainted and incompetent people. They further suggest that managers experienced career damage, embarrassment, anger and a loss of self-esteem.60 Recent empirical research in management shows that executives who change employers (or “jump-ship” as they refer to it) in the two years prior to company failure suffer fewer labor market consequences than those who remain.61 Weisenfeld, Wurthmann, and Hambrick describe the process of stigmatisation of those connected with corporate failure. They describe the process as advancing through phases including: stigmatisation of a group or

55 Hill, n 45 at 422-423.
56 Hill, n 45 at 422-423. Langevoort describes this behaviour as traits such as (inter alia) over-optimism, inflated sense of self and self-deception, see Langevoort DC, “Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls” (2004) 93 Georgia Law Journal 285 at 299-300.
58 Akerlof and Kranton (2000), n 6 at 726.
59 Hill, n 45 at 393.
60 Sutton and Callaghan, n 49.
all associated with a firm, singling out of one or two elites that are specifically identified for blame; stigma diffusion through repeated reports of an expanding list of perceived misdeeds; and, eventually professional devaluation. The process of stigmatisation results in emotional pain and a spoiled identity for corporate elites, which reduces their standing in the market for managerial services.\(^{62}\) It has also been shown that stakeholders render judgment on the circumstances of the financial failure, including subjective interpretations about the actions of individuals. The research describes how information cues shape outsiders’ perceptions of competency and ability. Assessment by outsiders depends on the locus of causality, that is, whether the cause of failure is attributable to internal or external factors. Thus, outsiders’ judgment of organisational failure is subjective and dependent on information cues and perceptions of causality. Importantly, the judgment process either “stigmatises or strengthens individuals and organisations after the event”.\(^{63}\)

Of course in some cultures, the extent of negative implications of bankruptcy and failure can be catastrophic at the individual level. For example, in Japan, research has shown a negative relation between suicide rates and the number of rehabilitation court petitions filed in the sample period from 2001 to 2002. The civil rehabilitation scheme offers an alternative to bankruptcy that allows individuals to negotiate a plan with creditors. The scheme is less stigmatising and offers a more expedient, user friendly and affirmative means of addressing personal financial problems.\(^{64}\) While the Japanese scheme applies to personal bankruptcy, the study emphasises the potential impact of stigma associated with business failure. An important point is that the study’s findings show insolvency law “plays a role in controlling debt and in mitigating the social stigma of indebtedness.”\(^{65}\)

This understanding of the negative identity consequences of entry into insolvency administration points to an identity loss for managers.\(^{66}\) Managers of failed companies are identified as exhibiting characteristics and engaging in behaviour that is inconsistent with the ideal of a “competent manager”. The stigmatisation represents a loss in utility.

**INSOLVENCY POLICY AND IDENTITY**

Companies enter insolvency administration at very different stages of decline or states of financial distress.\(^{67}\) Delaying entry into administration increases the chance that a company’s decline is so protracted that there is little or no chance of reorganisation and survival. Ideally, managers will make a decision to enter administration at a time when the likelihood of successful reorganisation is high. Information asymmetry provides opportunity for managers to make self-serving decisions.\(^{68}\) Company managers know more about capacity to repay debt and the level of profitability than lenders and shareholders. The relevance of agency analysis in this context is obvious, and such analysis would lead to the conclusion that managers will delay entering administration when it is in their interest to do so. The authors argue that the prospect of identity loss discussed in the previous section increases the propensity for managers to engage in self-interested delaying behaviour.

The authors suggest that identity economics analysis points to a decreased likelihood of optimal entry into administration when the law requires removal of incumbent managers. Because managers are generally not able to effectively diversify employment risk, the threat of removal can lead to

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\(^{65}\) West, n 64 at 66.

\(^{66}\) Akerlof and Kranton (2000), n 6 at 719.

\(^{67}\) Donohor, n 1.

opportunistic behaviour. The risk of losing reputation looms large in the context of a company experiencing financial distress. The prospect of insolvency brings the prospect of loss of employment, and significantly diminished prospects for future employment and earnings capacity. As Fama argues, the labour market rewards or penalises managers according to their ability to bring about favourable outcomes for an organisation. Along with more tangible effects of organisational failure is the loss of utility from identity loss. The side-lining of managers in VA will undoubtedly promote the immutable “future is like the past view” with a resultant identity loss. Removal of incumbent managers signals they have failed in their management role in a way that has led to insolvency, and that they are incapable of properly managing the company through the distress period. The VA system of removing existing managers provides a strong negative cue about competency and ability. The utility to managers of entering administration is thus adversely affected.

Prior studies offer insight as to how managers will respond to identity threats. Identity threat is defined as “experiences appraised as indicating potential harm to the value, meanings, or enactment of an identity”, with two responses to threats: identity-protection responses and identity restructuring responses. An identity-protection response involves strategies of derogation of parties that are the source of the threat, concealment or downplaying the identity or creating a positive distinctiveness for the threatened identity. In contrast, identity restructuring strategies involve changing the meaning or importance of an identity, or disengaging from the threatened identity. In the VA context, current legislation limits the options of managers in responding to identity threats associated with financial distress. Entering VA brings about the removal of incumbent management and appointment of an administrator, which arguably defines managers as failures. This largely removes the possibility that management can work to promote an identity to that of managers of a distressed company who are taking the necessary and appropriate steps to deal with financial distress. This increases the incentive for managers faced with financial distress to engage in derogation or concealment behaviour, which are unlikely to be productive in dealing with the complex issues of potential business failure.

A further issue with the VA approach is the increased likelihood of a drain of management resources as the company moves toward financial distress and the prospect of organisational crisis becomes more apparent. Crisis situations are a context where the resources and skills of competent managers are most needed. However, it is also a context where there is an increased likelihood of company director resignation in an attempt to protect their reputation and find alternative employment. In particular, models developed by Withers, Corley and Hillman indicate that directors that are less closely connected with the board are more likely to resign their position in the context of organisational crises. This represents loss of a significant and valuable input by independent directors. It is suggested that the VA approach to dealing with incumbent managers is likely to exacerbate this drain of management resources as financial distress related problems become apparent.

The Australian regime provides some incentive for directors to prefer the administration choice, if only to provide potential protection in the event of a subsequent insolvent trading action against them personally. There is a defence if directors take positive steps to prevent the company from trading.


71 Hill, n 45 at 437.

72 Amankwah-Amoah, n 63.


whilst insolvent,\textsuperscript{76} which is commonly interpreted to refer to appointing an administrator.\textsuperscript{77} However, the defence is a matter of hindsight: the company must subsequently be placed into liquidation for the cause of action to arise; and the liquidator (or the regulator in enforcing the public aspects of the liability) has to decide whether there is sufficient evidence to mount the litigation on the company’s behalf.

In contrast to the VA approach, the debtor-in-possession model provides managers with at least some opportunity to demonstrate their competence. To be sure, a signal of management failure remains by virtue of the company entering administration. However, the signal that managers are incapable of properly managing the company through the distress resolution period is mitigated. While there is undoubtedly a measure of stigmatisation, an opportunity remains for incumbent managers to limit its effects in the reorganisation period. To summarise, an identity economics analysis suggests that the debtor-in-possession policy approach is superior to the administration approach with respect to ensuring optimal decision-making regarding the timing of entry into insolvency administration.

**DISCUSSION**

The focus of this article has been to apply identity economics to analyse a single insolvency law policy issue. Through this article’s identity economics analysis, the authors show that management decision-making in the context of distress may be improved by an insider alternative to the external administration approach that exists in the Australian voluntary administration arrangements. However, the authors suggest that further improvement in the efficiency of insolvency law might be achieved by a more general consideration of how legal intervention influences the identity dynamic prevalent in corporations. What is contemplated here is that broadly influencing corporate culture can play a part in ensuring that managers make decisions in other than a self-interested manner.\textsuperscript{78} Langevoort describes the potential value of corporate culture in discussing how “belief systems” that determine the focus of managers as they make decisions have an important effect on legal compliance.\textsuperscript{79} He suggests that corporate culture is most effective when it is internalised or becomes part of a person’s identity in the manner suggested by Akerlof and Kranton (2005).\textsuperscript{80} Corporate culture then alters the utility preferences of individuals, and mitigates the potential for opportunistic behaviour. Indeed, there is prior evidence that incentives that promote and engage desired identities can provide a measure of control over actions.\textsuperscript{81} The difficult question however is how legal intervention can manoeuvre corporate culture into a position where it might be capable of improving decision-making in the insolvency context. However, the analysis presented in this article suggests that insolvency policy can be used to modify behaviour that is inconsistent with the ideal of a competent manager such that there is a loss of utility when behaviour differs from the ideal.

Substantive consideration of how behavioural economic theory, including the economics of identity, might inform the development of the many issues that arise in the context of corporate insolvency is beyond the scope of this article. One suggestion is to emphasise through soft law provisions the ideal of the competent manager. Nicholson, Kiel and Kiel-Chisholm discuss failures in the financial system in the context of the global financial crisis. Their research shows how improved governance of financial institutions might be achieved through the combination of soft law that can influence social norms and hard law that provides specific regulation.\textsuperscript{82} Examples of soft law

\textsuperscript{76}Corporations Act 2001 (Cth), s 588H(5) and s 588H(6).


\textsuperscript{78}Langevoort DC, “Opening the Black Box of ‘Corporate Culture’ in Law and Economics” (2005) 162 *Journal of Institutional and Theoretical Economics* 80.

\textsuperscript{79}Langevoort, n 78 at 80.


initiatives include further development of sector norms through professional associations and an emphasis on fiduciary duties. Sarra also provides a comprehensive discussion of corporate governance initiatives for banks that could assist in ensuring a timely, efficient and fair response to financial distress. Her analysis shows the benefits that arise in the context of bank and financial institution governance from attention to soft law issues such as the quality and representativeness of board governance, public disclosure, compensation, risk management and sustainability. These are matters that are already addressed to some extent by corporate regulators, in their explication of best practice for governance of corporations. The authors suggest that a concerted effort to incorporate and emphasise these ideals into the framework of insolvency law might make some progress toward modifying, in a positive way, decision-making around organisational failure. Addressing the issue of social norms offers a means of improving the operation of VA in the long run.

**CONCLUSION**

This article presents discussion of how the economics of identity is relevant to insolvency law policy concerning who should manage a company when it enters insolvency administration. Prior work has discussed this issue and made suggestions for reform based on an agency theoretical perspective. However, the agency framework does not provide a complete explanation, and this article shows that behavioral analysis focused on the economics of identity offers a novel and useful incremental insight. This analysis demonstrates the substantial opportunity for legal analysis that developing field of behavioural economics presents. As Jolls, Sunstein and Thaler state, “By drawing attention to cognitive and motivational problems of both citizens and government, behavioural law and economics offers answers distinct from those offered by the standard analysis.” This article’s identity economics analysis suggests that adopting the debtor-in-possession approach to management of insolvent companies, such as occurs with the US Chapter 11 scheme, is preferable to arrangements that sideline incumbent managers and transfer management to a trustee. This conclusion is reached because of the stigmatising effect of removing managers, and their consequential loss of identity.

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84 Jolls, Sunstein and Thaler, n 36 at 1471.